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LEGISLATIVE PROPOSALS TO ADDRESS CONCERNS OVER THE SEC'S NEW CONFIDENTIALITY PROVISION

HEARING

BEFORE THE

COMMITTEE ON FINANCIAL SERVICES
U.S. HOUSE OF REPRESENTATIVES

ONE HUNDRED ELEVENTH CONGRESS

SECOND SESSION

SEPTEMBER 16, 2010

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LEGISLATIVE PROPOSALS TO ADDRESS CONCERNS OVER THE SEC'S NEW CONFIDENTIALITY PROVISION

Thursday, September 16, 2010

U.S. HOUSE OF REPRESENTATIVES,
COMMITTEE ON FINANCIAL SERVICES,
Washington, D.C.

The committee met, pursuant to notice, at 10:05 a.m., in room 2128, Rayburn House Office Building, Hon. Barney Frank [chairman of the committee] presiding.

Members present: Representatives Frank, Waters, Maloney, Watt, Moore, Lynch, Scott, Green, Cleaver, Kosmas; Bachus, Royce, Manzullo, Biggert, Hensarling, Neugebauer, Campbell, Posey, Jenkins, and Lance.

The CHAIRMAN. The hearing will come to order.

We have some conflicts. We are trying to crowd a lot into a few weeks. So I am going to call on the ranking member to give his opening statement and then the gentleman from Texas, Mr. Hensarling. They have other business. So the gentleman from Alabama is recognized for 2½ minutes.

Mr. BACHUS. Thank you, Mr. Chairman, for holding today's hearing to examine the broad exemption from the Freedom of Information Act accorded the SEC under Section 929I of the Dodd-Frank Act.

Let me also thank Chairman Schapiro for being with us today and for her willingness to work with the committee in a spirit of bipartisanship and cooperation to address the concerns that have been raised about Section 929I by Congressman Issa and others.

The Dodd-Frank Act confers significant new supervisory and investigative authorities on the SEC. Combining these powers with the provision that appears at first blush to insulate the SEC from public scrutiny has caused some alarm among Members on both sides of the aisle. This hearing provides a welcome opportunity to address some of the confusion and to consider a solution that ensures proper accountability at the SEC, while not undermining the agency's important ability to exercise effective supervision over the thousands of firms it is responsible for overseeing in the post-Dodd-Frank world.

To her credit, Chairman Schapiro has been candid with the committee and with the American people in acknowledging the past failures of the SEC in protecting investors and regulating large investment banks. We can all agree that the agency that presided over the collapse of some of the largest financial institutions on

Wall Street and was apparently unable to stop Bernie Madoff from perpetrating the largest financial fraud in American history must be more transparent and any statutory departures from a general policy of openness must be crafted carefully. Unfortunately, Section 929I—and I think Congressmen Towns and Issa agree—doesn't meet this standard for good legislative draftsmanship, and the provision's broad wording has given rise to concerns that it could invoked to withhold information the public has a right to know. But the SEC would prefer it to remain secret for fear it would be cast in an unfavorable light.

At the same time, no one questions the SEC's legitimate and important need to preserve confidentiality of certain materials it collects during the examination process. In fact, some of these would be protected by contract law.

The CHAIRMAN. Would the gentleman request an additional 30 seconds?

Mr. BACHUS. Just 5 additional seconds.

Let me close by commending the chairman on something else. The Commission's anticipated action to prevent window dressing, the transfer the liabilities off balance to improve month-ending report, very similar to the Repo 105 tactics at Lehman Brothers, I think, is a symbol of a changing attitude under Chairman Schapiro's leadership; and I commend her and yield back the balance of my time.

The CHAIRMAN. I thank the gentleman.

The gentleman from Massachusetts, Mr. Lynch, is now recognized for 2 minutes.

Mr. LYNCH. Thank you, Mr. Chairman.

I want to thank the ranking member as well; and I would like to welcome our witnesses today, my other chairman, Chairman Ed Towns, and also our ranking member, Darrell Issa. Thank you for your good work on this. I also want to thank Harvey Pitt, who will be testifying a little bit later on the third panel, and whose opinion I greatly respect.

As many have noted, since the passage of the regulatory reform legislation this past summer, the SEC gained significant regulatory responsibilities with this new bill. I have always believed that it is important to provide regulators with the proper tools and resources as well as a certain amount of flexibility to do their jobs and accomplish their mission.

A recent example of the importance of the SEC's regulatory ability was evidenced in the aftermath of the flash crash in May. High frequency trading is suspected to have played a role in the crash. However, as Chairman Schapiro noted in her letter to us on July 30th—actually, it was a letter to Chairman Frank—"high frequency trading firms have historically been reluctant to provide information on formulas to the SEC out of privacy concerns." This obviously can hamstring the efforts of investigators to determine the cause of the crash and how to prevent another one in the future.

Section 929I addresses this very issue. It allows the SEC to protect the information and records it receives from regulated firms.

It is also a fact that I am sensitive, however, to the criticisms of the provision citing the need for more transparency within financial regulation, not less. I believe prudent checks and balances are

necessary within our financial system, so I appreciate the opportunity to discuss the legislative proposal before us that would affect this provision.

Again, my thanks to the witnesses, and I thank the chairman, and I yield back.

The CHAIRMAN. The gentleman from Texas is recognized for 2½ minutes.

Mr. NEUGEBAUER. Thank you, Mr. Chairman. Thank you for holding this hearing.

This is the first hearing I guess that we have had on Dodd-Frank since it became law, and it probably won't be the last. When you have such massive legislation that creates so many new programs and authorities, rulemaking authority, I suspect we will be looking back at the rule's provisions.

The purpose of government should be only to make sure there is integrity and transparency. We give certain agencies the authority to do that, to ensure that there is integrity and transparency in the marketplace, and we have given the SEC a lot of authority, some people think too much authority.

One of the things that we do want to do is in their normal course of business we want to make sure they are able to collect the information that allows them to regulate the entities that they are supposed to oversee. But, at the same time, we want them to be protective of that information when it is proprietary to those particular companies.

But by the same token too, the SEC needs to be accountable for their actions; and one of the concerns I think a lot of folks have about Section 929I is that it might give the agency some leeway there to claim that certain information is privileged under 929I and that information would not be available and the transparency integrity piece of government then is violated.

So I am glad that we are having this hearing today. I think it is important that we get this right. We rushed through a lot of these provisions as this bill was being marked up, and it is important that we go back now and make sure that in those areas where we didn't get it right, that we do get it right. We owe that to the American people. We owe it to the people who are relying on the SEC to protect their investments.

And with that, Mr. Chairman, I yield back my time.

The CHAIRMAN. I will yield myself 3 minutes.

The gentleman's statement that we rushed through these provisions is flatly inaccurate. And, in fact, with regard to this particular provision—and we are here to think about changing it and narrowing it and making it more specific—it was first essentially put before us by Chris Cox in 2006. I don't think that is a big rush. Chris Cox was chairman of the SEC under President Bush, and he asked for it.

In 2008, we were again asked for it when Chairman Cox was still the Chairman, and this committee voted out a bill unanimously that included it. Maybe the gentleman from Texas was rushed that day when he apparently didn't object to it. But that was over 2 years ago. And it went to the Floor and passed on suspension.

This has been around for a while. And it was introduced again in 2009 in both bodies. It was before us. When the subcommittee

voted on the provisions or the committee that Mr. Kanjorski had worked on, it was there. It was then in both bills throughout the conference period. The base text was posted on the 10th of June.

So it has been out there. All during the conference, Members had a chance to look at it.

Yes, it is a big bill. It has a lot of separate sections. We worked on it for a little over a year. And while we are now getting complaints that we rushed through it, we also had complaints we were having too many meetings and hearings. So this is a serious subject, and I think talking about it being rushed through demeans inaccurately the seriousness of what we are trying to do.

What happened apparently was there was a lawsuit that had been brought looking for information, and it became clear that this provision could have interfered with that lawsuit. Now that was not something that Chris Cox could have foreseen in 2006. I don't think Chris Cox was trying to hide anything in 2006. We have Harvey Pitt's testimony here; and Mr. Pitt, I don't think, was trying to hide anything.

This is a serious fact here that a legitimate issue to them now appears to have other consequences. What I am told by Chairman Schapiro—and she has tried very much to beef up enforcement—is that the initiative for this came from the enforcement people who said, if we aren't able to protect some proprietary information, it would be harder for us to get it. And that is the purpose.

No one, I hope, thinks we should be in any way shielding the SEC. I am convinced that it went too far. As I said, it has been something we have been talking about for 4 years. It wasn't until this lawsuit that people were able to look at the conflict. I would hope we could discuss this in a serious manner.

There was the absolute need for unmitigated transparency with regard to the SEC, and the question is, is the SEC doing its job? And the SEC has to understand that there have been too many examples of it not having done its job recently for people to rest easy on that. On the other hand, we don't want to make it harder for the enforcement people to get what they need. I don't know whether there is a way to sort that out.

Senator Leahy had a bill. He tried to hotline it. It was not hotlined. Let me say—and I am going to give myself another 30 seconds—it is clear that legislation is required, I believe. I know the chairman has done a very good job of trying to make this specific. But I think, given this, legislation is probably necessary. We will be looking at it. We have time to do something. And the Senate, for once, is interested in doing something. So we will be dealing with it.

But let's again be clear, this is a bipartisan request that has gone through two Administrations from two SECs. It was generated by the enforcement people. It has been out in public and debated in this committee—I will give myself another 30 seconds—for several years.

Someone noted that there was a conflict between that and the lawsuit. It came to our attention. We promptly had a hearing. That is an appropriate way to go. And it is my intention to work together—and I hope in a bipartisan way—with partisan cracks

along the way—that, I suppose, comes with the territory—to resolve this in an appropriate manner.

The gentleman from California is recognized for 2½ minutes.

Mr. CAMPBELL. Thank you, Mr. Chairman.

I will neither debate nor challenge your history on how we got here. But I am one of the bipartisan, bicameral bills—or a part of one of the bills that are both bipartisan and bicameral dealing with this. And, as the chairman suggested, we are here today because of a FOX Business Network lawsuit and information request. And the information request, my understanding is, was on Bernie Madoff and Allen Stanford and those Ponzi schemes.

Now we all understand the need with the Freedom of Information Act to protect confidential and proprietary information of the regulated entities, but I think what has—at least for this Member, and I would presume for many of the other Members who have introduced legislation—it is difficult to understand why anything involving Bernie Madoff and Allen Stanford is proprietary, confidential information that needs to be protected under the Freedom of Information Act. That leads us all to perhaps a conclusion that maybe what we are trying to do is shield, in fact, the SEC and perhaps some actions of the SEC.

Now as we look at the financial markets and the financial industry, both in the past and going forward in the future, certainly there are regulated entities that are under both SEC scrutiny and legislative scrutiny for actions in the past and will be for actions in the future. But the SEC should not be immune itself—the regulator—it should not be immune itself—not just the regulated—from the scrutiny of this legislative body as well. And it would appear that this Section 929I is—and I agree with the chairman—overly broad and permits the SEC to shield itself from scrutiny by this legislative body, which I think is inappropriate.

But I look forward to hearing both the testimony of the Members at the table now and then the chairman of the SEC later.

Thank you very much. I yield back.

The CHAIRMAN. No further requests for time.

Before me is the gentleman from New York, Mr. Towns, who is the chairman of the Committee on Government Reform and Oversight. He is now recognized.

STATEMENT OF THE HONORABLE EDOLPHUS TOWNS, A REPRESENTATIVE IN CONGRESS FROM THE STATE OF NEW YORK

Mr. TOWNS. Thank you very much, Chairman Frank, Ranking Member Bachus, and members and staff of the Committee on Financial Services for inviting me today.

The landmark Dodd-Frank Wall Street Reform and Consumer Protection Act made significant improvements to the accountability and the transparency of our Nation's financial system. The Act gives consumers access to more information about investment and it reins in the abusive and excessive practices on Wall Street.

Passing the Dodd-Frank Act was an important achievement. But our work in Congress did not end when the bill was passed. It is critical that we exercise vigilant oversight of implementation and that we act to close loopholes when they are identified. To that end,

I applaud you, Chairman Frank, for your willingness to hold this hearing to examine a significant loophole that I believe undermines the core purposes of the Dodd-Frank Act.

Section 929I of the Act would allow the SEC to avoid disclosing information the Commission receives during examination of companies if the information is used for surveillance, risk assessment, or other regulatory and oversight activities. This language is too broad. It allows the SEC to keep secret virtually any information it obtains under its examination authority.

SEC Chairwoman Mary Schapiro has asserted that the Commission will only use Section 929I as intended. But the SEC has already indicated its willingness to exploit this loophole. In an action the SEC brought against a broker-dealer, the Commission tried to use 929I to avoid an administrative law judge's order to comply with the subpoena. That clearly goes beyond the intent of the provision and the SEC's reasons for needing the provision in the first place.

Chairwoman Schapiro yesterday issued guidance that places limits on the Commission's use of Section 929I. This is a step in the right direction, and I do agree with that. But the Chairwoman's guidance is not sufficient because the Commission can change its interpretation at any time, and the fact that guidance is needed at all is evidence itself that the provision is too broad and subject to abuse.

The SEC's rationale for Section 929I is that the provision is necessary to ensure that the Commission can obtain sensitive information when the Commission is performing examinations.

Mr. Chairman, I introduced H.R. 6086 on August 10, 2010. H.R. 6086 repeals the secrecy provision of Section 929I and amends the Securities Exchange Act to clarify that any entity the SEC regulates under the Securities Exchange Act will be considered a financial institution for the purpose of FOIA Exemption 8. My bill strikes a careful balance to address the SEC's concerns without compromising the goals of transparency and accountability that are the heart of the Dodd-Frank Act.

In a letter supporting H.R. 6086, a coalition of 36 public interest organizations, including groups such as the Project on Government Oversight, the Sunlight Foundation, and openthegovernment.org wrote in support of this legislation: "This bill sends a clear message that public access is vital to accountability," and I am submitting a copy of that letter for the record today.

The culture of accountability must start at the top. Allowing the SEC to operate in the darkness or in secrecy will undermine the confidence of consumers and regulated companies.

I look forward to continuing to work with you, Chairman Frank, and the committee so that we can quickly and effectively address this issue. I want to thank the members of the committee. I want to thank you, Mr. Chairman, for holding this hearing today. I really feel that this is a start to be able to correct something that could be very detrimental as we move forward.

On that note, I yield back the 3 seconds.

[The prepared statement of Representative Towns can be found on page 45 of the appendix.]

The CHAIRMAN. The gentleman from California, Mr. Issa, will have 5 minutes and 3 seconds.

STATEMENT OF THE HONORABLE DARRELL E. ISSA, A REPRESENTATIVE IN CONGRESS FROM THE STATE OF CALIFORNIA

Mr. ISSA. Thank you, Mr. Chairman, and Ranking Member Bachus.

I respect the fact that this is the committee of jurisdiction that does oversee the SEC and that the nuances of what should or should not be made available under FOIA to a great extent falls within this committee.

Chairman Towns and I are here because we represent the committee that is really about transparency. We will always be the committee that probably starts off assuming that everything should be available unless otherwise justified.

Chairman Towns' bill and what one might call a companion or a similar bill, H.R. 5924, which I also authored, really tried to unring the bell. That is our position. Our position is, you start over. You essentially undo what happened in the Dodd bill, and then you thoughtfully and carefully weigh what Chairman Cox brought, what Chairman Schapiro is bringing, and don't give them what they ask for or what they want. Give them what they need. The decision of what they actually need in the long run will be yours.

But let's assume the following: Every bureaucrat, no matter how well intended, always wants to err on the side of caution unless the public believes they should err on the side of more.

Now as I look down at Mike Oxley above the chairman, I remember that, in fact, Sarbanes-Oxley passed under many of your watches. I am perhaps the only Member of Congress serving on a public board both before and after that, taking a company public and watching as we went through the SEC process.

The Securities and Exchange Commission is not an enforcement agency first. It is not the FBI. It does not deal in vast secrets. It is, in fact, an agency that exists for no other reason primarily than to ensure us transparency of the information and honesty of the information that public companies put out there in order that there might be public confidence, trust, and, thus, the free flow of funds to investments. The SEC exists in no small way in order to create transparency and honesty.

Now, of course, we have an enforcement responsibility, and often they ask for additional information and information that should not be made public. But, make no mistake, the SEC is about asking for proprietary information to be made public as a part of what they do. We all know that you can find out a great deal about a company—far more about a public company than you can a privately held company as a result of their wanting to be before us.

As Congressman Campbell said, it is impossible for us to understand how criminal enterprises such as Bernie Madoff's can, in fact, continue to enjoy some level of protection from scrutiny by the public. So Mr. Chairman, we are coming before you here today to a great extent not to debate whether suggestions made by former SEC Chairman Cox or current Chairwoman Schapiro are, in fact, appropriate. That is your decision to be made in good time. But we

are asking you to consider legislation that would effectively unring the bell, allow that process to go forward without prejudice based on what was put in the bill that we believe was overly broad.

I might point out to the committee—not that you wouldn't already know it but perhaps for the public—that the SEC prior to this 929I only granted 13 percent of FOIA requests. And, as far as we can tell, it was only overturned when they denied once.

So this is an agency that knows how to say "no," has the power to say "no," and says "no" most of the time. I think that is one of the reasons that in my letter to Chairwoman Schapiro, which I would ask unanimous consent to be placed in the record—

The CHAIRMAN. Without objection, it is so ordered.

Mr. ISSA. —we pointed out some of the details of that history, not to say by any means that her guidelines were inappropriate and weren't a good step but that, in fact, if we unrang the bell here today, they still only would grant about 13 percent of FOIA. They would fully protect company secrets. And if they can't, I certainly want to make sure that this committee, in due time, ensures that we do provide them the tools that they need.

I might note that there is a legitimate reason to say that no one should ever be able to use the Securities and Exchange Commission to backdoor their way into information that would not otherwise be available through FOIA. That is a good point and a good starting point.

So as we take this step forward I would hope that the members of the committee who have the absolute jurisdiction would start over to the extent possible, give us a quick remedy from an overly broad prohibition on FOIA, and then appropriately listen to Chairman Cox and Chairman Schapiro in the future.

Thank you for the extra few seconds. I yield back.

The CHAIRMAN. Thank you.

Again, I want to be very clear. From what I am hearing, it is because FOX filed that lawsuit and it was in the course of the lawsuit that people discovered the problems.

I just want to note, again, to repeat, in 2008, the House passed this bill—a bill including this unanimously. Some of the people who are now for appeal were cosponsors. It was put in, in 2009, when the committee debated the part of the financial reform bill of which this was a part, 45 amendments were offered, and none of them affected this. That is, nobody at the time, when we had a long set of markups, thought about it.

The bill went to the Floor of the House. It was in the House. It was also in the Senate, and 241 amendments were filed in the Rules Committee. None dealt with this. And then members will remember with varying degrees of joy the conference process during which every member of the conference offered amendments on a variety of subjects, and nobody offered an amendment on this.

So this has been out in the public—and I am saying that to be clear. Because the question is, how did this slip through? It didn't slip through. It was plausible language. Often you don't know something until it is time-tested, and the lawsuit tested this. So that is why we are here.

Having been through all this, having had it laying out before all of us who were here, and everybody here, conferees here, three of

us conferees there, two conferees there, it just didn't occur to anybody until it was called to our attention, and I believe that Congress is now acting appropriately. And I think what the gentleman from California suggested, we do have—let me just say by way of procedurally, we have a short time period now, and it may even get shorter. And there are two possibilities. One is that we try to amend—and I think it is clear that something should be done. Either we try to amend it in some way, as was proposed, or it is a two-step process of a repeal with a note that this should not be left undone and reapproached, and whether that would be later this year or next year, it could be done. Because, again, as I said, the history of this makes it very clear. It has been totally nonpartisan. So we can work on that.

Do any other members have any comments or questions for our colleagues? If not, according to the custom, we thank them.

I do want to note, yes, it is within our jurisdiction. One of the things I am very proud of with regard to this committee is that we have engaged in no turf battles with anybody, because I think that is Congress at its worst. When we are engaged in jurisdictional battles, we appear to the public to be just interested in sort of prestige. We have the full participation of both of these members in the conference, not restricted, de facto to what we talked about. And we will be drawing on the expertise of that committee which has jurisdiction over FOIA as we proceed. So I thank both gentlemen.

Mr. ISSA. I thank the chairman. And I would just ask unanimous consent that our report from May be included in the record as part of our submission.

The CHAIRMAN. The report on the SEC?

Mr. ISSA. On the SEC, yes. It is a published report.

The CHAIRMAN. So why do you have to publish it again?

Mr. ISSA. I would note for the record that you are right. Thank you, Mr. Chairman.

The CHAIRMAN. We will now call on Chairman Mary Schapiro. And I thank the gentlemen.

As the Chairman takes her place, I would ask unanimous consent to include in the record a statement from the Society of American Business Editors and Writers, not previously published, I would note. No, I take it back. It has been previously published. We will put it in. It is short.

Without objection, it will be included.

Chairman Schapiro, let me say I appreciate your coming. And I just want to say at the outset, no one I think does or should consider this in any way any kind of criticism or indictment. My own view is that you have significantly improved the enforcement mechanism.

I know Mr. Khuzami couldn't be here because of impossible conflicts, but I welcome him and what he has been doing.

So I want to make very clear—and I think everybody has made this clear—we are here in a spirit of cooperation. We have a common enterprise. We have conflicting goals, to some extent, which is tough enforcement but also complete openness. And I think, in good faith, we will work together there.

So, Chairman Schapiro, please begin. And as this is a complicated subject, I don't think anyone would object if we give you

the flexibility to go over the 5 minutes that we give some others from time to time usually. You are a one-person panel, so we can do that. Go ahead.

STATEMENT OF THE HONORABLE MARY L. SCHAPIRO, CHAIRMAN, U.S. SECURITIES AND EXCHANGE COMMISSION

Ms. SCHAPIRO. Thank you very much Mr. Chairman.

Chairman Frank, Ranking Member Bachus, and members of the committee, thank you for the opportunity to testify today on behalf of the Securities and Exchange Commission concerning Section 929I of the Dodd-Frank Wall Street Reform and Consumer Protection Act.

Section 929I was designed to improve our examinations of regulated entities by clarifying the protections afforded to regulatees that provide the Commission with sensitive and confidential materials as part of those examinations. It is a provision that we raised with Congress for several years in both a bipartisan and transparent manner. Indeed, as the chairman has noted, 2 years ago, the House of Representatives passed language that, while not identical, was substantively the same in its protection of examination documents as Section 929I.

Among other things, the SEC is responsible for examining in excess of 17,000 entities that play central roles in our capital markets, including investment advisers, broker-dealers, and credit rating agencies, to name just a few. During those inspections, our examiners frequently request confidential and sensitive business records that are critical to our oversight. Yet because of uncertainties in the law, some regulated entities have expressed concern about the Commission's ability to protect those documents from compelled disclosure to the public or to their competitors. That ambiguity has impeded our ability to obtain vital examination information on a timely basis.

Section 929I was designed to eliminate this substantial and longstanding impediment and facilitate more thorough and efficient examinations. 929I was never intended to exempt the SEC from the Freedom of Information Act, nor does it. FOIA is a landmark law that guarantees citizens access to government information, provided certain exemptions do not apply.

In the case of the SEC and other financial examiners, FOIA seeks to balance the public's right to information with the government's responsibility to provide effective supervision. Though FOIA, through Exemption 8, does provide important protections from disclosure for examination materials obtained from "financial institutions," that term is not defined in the law. Indeed, courts have not yet addressed whether certain entities the Commission has the authority and the responsibility to examine—for example, credit rating agencies, transfer agents and municipal advisers—are financial institutions for purposes of these FOIA protections.

Additionally, existing FOIA exemptions do not apply, of course, in non-FOIA contexts. So when a private party in litigation with another private party subpoenas documents from the Commission, potentially about its competitors, that the Commission has received through its examination program, the Commission has had to rely

on arguments of undue burden, relevance, or common law privilege to protect the information from disclosure.

Section 929I appropriately provides needed protection in this non-FOIA litigation context. Rather than use the Commission to gain access to information, private litigants should have to seek documents from the registered entity, which is, after all, best positioned to articulate the sensitivities of that information.

While the Commission believes 929I will improve its examination program by facilitating better and more timely access to vital information, it also shares a commitment to accountability and transparency that is embodied by the Freedom of Information Act. The Commission recognizes that Section 929I is meant to balance the public's right to information with the benefits of a robust examination program, a balance that is recognized under FOIA as well.

To ensure that these important and competing interests were appropriately balanced, including in the third-party litigation context, last month I instructed the staff to refrain from invoking 929I until the Commission issued guidance as to when and how to assert this provision. Yesterday, the Commission issued clear guidance to the staff on the appropriate use of 929I. A copy of that guidance is attached to my written testimony.

With respect to FOIA requests, the staff and the Commission will continue to rely on existing FOIA exemptions and use 929I only where the information is obtained through the examination program and where the courts have not yet determined whether the examined entity is a financial institution.

With regard to third party or non-FOIA litigation, 929I will only be invoked where the information, had it been sought via FOIA, could have been protected under existing FOIA exemptions and then only when the party cannot establish a substantial need to obtain it from the Commission. 929I will not be invoked in any matter where the SEC or the United States Government is a party.

Finally, you have asked that we comment on the bills introduced that would explicitly or effectively repeal 929I. I am concerned that these bills, as currently drafted, may not provide certainty to regulated entities concerning the protection of their proprietary information. In addition, none of these proposals address instances in which third parties seek to compel the Commission to produce documents in non-FOIA litigation through third-party subpoenas. I am, therefore, concerned these bills would diminish the Commission's ability to obtain in a timely fashion the information needed for comprehensive examinations.

In sum, 929I is important to our ability to develop a robust examination program that better protects investors. As you know, our examinations help us to identify compliance errors as well as wrongdoing, and where wrongdoing is uncovered, these examinations result in referrals to our enforcement division. A vigorous enforcement program goes hand-in-hand with a good examination program. Though we recognize the competing policy interests it raises, a return to the status quo ante will again limit the efficacy of our exam program. I do believe the Commission's guidance strikes an appropriate balance by addressing the primary issues that existed prior to this new law, while simultaneously protecting against application in a broader-than-intended manner.

Thank you very much, and of course I am happy to answer your questions.

[The prepared statement of Chairman Schapiro can be found on page 127 of the appendix.]

Ms. WATERS. [presiding] Thank you very much, Chairwoman, for being here today.

I recognize myself for 5 minutes.

Chairman Schapiro, the SEC has been asking for this authority for some time. In addition to some regulated entities—some regulated entities have refused to provide requested information to the SEC out of fear that the information would later be subject to a FOIA request. Can you provide specific examples of an instance where having the new confidentiality provision would have allowed the SEC to better influence its rules and regulations against a financial institution?

Ms. SCHAPIRO. Yes, I would be happy to. We have a number of examples where we have sought information that regulatees were uncomfortable providing the Commission because they felt that if we could not protect it from public disclosure, they could suffer serious competitive harm; and that would be public disclosure either through FOIA, where Exemption 8 might not clearly cover materials and protect them from disclosure, as well as disclosure through private litigation.

That would include, for example, instances where we have sought from proprietary trading firms their algorithms for trading. Their fear was that their algorithms that they use to dictate how they conduct their trading are highly proprietary and they would suffer severe disadvantage if that information was disclosed.

We have also had instances where a registered investment adviser that manages a number of very large funds refused to provide the Commission with details about its quantitative trading strategy for fear, again, that the information could become public and others could trade against that information to the disadvantage of those large funds.

We have also had instances, in the context of looking at insider trading, where firms have been uncomfortable turning over to us what they call their watch list. Those are the lists that are maintained by investment bankers to track companies on which they have insider information to make sure their employees are not trading on that information, and there are some examples of discomfort in that regard.

And then a final category would be with respect to the provision of internal audit reports that have been done by regulatees that they have not wanted to turn over to the agency. So sometimes we can't get the information. Sometimes it takes a very long time for us to get the information ultimately from these regulatees.

Ms. WATERS. Do you have an example of where you have seen proprietary information used in a way to advantage a firm or to disadvantage a firm with information that you had had in your possession?

Ms. SCHAPIRO. Congresswoman, the issue would be the firm's reluctance to give us that information in the first instance because if it were made public—a proprietary trading firm's algorithms are essentially their trade secrets. It is their formula to Coca-Cola. And

if that information becomes public, then others can trade to the detriment of that firm and its intellectual—

Ms. WATERS. So what you are saying is that you have had 100 percent refusal to give certain information. You have not received information that has violated confidentiality.

Ms. SCHAPIRO. No, not 100 percent refusal, certainly. We have had instances where we have had refusals and very long and protracted negotiations to try to find a mechanism through which these entities would be comfortable giving us the information. We do at the end of the day have the ability to subpoena the information. But I would really prefer not to see our enforcement program, which has so much to do with respect to fraud and manipulation and violations of the Federal securities laws, turned into a mechanism for suing firms just to get the production of documents that, frankly, should be produced to us in the course of the routine examination program.

Ms. WATERS. Thank you very much.

Mr. Neugebauer.

Mr. NEUGEBAUER. Thank you, Chairman, for being here today.

As I listen to this discussion and I listen to the testimony, one of the kind of questions that come up—some people say the reason we are here is because of the FOX Business News lawsuit. And that was more about what was, I think—as I understand it, their inquiry was more about what the agency's behavior was in their investigation to these two entities and not necessarily about any top secret information that you may have requested from these entities. Yet we have had a lot of discussion here today about asking these entities for more detailed information on their trading models and things like that.

These seem to be two different issues, and can you differentiate to me the difference of someone getting information on the behavior of the agency as opposed to someone getting information on the behavior of a company that the agency is overseeing?

Ms. SCHAPIRO. Congressman, I think there is a difference, and I think it is very worthwhile to explore that difference.

In the FOX litigation, which I should say is before a Federal judge who will make the ultimate decision about the remaining documents to be disclosed or not, FOX sought tips and complaints and referrals that had been received by the agency with respect to Madoff. They sought 2004 and 2005 examination information, 2006 and present enforcement investigation information, and information coming out of our Inspector General's investigation of how the agency handled Madoff. Tens of thousands of pages of documents have, in fact, been turned over in that litigation.

I agree with you that 929I should not be about shielding the Securities and Exchange Commission from accountability for its failures or for the actions that it takes, whether or not you view them to be failures in any particular context. I would say two things about that.

One is that, in response to Congressman Campbell, nothing in 929I prevents Congress from getting complete access to everything. It is quite explicit in the provision. Congress has full access to the agency for purposes of oversight.

But in the guidance that we have published that would bind our staff, 929I may never be invoked in non-FOIA litigation where the agency or the United States Government is a party. So I understand and appreciate very much the point that we must be accountable not just to you all but to the public and that by relying only on FOIA exemptions we think we can do a lot to ensure that there is a flow of that information about the agency to the public realm.

The last point I would make is that we do have exemptions under FOIA for investigations and to prevent the disclosure of material that would interfere with an active investigation or ongoing enforcement proceeding. In the Madoff context, there are multiple ongoing enforcement proceedings. And so that Exemption 7(A) from FOIA has been invoked with respect to some of those documents.

Mr. NEUGEBAUER. And I guess you have heard and you have received letters from various members about the concerns about your implementation of this and the broadness of it. And you have yourself issued guidance on the use of 929I. Is it your position that you would support legislative language that would clarify and give more specific guidance on this, maybe in keeping with even some of your direction that you have issued in your guidance?

Ms. SCHAPIRO. Congressman, I very much would. I think codification of the guidance—it limits the agency's discretion very dramatically—I think would be a very good step. We are very anxious to work with the committee to try to get to the right results here. We want great examinations. You want us to do great examinations. We also want to protect business' ability to have sensitive and confidential information in the hands of the government without it necessarily being broadly exposed.

Mr. NEUGEBAUER. I thank you.

Mr. Chairman, I yield back.

The CHAIRMAN. The gentleman from Texas formulated an important question. That is, one option would be to statutize the guidance because guidance can come and go; and that, I think, is one of the things we should consider.

I guess there might be some agreement conceptually, but it isn't always easy to try to take the concept into reality. That is, we all agree—and you, Chairman Schapiro, said so—the SEC shouldn't be shielded in any way from the media, from the public, from Congress, which it wouldn't be anyway. The only question is, is there some concern that if there was nothing along these lines you would encounter more resistance in trying to get proprietary information? And I guess particularly the question would be, if you got proprietary information and there wasn't anything wrong, would people have that risk?

I don't know whether there is agreement on that. I think there is, generally. Both sides have understood the importance of protecting proprietary information; and, indeed, when we had an amendment offered I think in the conference about—I think it came from the Senate on the Office of Financial Information, there was some concerns on both sides that it was being too intrusive in getting private company data. So that is one of the things we have to look at. So we can obviously take a look at that.

I do think it is going to be very important here—and I know you want to discuss this, and I appreciate that—that we hear particu-

larly from the enforcement people. And I think if the enforcement people could give us their very specific needs on this, that would be very helpful to us.

Let me also say, we have a couple more weeks. We will be talking together across the aisle. I am hoping we can come together on something. I think some legislative action would definitely happen. The Senate has already talked about this. So it would be my hope that by the end of next week, we could get some agreement on where we are on all this so that we could probably do something on suspension that would be a necessary—in the final week before we get out and the Senate would so that this would be taken care of. So that, as I said, was the question about statutizing.

But let me just say, one other question that has to be asked, the concern is that because things are subject—you did say, if I heard you correctly, because I was in and out, that you would not be invoking this with regard to the litigation that FOX has brought, is that correct?

Ms. SCHAPIRO. That is correct.

The CHAIRMAN. So this will not affect their lawsuit?

Ms. SCHAPIRO. No, it will not. We have made it quite clear in the guidance that where the United States is a party, either prosecuting or being sued—it is clear in our guidance, that guidance was—

The CHAIRMAN. Has that been clear in whatever court processes are going on with regard to the FOX lawsuit?

Ms. SCHAPIRO. Yes, that is exactly right. About a month ago, I directed the staff not to use 929I under any circumstances until the Commission could—

The CHAIRMAN. So this is irrelevant to the FOX litigation?

Ms. SCHAPIRO. Yes, yes.

The CHAIRMAN. I appreciate that.

Let me ask one last thing, and it might be helpful to the argument that you and your predecessors have been making. Are there examples of resistance that came from the subjects of an investigation because of the concern that through FOIA proprietary information would be made public? That would be very helpful for us to know. Was this a theoretical fear or have you, in fact, encountered this?

I see Mr. Pitt is here, and I will put him on notice that I will be asking him if he can think of any examples of that as well because I think that would be very relevant for us.

Ms. SCHAPIRO. Mr. Chairman, I believe you had stepped out of the room, but we have many examples with respect to proprietary trading algorithms, with respect to investment advisers and fund managers, personal trading records, with respect to internal auditor reports; and I would be happy to supplement them—

The CHAIRMAN. Where people have resisted giving them to you on the grounds that they would be—

Ms. SCHAPIRO. Yes.

The CHAIRMAN. I apologize. And I should have asked before I duplicated.

The gentleman from California.

Mr. CAMPBELL. Thank you, Mr. Chairman; and thank you, Chairman Schapiro.

Let me just—on the prior question, I appreciate, as I understand it, your agreement that 929I is overly broad and would accept some codification of some restrictions in that regard, correct?

Ms. SCHAPIRO. Yes.

Mr. CAMPBELL. Until that occurs, this guidance that you have given can be changed, can be modified, whatever. Would you agree that with any changes or modification to this guidance, you would inform this committee immediately prior to it—in case, as the chairman suggested, we are running out of time on the legislative clock this year.

Ms. SCHAPIRO. I would be happy to do that. And you should know, this is Commission guidance. The Commission voted to issue it. So it is not just my decree as chairman. But I would be happy to notify the committee if there were to be any change.

Mr. CAMPBELL. Okay. Thank you.

One question. Now this would be out of the purview of this committee. This would have been the Government Oversight Committee because of FOIA. One of the things you mentioned in your guidance that you issued yesterday is a lack of a definition of financial institutions. Is that something that Government Oversight should be looking at, a better or a complete definition of financial institutions for FOIA?

Ms. SCHAPIRO. I believe that it is undefined. It has generally been defined by reference to the government in the Sunshine Act, I believe, but it doesn't include in that list all of the, for example, new entities the SEC will have responsibility for regulating, such as municipal advisers or some, like credit rating agencies, which have never been found by a court to be a financial institution. It could be defined, I suppose, with a longer list or it could be defined to say that regulated entities which are examined by the Securities and Exchange Commission are financial institutions.

Mr. CAMPBELL. Right. Because there could be new regulated entities 2 years from now that don't exist today, entities that we don't even know about at the moment.

Ms. SCHAPIRO. Exactly.

Mr. CAMPBELL. As has been discussed, we are here because of the FOX Business Network lawsuit pending, and to what extent I don't know, because of the lawsuit. But it does appear, certainly to this Member and I think to other Members, that withholding information on the Stanford and Madoff entities is hard for us to understand, why that is a proprietary or confidential issue.

Ms. SCHAPIRO. Congressman, I understand that concern. And I will say that, while we could have withheld many documents, we have turned over tens of thousands. And a judge will obviously make the ultimate decision about whether additional documents should be turned over.

But there is ongoing litigation with respect to Madoff and Stanford, and we are only relying—I should be very clear—on existing FOIA exemptions to withhold any information in the FOX litigation. But there is information that has the potential to impact the ongoing investigation of parties related to Madoff that we think is important for us to protect until such time as that litigation is concluded, and then I would imagine many more documents will be released.

Mr. CAMPBELL. Okay. I guess I am still trying to understand. So, initially, was 929I used to deny release of documents and then now you have released more by using the previous or existing—I am just trying to understand how this works.

Ms. SCHAPIRO. My understanding is that we originally relied upon existing FOIA exemptions and only existing FOIA exemptions. My understanding is also that we have never filed anything with the court or officially presented to the court 929I as an additional basis for withholding documents. But it was, I understand—and, again, I wasn't there—discussed in a conversation between FOX and SEC lawyers and potentially a clerk of the judge that 929 could conceivably be an additional basis for withholding of documents.

That was before I directed the staff not to invoke 929I. That is what brought it to all of our attention, as the chairman suggested, but it has never been put into a pleading or officially put before the court. We are not relying on 929I now as this litigation continues. We are relying only on existing FOIA exemptions, as we have all through this litigation.

Mr. CAMPBELL. Okay. One final question in my last seconds here related to something that Ranking Member Issa mentioned, that 87 percent of FOIA requests have been denied by the SEC. I presume that is your chairmanship, prior chairman, a number of chairmen, I presume. That does seem like a very high number. Is that because of a lot of—would you like to explain?

Ms. SCHAPIRO. We are a bit unusual with respect to FOIA. For example, we have had over 10,000 FOIA requests this fiscal year at the SEC. I will tell you that the FDIC, the Federal Reserve Board, and the CFTC combined had about a third of that, 3,500 in Fiscal Year 2009.

Mr. CAMPBELL. Had a third of those requests?

Ms. SCHAPIRO. A third as many requests. Those three agencies had about 3,500. We have over 10,000. Approximately 70 percent of our requests come from commercial vendors of information—who are seeking information for due diligence purposes or to repackage and sell in another context, which I think is very interesting. And 75 percent of those requests find no information. So that is by far the largest percentage of our FOIA requests. There is just simply no information found because of—

Mr. CAMPBELL. So you are actually not denying anything. It's that you are complying with the request. There is just nothing there?

Ms. SCHAPIRO. Right. So perhaps the statistics in the best light for the Securities and Exchange Commission, 79 percent in Fiscal Year 2009 were either granted in full or no information was found, but 64 percent of that was no information found. Twelve percent of requests were denied in full or in part.

The other reason I think we have the higher denial rate, quite honestly, than other agencies is our law enforcement function, and by far the most used exemption by the SEC is Exemption 7, which goes to law enforcement activity.

Mr. CAMPBELL. Thank you.

The CHAIRMAN. The gentleman from North Carolina.

Mr. WATT. Thank you, Mr. Chairman; and Madam Chairman, I am sorry I had to miss your testimony. I have two really wonderful hearings going on in my two committees at the same time, this committee and the Judiciary Committee, which is sharing something on digital competition in the digital world. It is extremely exciting, and I thought I wanted to go over there and hear that testimony.

I just have one question. I, for the first time, have seen this May 18, 2010, report of the Committee on Oversight and Government Reform since I don't sit on that committee, and it seems to be a rather scathing indictment of the SEC in a number of respects, and I was wondering whether there are any specific parts of the findings of that you would dispute vigorously or you think are overstated or is it generally true when you came in and are these issues being addressed?

Ms. SCHAPIRO. Congressman, that is a minority staff report, which I have to say I read when it was released, but it has been several months. So I would be hard pressed, I think, to give you specifics, although I would be happy to do that for the record.

I will say that I think it doesn't recognize extraordinary changes at the SEC over the last 18 months, and while we have a long way to go in terms of rebuilding our culture, ensuring that our focus is always on market integrity and investor protections, we have made a lot of changes that respond to the specifics that are raised in that report.

And you have heard me testify many times about the post-Madoff reforms, the post-Stanford reforms, the failure of the consolidated supervised entity program, the bankruptcy of Lehman Brothers and others, the lessons the SEC learned from those and the actions that we have taken with respect to new leadership throughout the agency, new training, new skill-sets, and new regulatory programs, where appropriate, to deal with these kinds of issues and problems. We have really left no rock unturned to try to make sure that this agency is one that the American public can rely upon.

But with respect to specifics in that report, I would be more than happy to provide something for the record. As you can imagine, I don't agree with some of the characterizations.

Mr. WATT. Thank you for doing that, and I would ask you to do that.

I am happy I asked the question because you call to my attention that it is the ranking member's report, the minority part of the committee's report, rather than the Committee on Oversight and Government Reform. It is probably not even advertised well because it says right at the top, "U.S. House of Representatives Committee on Oversight and Government Reform" in great big letters, and then it says right under that Darrell Issa, California 49, Ranking Member. It seems to me if Mr. Issa were going to do a report, he could at least caption it appropriately.

So I would welcome your responses so that we can get a clear picture of not so much what the history of the SEC has been but what changes are being made to make it a more effective advocate for consumers and protector of the public.

So, with that, Mr. Chairman, I didn't hear the testimony, so I yield back the balance of my time.

The CHAIRMAN. The gentleman from Florida.

Mr. POSEY. Thank you, Mr. Chairman.

Madam Chairman, I wonder if you could share with us—we have talked about the denials of the FOX request—exactly what was requested and exactly why it was denied.

Ms. SCHAPIRO. I would be happy to do that. I would like to not be incomplete, though, in my response. So I would prefer to do that for the record.

I can tell you generally, at the risk of leaving something out, that they sought tips and complaints—what happens we call TCRs—tips and complaints and referrals—with respect to Madoff conduct prior to his—I believe all of him, not just prior to his arrest, 2004 and 2005 examination reports, information with respect to the 2006 present enforcement investigation, and then materials surrounding the Office of the Inspector General's investigation, but I don't want to represent to you that is everything. I would need to do that for the record.

Mr. POSEY. Could you give me an example of how that might interfere with any current proceedings now, even hypothetically if you want to? That sounds like a very reasonable request to me.

The case is closed. The SEC did nothing. Nobody was punished. We don't even know where all the people were who screwed up now. I asked you that last time. You couldn't tell me. Give me an example of why we need to protect this proprietary information.

Ms. SCHAPIRO. Congressman, first of all, you should know we have turned over tens of thousands of pages in response to this request; and a Federal judge will make the decision whether, under existing FOIA exemptions, the SEC has appropriately withheld additional information.

I can imagine that there could be information with respect to related parties to Bernard Madoff Investment Securities that may well be subject to investigation and ongoing enforcement by the Securities and Exchange Commission or the United States Attorney's Office that would not be in the interests of those investigations and actions to be disclosed. But that is a hypothetical, because I don't know the specific answer to that. I would be happy to try to provide that to you.

Mr. POSEY. It just seems like they are asking for records that are over 4 years old, and as old as how old are some of the records they are asking for?

Ms. SCHAPIRO. Again, I don't know the very detailed specifics of their request, but there is no question that these date back a number of years. But, again, many tens of thousands of documents and pages have been—

The CHAIRMAN. Would the gentleman yield?

Mr. POSEY. Yes.

The CHAIRMAN. Chairman Schapiro, a piece of advice. When someone asks you why you haven't turned over anything, the fact that you turned over 10,000 is not a good answer. Quite frankly, it sounds like the lawyers kind of cooked up an answer for you. Let me just give you my advice. It's like all the days you didn't rob any-

body—not that you robbed anybody. The fact that you turned over pages is no answer to the gentleman's question.

The other thing I would say is this: The fact that a judge will ultimately decide it doesn't answer the question, because the judge isn't preventing you from doing it. So, again, you may have other reasons.

I would just recommend—the question was, why not turn these over? The fact you have turned over other things is not in issue or that a judge may make you turn them over doesn't go to your rationale for not turning them over.

Ms. SCHAPIRO. I should say, Mr. Chairman, I have a bias—we have a bias towards turning over anything that we can. There are ongoing law enforcement investigations by the Securities and Exchange Commission and the United States Attorney's Office with respect to individuals and entities associated with Madoff, and I believe that—

The CHAIRMAN. If the gentleman would yield again, that gets right to the point I think the gentleman was saying.

Let me make this proposal to my colleagues. That is, next week would you be willing to conduct a confidential briefing, a members-only briefing that might give some more specifics about some of this? I think that would be very helpful, and members who wanted to go could go. If you could agree to do that and get back to us, I think that would be very helpful where you could discuss some of this information.

The idea there might be some constraints legitimate but not to FOIA, then that would be undercut by talking about it here. But I think if you were able to do your—enforcement people could do a members-only briefing next week, that might be helpful.

The gentleman has an additional 2 minutes.

Mr. POSEY. Thank you very much, Mr. Chairman. That would be very helpful.

I have had a little bit of experience with government agencies over the years. Usually, they want to avoid any sunshine to protect incompetency, not to really do the more upscale performance that you have suggested. And I am not suggesting that yours is going to protect any unknown incompetency any further, but that has just been historically why I have seen agencies stonewall letting documents go to the press. And I guess every member of this committee has made it very clear and have been fairly passionate about the need to have transparency in government. So I would be interested in having the questions answered in private, as the chairman suggested, if necessary.

And I would also just be curious to know, if the agency's call was wrong in withholding information that should be public, what are the consequences? What are the penalties for the employees who made that bad call?

Ms. SCHAPIRO. The staff makes the decision based on expertise and guidance and counsel from the General Counsel's office about whether or not information needs to be disclosed. We don't punish people if they made a wrong call about whether a document could legitimately be held under a Freedom of Information Act exemption. If somebody had a pattern of making bad calls or judgments,

we would have to take that into consideration in performance evaluation—

Mr. POSEY. I think I got my answer. Just like the Madoff scandal, nobody has even had their wrist slapped.

I think that maybe when we look at reforming the agency, we might want to put a little personal responsibility and accountability there for that. Right now, if there's no penalty whatsoever for making bad calls—and if anyone has ever been disciplined by the SEC, I would like to know about it because I haven't yet. I have read some books. I have read all I could on the issue. I heard the supervisors testify. I have heard the Secretary testify. Nobody has been punished yet about the Madoff mishandling. We don't even know where those people are now, the two to three dozen examiners and investigators who blew the whole thing, and I was under the impression you were going to find out for me and let me have that information, but I haven't received it yet.

But I think what everybody is alluding to is we just want to see some accountability. That is what this whole thing is about. And, as the chairman said, we ask an agency head what time it is and they start describing the clock till our time runs out. I just wish we would stop some of the game playing and just be kind of frank and forthcoming with this stuff.

Thank you, Mr. Chairman, for the extra time.

The CHAIRMAN. The gentleman from Kansas.

Mr. MOORE OF KANSAS. Thank you, Mr. Chairman.

Chairman Schapiro, you mentioned in your testimony that on September 25, 2009, the SEC's Inspector General issued a report entitled, "Review of the SEC's Compliance with the Freedom of Information Act." That report contained 10 recommendations with respect to strengthening FOIA, most of which the SEC concurred with. Two questions.

First, when you became the Chairman of the SEC, were you aware of these problems with respect to FOIA compliance or was the IG report the first time you were made aware of these problems?

Second, you also mentioned one remaining item from that report that has yet to be resolved. What is the issue and why has that not been resolved yet?

Ms. SCHAPIRO. Congressman, the Inspector General report, as you point out, was issued in September of 2009; and within a few weeks after its issuance, I hired a new Chief Freedom of Information Act Officer with deep experience in this area.

As you say, the IG made 10 recommendations. Nine have been closed out to the satisfaction of the Inspector General. The one that remains open relates to developing new performance standards for employees in the Freedom of Information Act office, and we are working on that. It is not resolved only because it actually would require negotiation with the SEC's union in order to do that.

Mr. MOORE OF KANSAS. Okay, very good. Thank you. I yield back.

The CHAIRMAN. The gentleman from Texas, Mr. Hensarling.

Mr. HENSARLING. Thank you, Mr. Chairman.

Forgive me, Madam Chairman, I missed your testimony, so we may cover some old ground here.

I understand that you have previously stated—perhaps you stated in your testimony that 929I is necessary or helpful because it eliminates uncertainty. Is that correct?

Ms. SCHAPIRO. Yes.

Mr. HENSARLING. As I understand it, the Commission's guidance says that, "The Commission should make disclosures where permitted by law when the need for confidentiality is outweighed by the public's interest and accountability and transparency."

So I guess my first question is, if the Commission still reserves the right to disclose information whenever it decides that the public has this interest and accountability and transparency, how is it that regulated entities achieve a greater level of certainty then with 929I?

Ms. SCHAPIRO. Because I think regulated entities with whom we work on a daily basis understand that the Commission appreciates the competitive harm that can come from something like disclosure of a high frequency trader's algorithm. So they have a higher level of comfort that the agency, as an expert in these kinds of matters, will in fact understand the potential damage from certain kinds of disclosures.

Mr. HENSARLING. I'm not sure I still understand. I am still confused by the nexus to 929I, though.

Ms. SCHAPIRO. It is not ironclad in the sense that, yes, just like under FOIA, FOIA doesn't prohibit you from disclosing anything. It gives you the ability to not disclose certain kinds of information. So, yes, you are right in the sense that the agency has discretion in many areas to continue to disclose even where there might be an applicable FOIA exemption.

Nonetheless, as I said, regulated entities trust that the agency understands that to produce a list of holdings by a hedge fund or a mutual fund or to produce a trading algorithm that would allow someone to trade against that firm's interests would be potentially devastating to those entities and that the agency wouldn't do it.

Mr. HENSARLING. Fairly basic question. In years going back, Congress has increased the authority of the SEC in a number of areas including the authority to compel registered entities to provide information and records. So, number one, clearly under the 1934 Securities and Exchange Act, I am under the impression you already have the power to subpoena witnesses to require the production of records from registered entities. I understand if they fail to comply, you have the authority to impose monetary penalties. You can refer the cases to DOJ, and I am just trying to figure out why is it that 929I is needed or is it needed to somehow convince registered entities to cooperate? What does it add to the mix?

Ms. SCHAPIRO. Congressman, I can tell you that we have examples where registered entities have refused or held up dramatically our examinations by not giving us information.

We could use a subpoena. There is no question about it. I don't actually think they would prefer to get a subpoena. I actually think they would prefer to voluntarily produce information or produce information pursuant to our examination authority with the understanding that it can be protected rather than actually require us to go and sue them, leading to all kinds of additional issues for that entity.

I also don't think it is the best use, honestly, of the SEC's enforcement resources to spend a lot of time having to pursue regulated entities to give us documents that they frankly should be giving us under our examination authority. I think you all and we would rather have our enforcement staff out there looking for fraud and prosecuting violations of securities laws.

I know, and I think you will hear on a later panel, that lawyers counsel their regulated entity clients to try to always cooperate and provide information to the SEC and that will be easier to do if there's a higher level of comfort that we can protect that information from disclosure to their creditors.

Mr. HENSARLING. My time is about to run out. That's prior to my arrival here. Some of the legislation that deals with this has been discussed. Can I assume that you are familiar with H.R. 6086, Chairman Towns' legislation, which appears to not be a straight repeal? Are you familiar with his legislation?

Ms. SCHAPIRO. Yes, Congressman, and he was here, actually.

Mr. HENSARLING. Sorry I missed that portion.

Can you comment briefly on your opinion of his legislation.

Ms. SCHAPIRO. Sure. It would repeal 929I, but it would add a provision which we think is quite important, making it clear that under FOIA Exemption 8, any entity that was regulated and examined by the SEC is considered a financial institution.

I think where it is not as helpful is in the context of third-party litigation, where two parties, private parties, are suing each other, serve the Securities and Exchange Commission with a subpoena to get information about each other that is potentially competitively damaging, and we don't have the capability without 929I to have a relatively high level of assurance that we would not have to disclose that information. I do believe that is an issue we can resolve.

The CHAIRMAN. I am told, by the way, that the Senate Judiciary Committee has voted out by voice vote a bill that is very close to the Towns bill. And I have previously said, I am asking everybody now, let's think about this; and by the end of next week I am hoping we might be able to come to a consensus here so it will give us enough this week to act on something.

The gentleman from Texas, Mr. Green. We have some votes, but it now looks to me we only have two more members after this. We'll be able to finish with you and then go to the votes and then come back for our third panel. Mr. Green.

Mr. GREEN. Thank you, Mr. Chairman; and thank you, Madam Chairman, for appearing today.

I am a person without a made-up mind as to what the remedy is, and I would welcome your testimony because the intelligence that you are quoting us is going to be very helpful.

I would like to make a comment and receive your response, if I may. You have mentioned the ongoing investigation exception, but what we haven't said and perhaps it is assumed but hasn't been said is simply this, that exception exists because persons who are being investigated have a way of allowing their factual circumstances to metamorphose. They don't remain static. They are somewhat dynamic. And as they receive information about what you may have, they can sometimes conform their defense, if you will, around what they know your offense can produce. Is that a

fair statement, that the ongoing investigation exemption is to allow you to effectively prosecute, if you have to?

Ms. SCHAPIRO. That is absolutely right. There is one part of Exemption 7 that is geared toward protecting law enforcement techniques. In our case, it would be how we look at certain kinds of trading information and sift through it to find particular patterns of trading or practices. But there is an exemption that specifically contemplates that law enforcement needs to be able to protect some of its techniques from disclosure.

Mr. GREEN. And with reference to proprietary information, this is a highly competitive industry that you regulate, and every edge that you have as a businessperson you want to protect to the extent that you can, and competitors will sometimes want to acquire the information that they can about your edge so as to negate your edge. And proprietary information, simply put, as I am understanding it today, is to protect the edge that you have as you try to compete in a highly competitive market. And if there is a way to acquire information about that thing that helps you to succeed, others will co-opt it and use it. Perhaps it won't hurt you, but it could also work to your detriment for this to be utilized by your competitors. Is that a fair statement?

Ms. SCHAPIRO. That is fair.

Mr. GREEN. So you are trying to protect proprietary information. You are trying to protect ongoing investigations so that they can be effectively prosecuted, and, in so doing, you are trying to balance this need of the public to know about these things, and there is something called judicial determination. When you reject a request, there is an opportunity to have a disinterested third party, known as a judge, to look at it and say either you made the right call or you made a bad call; is that a fair statement?

Ms. SCHAPIRO. That is fair.

Mr. GREEN. Is that process lengthy? And I want you to be as candid as you can be. I know we all have our biases. But is that a lengthy process to the extent that it is seen as a means by which persons simply go into some never never land and they never get the results that they want?

Ms. SCHAPIRO. I don't know the specific answer to that. I have no doubt that it is a process for sure and that there are costs associated with having to appeal a FOIA denial to a Federal judge; and so, as a result, I think our bias should be that wherever we can, we should release information unless it is going to clearly fall within one of the existing FOIA exemptions or cause real commercial harm to an entity.

Mr. GREEN. Thank you.

With my final seconds, 10,000 requests so far this year. How many people do you have working on just managing these requests? It seems to me that takes an inordinate amount of personnel and you have to have support systems. Talk about that, if you would, briefly.

Ms. SCHAPIRO. We have 30 people in the Freedom of Information Act Office, but they also call upon people throughout the agency to actually do the searches for documents within each division or department to make sure that we have covered everything.

We have some technology. One of the recommendations of the Inspector General was to improve our technological capacity to handle FOIA requests, and we have taken a number of steps in that regard, to the satisfaction of the Inspector General.

We stepped up dramatically in the last year our training of employees so that they have the latest techniques in order to handle this just extraordinary, I think by comparison—

Mr. GREEN. Thank you. My time has expired. Thank you.

The CHAIRMAN. The gentleman from Missouri.

Mr. CLEAVER. Thank you, Mr. Chairman.

I have just one question. I am concerned about repealing a law that has only been on the books for a minute or two. Do you believe that we have had enough time to evaluate it or do you think we need more time for evaluation?

Ms. SCHAPIRO. Congressman, I think it is a fair argument that 929I as drafted is broader than it needs to be to protect the information we believe needs to be protected, which is why we issued guidance that we think really hits the right spot. It relies on existing FOIA exemptions, except with respect to whether something has been determined to be a financial institution. There was a little coverage there, and it helps us in the third-party litigation context. I think that is the right place for us to be, and whether Congress is satisfied that we have binding guidance, as we do on our staff, or feels the need to amend the law to achieve the same result, that is I think a judgment call for all of you. We really stand ready to help get that done.

Mr. CLEAVER. So no comment. Thank you.

The CHAIRMAN. The timing is good. Chairman Schapiro, thank you. You have been very helpful. The guidance is helpful, and your responses as well.

I would urge you to think about a confidential briefing. I think that would be very much in your interest because I think members are not close-minded on this, but they want to ask questions. And I would say, in my experience, the discretion of members of this committee can be trusted. We have not had confidential information inappropriately shared.

We are going to recess now and come back for our first panel. There are three votes. The first one will take about 20 minutes, and the second one will take 5 minutes. I would say in about a half hour we should be able to be back. So witnesses can take a break, if they want to get a bite to eat or something, but we will be back here in about a half hour, and we will begin immediately with our next panel. We are in recess.

[recess]

The CHAIRMAN. We will reconvene. I apologize to the witnesses for this delay, and we will begin with Mr. Pitt.

STATEMENT OF THE HONORABLE HARVEY L. PITT, CHIEF EXECUTIVE OFFICER, KALORAMA PARTNERS, LLC

Mr. PITT. Chairman Frank, members of the committee, I am pleased to have this opportunity to testify regarding Section 929I of Dodd-Frank and pending legislative proposals that would modify or eliminate it. My views are solely my own and don't represent the

views of any client. With the committee's permission, I will only briefly summarize my written testimony.

The CHAIRMAN. You may do that at the committee's encouragement, Mr. Pitt. Any documents, statements, or supporting material that any of the witnesses wish to be submitted will be, without objection, made a part of the record.

Please go ahead.

Mr. PITT. Thanks.

I start with the belief that there is and should be a strong presumption in favor of ensuring the accountability and transparency of government agencies and their decision-making. But Section 929I, particularly as it has been interpreted, does not vitiate SEC transparency or accountability. Rather, I believe it was intended as a necessary tool to permit the SEC to be as effective and efficient as it can be in performing not only its existing functions but the myriad of new functions that have been assigned to it in under Dodd-Frank.

The Commission gathers a wide range of proprietary and confidential information from those it directly regulates. To perform effectively, it has to obtain information rapidly, with a minimum of effort and contest. Section 929I was intended to permit the Commission to do that, as bank regulators have done for decades.

Persons who are fearful of improper disclosure of their proprietary or confidential information work assiduously to limit or condition the SEC's prompt receipt of information, as well as condition the terms on which the SEC receives it. I know this because I used to represent such persons when I was practicing law.

Once the SEC obtains information, corporate competitors and creditors try to wrest that information from the SEC to use against those who have entrusted their sensitive data to the agency. Section 929I enables but does not compel the SEC to prevent those kinds of injustices from occurring. To the extent that there are concerns about its breadth, the SEC's guidance yesterday should allay those concerns.

There are two principal ways in which proprietary data may be sought from the SEC, either through the FOIA or through nonFOIA means such as litigation, subpoenas, or discovery demands. 929 clarifies the reach of two existing FOIA exemptions and it is critical, given the new classes of entities the SEC is charged with regulating and overseeing. With respect to non-FOIA demands, the SEC is given an equivalent of the bank examiner's privilege that bank examiners have long enjoyed.

I believe that the provision clearly prohibits the Commission from withholding information from Congress, as it should; and it would not shield, particularly as interpreted, materials necessary to determine how the SEC is doing its job. It enables the Commission to preserve confidentiality of private sector companies' sensitive data if making that data public would inflict unfair harm.

The SEC's issuance yesterday of guidance, in my view, is an example of government operating at its best. The guidance is binding on the Commission and its staff and makes perfectly clear that the new provision would be administered intelligently and fairly and not as some automatic barrier to disclosure.

The committee's invitation asked for responses to a number of questions, and the only one that I would just single out here is that the current bills that are pending which attempt to either repeal 929I or otherwise limit the SEC's abilities I think raise some problems. What we really need, if there's going to be an adjustment, is a carefully constructed approach that is comparable to the SEC's guidance, and I believe that as interpreted by the SEC, Section 929I will be only a useful but not an abused tool in the SEC's arsenal to obtain necessary data.

Thank you.

[The prepared statement of Mr. Pitt can be found on page 114 of the appendix.]

The CHAIRMAN. Next, Angela Canterbury, director of public policy for the Project on Government Oversight.

STATEMENT OF ANGELA CANTERBURY, DIRECTOR OF PUBLIC POLICY, PROJECT ON GOVERNMENT OVERSIGHT

Ms. CANTERBURY. Chairman Frank, Ranking Member Baucus, and members of the committee, thank you for inviting me to testify today and for your willingness to revisit this issue. I am the director of public policy at the Project on Government Oversight (POGO).

POGO has a keen interest in ensuring the public can hold our financial regulators accountable for protecting the interests of taxpayers, investors, and consumers. This is why we are deeply concerned about Section 929I of the Wall Street Reform and Consumer Protection Act.

Section 929I would provide the Securities and Exchange Commission with an unnecessary and overly broad exemption to the Freedom of Information Act and a blanket authority to withhold records. It strips protections of due process currently in place and gives the Commission an accountability shield that is not in the public interest. Indeed, limiting disclosure of public information should not be done lightly, and the burden should be on the SEC to show very compelling and specific need. With all due respect to Chairman Schapiro, they have not yet done so.

Although we fully understand the need to protect against disclosure of certain confidential information collected by regulators, preexisting FOIA exemptions are more than adequate. In fact, the concerns raised by registered entities and the SEC seem very inconsistent with reality.

The courts have strongly censured the SEC for nondisclosure, and last year an audit conducted by the SEC's Office of Inspector General determined that the SEC practices create a presumption of withholding in spite of the President's mandate for a presumption in favor of disclosure. The OIG also found that the agency's FOIA release rate was significantly lower compared to all other agencies.

But, today, Chairman Schapiro said it all when she said we have a bias toward turning over anything we can. Notably, today, she could not come up with one instance in which confidential information business collected by the SEC has been revealed to the public through FOIA or litigation.

The public stakes in more, not less, transparency and accountability at the SEC cannot be overstated. American families continue to suffer from the financial crisis created in part by systematic regulatory failures. The SEC claims to need 929I so that it can more effectively obtain records, police Wall Street, but the SEC's failures, most notably its botched investigations of the Madoff and Stanford Ponzi scheme, had to do with enforcement, not availability to collect records.

On the other hand, if the serious problems with the agency's operations exposed by these and other scandals are kept hidden from the public, as 929I allows, the SEC will not be held accountable.

In one recent case, former SEC enforcement attorney Gary Aguirre was able to use FOIA to prove the agency had retaliated against him and bungled his investigation of insider trading at Pequot Capital Management. He eventually used these records to force the SEC to reopen the case, leading to a $28 million sanction and vindication for Mr. Aguirre's wrongful termination.

We understand that the Commission's job is made more difficult when registered entities refuse to cooperate, but we are not convinced that the agency is uniquely burdened, nor is it lacking in the power of subpoena or the ability to levy penalties. We do not believe it is necessary to expand Exemption 8 either, but if Congress shares the Commission's concern that certain newly regulated entities may not be considered financial institutions, then it might be appropriate for Congress to make that clarification. In any case, because it is already aggressively applied, Congress should examine Exemption 8 and apply clear standards for employing it.

Also, we do not believe that it is in the public interest or in the services of the Commission's core mission to give the agency extraordinary authority to refuse subpoenas from civil litigants as the SEC guidance does. Why should defrauded investors, whistleblowers who suffered retaliation, the media seeking to uncover corruption, or any other party be denied access to public documents that might make the difference in exposing corporate malfeasance or holding the agency accountable?

Again, the SEC has not demonstrated a real need. In fact, it already is very difficult for a civil litigant to enforce a subpoena on a Federal agency. The SEC has many tools at its disposal for quashing subpoenas and can already warn registered entities if confidential information might be disclosed in a subpoena. The decision about whether or not a subpoena should be enforced should be made by the courts on a case-by-case basis as is the norm, not by the SEC. For this reason, we do not support the SEC's guidance in this area.

In any case, we do not believe the agency guidance is sufficient to allay concerns of the public's interest since it can be changed with no public notice, oversight. Nor is the agency discretion appropriate for Exemption 3 or subpoena refusal, particularly this agency's discretion.

So we concede there is some agreement to codify the changes to 929I, but the solution is to re-ring the bell, as Representative Issa said today, not codify the agency's guidance, which is another accountability shield. We urge you to pass H.R. 6086, H.R. 5924, or

similar legislation to repeal this blanket secrecy provision, and I invite you to review our other recommendations calling for additional examination of Exemption 8 and follow-up of the audits by the OIG.

I thank you very much.

[The prepared statement of Ms. Canterbury can be found on page 57 of the appendix.]

The CHAIRMAN. Next, Rick Blum, who is the coordinator of the Sunshine in Government Initiative.

STATEMENT OF RICK BLUM, COORDINATOR, SUNSHINE IN GOVERNMENT INITIATIVE

Mr. BLUM. Mr. Chairman, thank you for the opportunity to testify today. I especially want to thank you for holding this hearing.

I testify today on behalf of the Sunshine in Government Initiative, a coalition of media associations promoting transparency in the Federal Government. We would like to emphasize four points. First, the statute as written is too broad. I think we have heard that today. Second, only an act of Congress can fix this problem. Third, the approaches pending before Congress to fix 929I would be better than no action at all. And, fourth, Congress should strengthen the disclosure and review of proposed statutory exemptions to FOIA.

As you have already heard, under 929I, the Commission could exempt from disclosure any information about official business, including its approach to oversight and supervisory information having nothing to do with trade secrets. Simply put, the statute gives too much discretion to the SEC to decide what should be disclosed or withheld, a key factor the courts look at in FOIA Exemption 3 cases.

Even with 929I, the sought-after cooperation from private entities may continue to be elusive. For example, one influential firm reacted to Dodd-Frank by telling firms to stamp confidential on documents they used to freely turn over to the SEC. For these and other reasons I identify in my written testimony, we believe 929I is overbroad and Congress should take action.

Second, only an act of Congress can remedy 929I's flaws. Even the most disclosure-friendly guidance is no substitute for congressional action. We have seen agencies interpret statutory exemptions to FOIA as broadly as they see fit once they have the discretion. The lesson's clear: Over time, when Congress writes broad exemptions, the government broadly uses them.

Turning to solutions, either repealing 929I or expressly applying Exemption 8 to FOIA to the SEC and the firms it oversees would improve the status quo. It is important to provide clarity, not breadth. Exemption 8 has its own flaws. Chiefly, it is broad as well. But this approach avoids enacting broad ad hoc exemptions like 929I.

On the issue of third-party subpoenas, the SEC's position could significantly hinder open judicial proceedings, and the issue deserves closer scrutiny. These issues should not be taken up lightly but publicly, deliberately, and separately from the FOIA discussion.

I want to use my remaining time to note one reason this hearing is being held today. This controversy arose because the process that

Congress uses for proposing statutory exemptions to FOIA is flawed, leading repeatedly to imprecise or overbroad or redundant legislation. This committee fell victim, in a sense, to this weakness.

In the meantime, by our account, Federal agencies have used over 250 Federal laws over the last decade to deny FOIA requests. That is in addition to FOIA's categories that exempt from disclosure things like trade secrets or classified information. 929I is just one of these secrecy statutes. Sometimes the purpose of these exemptions is understandable. Other times it is not. Why protect the identities of honeybee handlers or watermelon growers?

Congress should take modest, feasible steps to strengthen how these proposals are considered, such as enforcing the open FOIA Act of 2009 which requires all proposals to cite FOIA's Section (b)(3), promoting disclosure in searchable form at the time these proposals are introduced, routinely referring Exemption 3 proposals to the Oversight and Government Reform Committee which has oversight of FOIA, as we know, for brief review, or showing new Exemption 3 statutes are necessary and existing statutes are inadequate.

These feasible steps can avoid needless litigation and congressional controversy by reinforcing our democracy's promise that the public should know what the government is up to.

To conclude, Mr. Chairman, journalists tell us they are chiefly concerned that the language in 929I is too broad and only an act of Congress can fix this problem. We look forward to working with this committee to improve both this provision and the way Congress handles such secrecy provisions in the future.

We appreciate this opportunity and look forward to your questions. Thank you.

[The prepared statement of Mr. Blum can be found on page 48 of the appendix.]

The CHAIRMAN. Mr. Steven Mintz.

STATEMENT OF STEVEN G. MINTZ, FOUNDING PARTNER, MINTZ & GOLD LLP

Mr. MINTZ. Good afternoon, Chairman Frank, Ranking Member Bachus, and members of the committee. My name is Steven Mintz. I am the founding partner of Mintz and Gold. Thank you for inviting me to testify on this important issue.

During the past few years, I have served as lead counsel on a number of Freedom of Information Act lawsuits against the Federal Reserve, the Department of the Treasury, and the Securities and Exchange Commission; and I have been successful in forcing the Treasury to produce documents related to the AIG and Citigroup bailout and to force the SEC to produce documents related to the failed investigations of Bernard Madoff and R. Allen Stanford.

Section 929I of the Dodd-Frank Act has an unintended consequence of weakening government transparency. Section 929I gives the SEC unreviewable control over the information it has to share with the public and is directly contrary to the transparency goal of the Dodd-Frank Act.

FOIA was enacted in 1966 with the notion that a democracy requires accountability and accountability requires transparency. A

central feature of FOIA is the role of courts in mediating disclosure disputes between citizens and the executive branch.

Section 929I gives the SEC the power to refuse disclosure of any document or record as long as it can say it was obtained through or even based on or derived from the exercise of the agency's surveillance, risk assessment, or other regulatory and oversight activities. This broad language, combined with Exemption 3B, completely eliminates the role of the courts as the arbiter of disputes under FOIA.

While Chairman Schapiro has taken the position that the new FOIA exemption is required to protect proprietary information and trade secrets of business submitters, this type of information has always been protected by Exemption 4. Any legitimate concerns that regulated firms have about their proprietary data are satisfied by Exemption 4 and SEC rule 83, which provides a specific procedure for an entity submitting information to request confidential treatment and to be heard if a FOIA request affecting the information is made.

The same is true for proprietary information sought through subpoenas; and, frankly, the guidelines that have been proposed by the chairman now simply want to substitute out the role of courts to be the final decisionmaker and to substitute in the SEC as the ultimate decisionmaker on whether information should be released or not. That changes and reverses the role.

The suggestion that the SEC needs a new FOIA exemption to compel regulatory compliance is troubling. With subpoena power and sanctions that are available, the SEC can force registered entities to produce information; and if that remains a problem, the solution should not be to entice those entities with promises of secrecy but, rather, to adopt additional regulations to ensure that they will comply with SEC requests for information.

Section 929I is also unnecessary to prevent interference with the SEC's law enforcement functions since materials compiled for law enforcement purposes are already protected by Exemption 7A. By the same token, privileged documents are covered by Exemption 5, and records implicating personal private interests are covered by Exemption 6.

In addition, the SEC also uses Exemption 8 improperly, in my own view, to block FOIA requests. Section 929I provides the agency with a get-out-of-jail-free card, enabling it to invoke Exemption 3 without actually conducting a document-by-document review. Instead, the agency can bypass FOIA by simply labeling the requested documents as material obtained pursuant to its regulatory authority.

The SEC has not pointed to a single instance in which it has been denied the use of an existing FOIA exemption because of statutory language that is overly narrow. Both my own experience with the SEC and the findings contained in the report of the Inspector General suggest that the SEC is struggling with FOIA compliance not because of inadequacy of existing exemptions but because it does not have the resources it needs to collect and review materials as FOIA requires.

I respectfully submit that an evisceration of FOIA through 929I is neither necessary nor appropriate. The SEC should not receive

an agency pass from the Freedom of Information Act. Accordingly, Section 929I needs to be repealed in its entirety. The recommendation by Representative Issa, I agree with that. Let's repeal it, and if they need one, it can be done properly.

Thank you again for giving me this opportunity to testify, and I look forward to answering any questions that you may have.

[The prepared statement of Mr. Mintz can be found on page 88 of the appendix.]

The CHAIRMAN. Ms. Susan Merrill.

STATEMENT OF SUSAN L. MERRILL, PARTNER, BINGHAM McCUTCHEN LLP, ON BEHALF OF THE SECURITIES INDUSTRY AND FINANCIAL MARKETS ASSOCIATION (SIFMA)

Ms. MERRILL. Thank you, Chairman Frank, Ranking Member Bachus, and members of the committee. I am Susan Merrill, a partner in the Broker-Dealer Group of the law firm of Bingham McCutchen.

Prior to joining Bingham, I served as the Chief of Enforcement at FINRA, the Financial Industry Regulatory Authority; and prior to 2007, I served as the Chief of Enforcement at the New York Stock Exchange.

Thank you for the opportunity to testify today. I appear on behalf of SIFMA, the Securities Industry and Financial Markets Association, to provide an overview of the securities industry's position with respect to Section 929I of the newly enacted Dodd-Frank Wall Street Reform and Consumer Protection Act.

The securities industry has a strong interest in maintaining an open, cooperative, and efficient dialogue with the Securities and Exchange Commission in the course of SEC exams. Registered entities being examined understand that it is in no one's interest to hinder the Commission's ability to comprehensibly complete its work. However, the industry's practical ability to produce certain types of sensitive proprietary or confidential information to the SEC was, prior to the Dodd-Frank Act, significantly impeded by Federal laws governing the Commission's legal obligation to publicly disclose such information in certain circumstances, whether the SEC supported such disclosures or not.

Section 929I directly addresses these issues. We believe the practical effect of this provision will lead to greater trust, openness, and efficiency between regulators and the industry and ultimately to better protection for investors and stronger markets. It is for these reasons that we support the new law and oppose the efforts to remove it from the Wall Street Reform and Consumer Protection Act.

One logical question in response to the industry's concerns is wouldn't the type of information firms fear disclosing be protected under the FOIA exemptions? The answer is not necessarily. The FOIA exemptions are simply too imprecise to allay the industry's fears regarding public disclosure, and the issue runs deeper than mere semantics because it is this lack of clarity that impedes the flow of necessary information between firms and the SEC staff. And, similarly, it is the clarity provided by Section 929I that will foster open communication between the firms and the SEC.

But FOIA is not the only source of concern prior to the Dodd-Frank Act. Additional Federal laws obligate the Commission to dis-

close documents in its possession in response to third-party subpoenas. Information so produced generally enters the public domain upon production by the SEC. The FOIA exemption for trade secrets, confidential communication, and exam reports simply do not apply here.

The Commission is left to the uncertainties of the common law and to general litigation and discovery processes in seeking to protect from disclosure the most sensitive information it receives from regulated entities in the course of this exam. The fact that the FOIA exemptions do not apply to third-party subpoenas served upon the SEC is, in the industry's view, the most important consideration in weighing the interests served by Section 929I. Since 929I squarely addresses this issue, its provisions will function to foster a more open and cooperative dialogue between the securities industry and its regulators.

With no risk of compelled disclosure looming over the production of information, regulated entities are now able to produce all that people would likely agree the Commission should have access to without fear that the Commission will later be legally obligated to disclose it.

Section 929I effectively closes the third-party subpoena loophole that provides a path to compel public disclosure of confidential information even when the FOIA exemptions are met. There is a sound logic in Congress' recognition of the fact that there are certain types of sensitive information that one would not expect a financial institution to disclose to the public but which one would expect them to freely disclose to its regulator. Section 929I achieves this balance, and I urge the committee to leave it intact.

[The prepared statement of Ms. Merrill can be found on page 71 of the appendix.]

The CHAIRMAN. Thank you.

A couple of things to make clear. There is going to be legislation. The guidance that is going out, even if people thought it was perfect, doesn't suffice, because it can be undone. So it has to be statutory.

Mr. Blum, I did have some questions about the procedures. I think you may be looking for procedural solutions that—nothing is going to be a substitute for people reading. This particular issue has been in the public domain since 2008. It has passed the House unanimously.

As far as referring to the Committee on Government Reform, members of the Committee on Government Reform were members of the House-Senate Conference Committee on this. They had a month to look at it. Frankly, I think people looking at it in the abstract didn't fully understand it until the lawsuit. So I am not sure anything would suffice, and that is not something to be cured. Sometimes you don't understand what something means until in fact it gets put into effect. So I understand the perceiving of things, but procedurally this couldn't have been truer. It just took the lawsuit.

Mr. BLUM. Can I address that point?

The CHAIRMAN. Yes.

Mr. BLUM. It is true, under the procedures that we think would improve the situation, you might not find out that there's a concern—

The CHAIRMAN. Excuse me, I would take exception to slipped through. Nothing slipped through here. It was public.

Mr. BLUM. I appreciate that very much. But we see this happen very often where—

The CHAIRMAN. What exactly is your procedural solution to this?

Mr. BLUM. We think that there have been inadequate reviews of—

The CHAIRMAN. But what is your procedure, again? It has been out there in public. What is the procedural way to force the review?

Mr. BLUM. I think having a referral to the Committee on Oversight and Government Reform in the House would help and just do it routinely.

The CHAIRMAN. I would note that this was before them for a month, and it didn't—I'm not sure—as I said, they saw it. Nobody understood the implications of it until the parties in the lawsuit brought it to their attention.

Mr. BLUM. I think that when agencies propose these, they ought to go to the stakeholders. I don't know how many reporters saw this before it was introduced and there was a lawsuit; and, frankly, my job is to look for these things.

The CHAIRMAN. I have to say some responsibility, I thought, went on the media to cover the agencies that they are covering. There was never any secret about that. It was set up in public letters. We discussed it in hearings.

Mr. BLUM. Sure.

The CHAIRMAN. I am not sure how much we can spoon-feed the media. Nobody ever got in the way of the media covering this agency or this committee or this Congress.

Mr. BLUM. We are not asking for it to be spoon-fed. I think what we are asking is to have a fair hearing and adequate review for the impact on FOIA.

The CHAIRMAN. We have had hearings on this, and nobody noticed it until the lawsuit.

Mr. BLUM. And I think that the language actually evolved from the timeframe that you are talking about. I think the earlier versions were probably slightly narrower. Some of the really broad language didn't come in until June.

The CHAIRMAN. I am sorry. But the language that was in the final bill was there for over a month. It was in the public. And, in fact, it was in both bills adopted in the House and the Senate. So it didn't evolve.

Let me just ask one other question. What you have is this: And the one concern I think is on the third-party litigation. Congress passed—it was controversial—over the veto of Bill Clinton a limitation on the ability of plaintiffs to get discovery in corporate litigation. One question raised is, is this a way around that?

Now that was actually passed by Congress. I think it was the only bill passed over Bill Clinton's veto. And to get discovery in a private securities lawsuit you need to meet a certain standard. Does this become a way around that?

That is just a question that occurred to some of us as we were listening. Namely, if the SEC has subpoenaed—has gotten information for regulatory purposes and you are in a lawsuit and you might not be able to meet the standard of the Securities Litigation Act, is this a way for you to get discovery without meeting that standard? And, if so, is that something to be concerned about?

Any of the panelists?

Mr. PITT. The answer I think, Mr. Chairman, is yes. Without 929I, or something like it, litigants who have very different objectives would be able to get around some of the barriers on discovery. It doesn't mean that the precise wording of 929I is ideal, but it does mean that there is both the FOIA and the non-FOIA component, and both have to be addressed.

The CHAIRMAN. Let me go down the list on this. Is that any kind of a concern that—should anything that the SEC gets for its purposes—and I think there is some consensus here about the SEC not having it—but should anything the SEC gets from a private company be fully available to any litigant who has an issue with that company, who might not, in the absence of the SEC getting it, otherwise be able to get at it? Ms. Canterbury?

Ms. CANTERBURY. No, sir. I don't believe in every case. But I think our concern is for the whistleblower who comes to the Securities and Exchange Commission.

The CHAIRMAN. Okay. Let me stop you, please.

Fine, because that is what we have the advantage of in legislating, and that is a distinction we could make in the legislation. We could protect whistleblowers, but purely private disputants in a commercial dispute could be treated differently. I appreciate that distinction, and that would be very much the kind of thing we could look at.

Ms. CANTERBURY. Defrauded investors who cannot go to the Bernie Madoffs but have to go to the SEC to prove harm.

We are also concerned that the SEC is empowering itself to make a determination that should be made by the courts. I don't know of any other agency that has this kind of discretion—

The CHAIRMAN. Let me ask you this: If we were to leave it as it is, when a court was deciding whether or not to—

Let me ask you this, because I don't know the law here, and there are lawyers here who will.

I am a private company whose material has been taken by the SEC. Some litigant against me in a purely private dispute—not a whistleblower—seeks to get that information and subpoenas it from the SEC. Who has the ability to defend against this subpoena? Do I have a right to intervene and defend against a subpoena?

Ms. MERRILL. If you are given notice, if you receive timely notice.

Mr. MINTZ. The industry's concern is that the SEC oftentimes doesn't follow their own procedures and provide them with notice. But once they provide that confidential information, whether there is a FOIA request or a third-party request—

The CHAIRMAN. I am sorry. I tend to ask very specific questions, and I would appreciate very specific answers. So now the answer is apparently—and please don't assume I know more than I know. The answer is that if I have gotten notice from the SEC that some-

one in a subpoena is seeking my private information, I have the right to go to court to defend against this subpoena?

Mr. MINTZ. I can appear in Federal court, make a motion to protect my—

The CHAIRMAN. "Yes" would handle that.

Mr. MINTZ. "Yes."

The CHAIRMAN. But you are telling me that the problem is that the SEC may have been lax in giving the notice?

Mr. MINTZ. That is what the industry is telling me as we sit here today.

Ms. MERRILL. I think that the issue is that, if you receive timely notice that your documents have been subject to such a subpoena, then you do have the opportunity.

The CHAIRMAN. All right. Again, these things get complicated. One thing you could do would be to say that subpoena couldn't be enforced until you got notice and time to respond. That would take care of that. So you do have the ability.

Now the question that I have for everybody is this—again, these are questions I don't know the answer to. If I am given notice and have a chance to go in and defend, is the standard that I use to prevent them from getting this the same as in the Securities Litigation Act or would there be a lower standard? Mr. Mintz.

Mr. MINTZ. I can't speak specifically to the Securities Litigation Act, but I can tell you that if a third party is seeking to protect its own proprietary information, it is going to be a common law privilege. And if it is—

The CHAIRMAN. We are beyond that. A statute was passed over Bill Clinton's veto—it was taken very seriously—which raised the level of the predicate you need before you get into this. And it would seem to me we would be undermining that if people like it. Some people didn't like it. Bill Clinton vetoed it. Some people thought it was a terrible idea. I do not think it has the negative consequences others have said, but there it is.

Would there be an objection if we did this to saying that, in those cases where we are dealing with third-party commercial litigation, the standard for enforcing a subpoena would be the same as the Securities Litigation Act? And if you are not familiar with it off the top of your head, if you would get back to us.

Again, in fact, it is easier to say "yes" or "no," but that is how we get in trouble, and that is why we need to do this. To me, that is the one, frankly, sticking point.

We don't want—I keep talking about all my legal ignorance, I will show my legal knowledge with some Latin here—sub silentio to amend the Securities Litigation Act. So if all of you would address that issue, the question would be—and I think they should go to meet some of the concerns that people had.

If your proprietary information, given to the SEC for its purposes, was the subject of a subpoena by a litigant against you, do we resolve this in part by saying, okay, first of all, the subpoena can't be enforced until you have been given notice by the SEC; and, secondly, the standard which you can use to defend is the same as the one we set in the Securities Litigation Act? Yes, Ms. Merrill?

Ms. MERRILL. If I may, I don't think that simply allowing the entity that is being regulated by the SEC, a securities industry reg-

istrant, to go to court and defend at all addresses the problem and the reason that the SEC sought this legislation to begin with. I will give you an example.

This legislation is trying to allow the SEC to take what it gets while it is in an exam mode and protect it from anyone having to 3 years down the line go into court and make those arguments. And here is why:

If you are sitting with an examiner and the examiner says, please show us everything we need to understand how you trade and hedge your global book across five entities in five different jurisdictions—which is what many global firms do. They pass the book as it trades. And as one market closes and it trades in Tokyo and then the sun comes up somewhere else and they trade it to another foreign affiliate—and the entity, the securities entity that is regulated in the United States says, I would show you all of this in order for you to understand our entire global strategy so that you can make a decision about the systemic risk that you are looking into, but I would rather not because I don't know if what I am going to show you is going to end up being protected 2 years, 3 years down the line when some magistrate or judge decides whether or not they think it should be protected. And so they simply will say, I would rather not show you that.

And that is an example of where the SEC's enforcement proceedings and powers do not reach.

The CHAIRMAN. If that were true, we might empower the SEC to do more. What I am suggesting is that we tell that entity, but here is that standard. That is, at any point, no one—and that is why I am suggesting that might mediate that conflict—no one would be able to get that information unless they could independently have gotten it under the bar set by the Securities Litigation Act, that they could show that there was some basis for this and it couldn't purely be a fishing expedition. Mr. Mintz?

Mr. MINTZ. The only point I would add is, if the final decision is being made by a court as opposed to the agency itself, then I think we have something that is—

The CHAIRMAN. Then the question is, what is the standard by which the court does it? And I do think there is a problem. And we could carve out whistleblowers. I think we had some good whistleblower stuff in the bill in general, and we were very sympathetic to that. But that is the one area—and, again, I am hoping that we do something by the end of next week. Yes, Ms. Canterbury?

Ms. CANTERBURY. I am just concerned that there is not really a problem here to fix. We have not seen one example of proprietary information provided in this setting, so is there really a problem?

The CHAIRMAN. Maybe not. But I don't know that we should not try to anticipate one. And if what we are talking about doesn't do any harm, I don't understand why we wouldn't try to do it. We don't always want to be reactive.

I take it back. What the SEC tells us is the harm is this, not that proprietary information has been so much released but that they have had a greater degree of resistance to doing it.

Yes, Ms. Merrill?

Ms. MERRILL. That is what I was going to say. I think that the issue is that there is not now a free and open relationship between

the regulated and the regulator. And if you want that to grow so that the SEC, in its exam provisions, can actually understand what these firms are doing and do what it needs to do to regulate the systemic risk in the system, then you have to give them the tools to let them have that relationship.

The CHAIRMAN. I am sympathetic to the issue. But I think your overall argument—the notion that we will reach a point where there will be that harmonious relationship between the regulator and regulated brings to mind Woody Allen's paraphrase of the old hope, "The lion may lay down with the lamb, but the lamb won't get much sleep."

The likelihood of reaching—I can see where you might diminish the resistance. But an open, cooperative—look, let's be clear, too. We are not talking about the average company. The SEC doesn't—I hope—randomly go out and decide to get all this information. They are generally doing that where there is some reason to think that something wasn't so hot. So the notion—

Ms. MERRILL. That is not true of the exam content.

The CHAIRMAN. I am sorry. I have not finished yet.

Again, I think you have given me an ideological—let me put it this way: The notion that we are going to have this wonderful voluntary cooperation between the regulator and the regulated is not I think the model that we want to legislate to.

Yes, Mr. Pitt?

Mr. PITT. Let me first say there are examples, many of which can't be identified publicly, but there are examples where proprietary data has not only been sought but received. But the specific problem—

The CHAIRMAN. Sought by a private party?

Mr. PITT. By a private party, yes. After the Madoff problem, one of the things that has happened now in SEC investigations is that these investigations now take months and months and months. And because the staff is concerned about missing anything—which they should be—they now demand far more paper and far more documentation than is necessary for the traditional kind of an examination. I am not saying that is improper. I am just saying this is now a fact of life.

We work with a lot of entities that produce volumes and volumes of material that the SEC usually doesn't need. But once the SEC has it, it doesn't want to give that information up. And there are sound policy reasons why it shouldn't. I believe that this committee, if it is going to adjust this provision, should look at who is making the request and what the purpose is.

People have mentioned whistleblowers. I don't see that as being a proper subject of 929I, but I do believe that if it is one private competitor trying to take advantage of another competitor's investigation or examination by the SEC, then there ought to be clear enough protection.

The CHAIRMAN. I am trying to get something done here. Let me ask this, conceptually—and I would I guess, Ms. Canterbury, Mr. Blum, Mr. Mintz, is anyone arguing that anything the SEC gets ought to be available to a private party simply because the SEC had it? Does anybody advance that argument?

Ms. CANTERBURY. No.

The CHAIRMAN. Okay. And I appreciate that. I didn't think so, but it is good.

So then the question is—it doesn't mean—that is the problem with a simple repeal. The question is, what could we put in there? What are the legitimate barriers that ought to be exerted if we all agree that not everything the SEC gets should go to everybody else?

I think whistleblowers will be exempted. They get the free ride.

The next cut for me is—the Congress has already litigated with the Securities Litigation Act which sets this barrier, and that would be one conceivable barrier to look at it, which is to say that a private party has to meet the same requirements—a litigant, a competitive litigant. And you could also separate out shareholders. There are different categories. There are whistleblowers, there are shareholders, and legitimate shareholders and competitors.

I don't expect to get those all resolved now. I would invite any of you, we have about a week to think about it. This helps me. This makes progress as we conceptualize it. There is going to be legislation. The Senate is moving, and there is a great deal of public demand. So there is going to be legislation.

And I think there is consensus in a number of areas. The SEC has already conceded it should not be itself able to defend. That will be clear. And they have already, as you know, Mr. Mintz, waived any notion of invoking it in the lawsuit that you are doing, whistleblowers.

But then when we get to other categories there is a question about what different level should you have to meet if you are a private litigant to get information the SEC got and by what category? And anybody who has any suggestions on that, we would be glad to listen.

Is there anything further the witnesses want to say?

Ms. MERRILL. I think at a minimum, you would want to extend the FOIA exemptions to the private litigation field so that third-party litigants would not be able to get information that is protected if it were asked for under a FOIA request.

Ms. CANTERBURY. I believe that there are currently standards for a weighing privilege that are very different from FOIA and it involves a judge gauging the public interest versus the private interest. And that is a completely different ball game.

The CHAIRMAN. I would invite both of to you submit further conversation.

Again, there needs to be some limits. But I would say as well, when you are going into court, you have to go, FOIA or this or that. We can mix and match and take one from column A and one from column B.

So, yes, I think everybody would agree. There have to be some standards that differentiate—let's put it this way. I think there is consensus. There is information we want the SEC to be able to get fairly freely, although—we want to diminish resistance to the SEC reaching broadly for information by giving some degree of protection to the proprietary information, absent some showing of wrongdoing, etc., or some other thing. And if you will help us with that, I think we may be able to greatly advance this.

Mr. PITT. Would it be useful if we submitted something to you in writing?

The CHAIRMAN. Yes, it would be.

And, Mr. Blum, if you will give us your phone number, we will call you every time we have an amendment.

Mr. BLUM. I wasn't looking for special treatment.

The CHAIRMAN. I am sorry. I thought you were when you said to "notify the stakeholders." If you talk about notifying the stakeholders, that is special treatment for the stakeholders, as opposed to simply making it public.

Mr. BLUM. I would hope that by the end of next week, there would be clear differentiation between dealing with the third-party issue separately from the FOIA issue and that in that process, there is some way to draw that clear line.

The CHAIRMAN. I thought that is what I was talking about. Yes?

Mr. BLUM. But I think 929I puts the two together. And I think that there has to be some clear line—

The CHAIRMAN. I understand that. We are going to amend it. We are going to change it. We are going to change the law.

Mr. BLUM. Okay. But I hope that there is some way—a clear line to immunize whatever comes out of this from allowing the SEC to avoid embarrassment.

The CHAIRMAN. Mr. Blum, I will ask you, have you not been here for the last 3 hours? I am offended by that question because—I am sorry. Please listen, and I will listen to you—it is so clearly contrary to the subject of the conversation we have been trying to have. It is tendentious for a reason I don't understand.

First of all, we have been making it very clear that the SEC itself will not be involved, that they won't be able to use it. We are talking solely about protecting third-party proprietary information. I thought we were clear, and I am frankly disappointed, I should say, by the tone of the question.

Now go ahead.

Mr. BLUM. Let me refrain—you have been a clear champion of transparency by having the open committee process and by doing many things to make this a more open process, and we appreciate that very much. At the same time, I just want it to be clear that, by way of example, if the SEC is investigating something or is cooperating, and writes a supervisory letter, a year later if no action has been taken, say—say the SEC doesn't like the formula that a credit rating agency uses and suggests changes. Will the public see that supervisory letter? So it is not a third party—

The CHAIRMAN. Mr. Blum, nothing in what we have been talking about suggests that would be protected. Is a supervisory letter like that third-party proprietary information? Excuse me, Mr. Blum. I will listen after I have made this clear. But we have been very clear that we are talking solely about proprietary information from a registrant which the SEC gets. How could you possibly confuse that with a supervisory letter? And I will be glad to listen.

Mr. BLUM. The point is well taken.

The CHAIRMAN. I thank you.

And, yes, I do invite—and, by the way, some of you might be more inclined to write statutory language. Some can do it, conceptually in English or whatever.

But I am serious. I don't expect everybody to agree to everything. I think we have a great deal of agreement. And I say this, but it is in everybody's interest because if there is any significant controversy, our chances of getting this done by the end of the month diminish. And it still has to go to a President who will be listening to the SEC. So if you can help us along these lines of dealing with protecting the whistleblower function. The SEC is completely unprotected, the whistleblower is completely protected, and third-party proprietary information somewhere along that spectrum, that is where we want to go.

I thank the witnesses. This has been very useful for me.

Ms. CANTERBURY. Thank you.

Mr. PITT. Thank you.

[Whereupon, at 1:05 p.m., the hearing was adjourned.]

A P P E N D I X

September 16, 2010

Ron Paul

US House of Representatives
Committee on Financial Services
Congressman Ron Paul
SEC Confidentiality Hearing
September 16, 2010

Mr. Chairman,

Thank you for holding this hearing. The topic of the SEC's new confidentiality procedures is an important one. The revelation that language had been inserted into the Dodd-Frank bill giving the SEC great exemptions from the Freedom of Information Act was shocking, but unfortunately not surprising. In a conference report that is 2300 pages long and rushed through Congress there is an incredible opportunity for slipping in all sorts of objectionable legislative language that will not be noticed until someone is negatively affected. It would not surprise me if Dodd-Frank contained other surprises that might crop up in the future.

While defenders of the SEC might point to certain trade secrets or proprietary information that the SEC might have access to which should not be publicized, no one ever questions why the SEC has access to that information in the first place and what use it might possibly be. Given the SEC's shoddy performance as a regulatory agency, we should not be seeking to give it more power, more funding, or more exemptions from oversight, but instead should be focused on shutting it down. In the Madoff and Stanford cases the SEC repeatedly ignored information from concerned parties over the course of many years, allowing these fraudulent schemes to operate with an implicit imprimatur.

To reward a failed regulatory agency by changing legislative language to make them even less transparent is unconscionable. I am one of a number of members who have introduced legislation to repeal the new language and keep the SEC transparent, and it is my hope that the Financial Services Committee seriously considers these legislative proposals this fall.

Statement of Hon. Edolphus Towns
Chairman, Committee on Oversight and Government Reform
September 16, 2010

Thank you Chairman Frank, Ranking Member Bachus, Members, and staff of the Committee on Financial Services for inviting me here today.

The landmark Dodd-Frank Wall Street Reform and Consumer Protection Act made significant improvements to the accountability and transparency of our nation's financial system. The Act gives consumers access to more information about investments and it reigns in the abusive and excessive practices of Wall Street.

Passing the Dodd-Frank Act was an important achievement. But our work in Congress did not end when the bill was passed. It is critical that we exercise vigilant oversight of implementation and that we act to close loopholes when they are identified. To that end, I applaud you Chairman Frank for your willingness to hold this hearing to examine a significant loophole that I believe undermines the core purposes of the Dodd-Frank Act.

Section 929I of the Act would allow the SEC to avoid disclosing information the Commission receives during examinations of companies if the information is used for "surveillance, risk assessments, or other regulatory and oversight activities." This language is too broad. It allows the SEC to keep secret virtually any information it obtains under its examination authority.

SEC Chairman Mary Schapiro has asserted that the Commission will only use section 929I as intended. But the SEC has already indicated its willingness to exploit this loophole. In an action the SEC brought against a broker-dealer, the Commission tried to use section 929I to avoid an Administrative Law Judge's order to comply with a subpoena. That clearly goes beyond the intent of the provision and the SEC's reasons for needing the provision.

Chairman Schapiro yesterday issued guidance that places limits on the Commission's use of section 929I. This is a step in the right direction. But the Chairman's guidance is not sufficient because the Commission can change its interpretation at any time and the fact that guidance is

needed at all is evidence itself that this provision is too broad and subject to abuse.

The SEC's rationale for section 929I is that the provision is necessary to ensure that the Commission can obtain sensitive information when the Commission is performing examinations.

Prior to Dodd-Frank, the SEC relied on an existing exemption under the Freedom of Information Act (FOIA) to protect information obtained under its exam authority. Exemption 8 protects matters that are "contained in or related to examination, operating, or condition reports prepared by, on behalf of, or for the use of an agency responsible for the regulation or supervision of financial institutions." The SEC has expressed concern that the new entities it is responsible for regulating under the Dodd-Frank Act, such as private equity funds might not be considered by the courts to be "financial institutions" under Exemption 8.

I introduced H.R. 6086 on August 10, 2010. H.R. 6086 repeals the secrecy provisions of section 929I and amends the Securities and Exchange Act to clarify that any entity the SEC regulates under the Securities Exchange Act will be considered a "financial institution" for purposes of FOIA Exemption 8. My bill strikes a careful balance to address the SEC's concerns without compromising the goals of transparency and accountability that are at the heart of the Dodd-Frank Act.

In a letter supporting H.R. 6086, a coalition of 36 public interest organizations including groups such as the Project on Government Oversight, the Sunlight Foundation, and openthegovernment.org wrote "[t]his bill sends a clear message that public access is vital to accountability." I am submitting a copy of that letter for the record.

The culture of accountability must start at the top. Allowing the SEC to operate in the darkness of secrecy will undermine the confidence of consumers and regulated companies.

In conversations with my staff, the SEC has indicated that legislation as broad as 929I is not necessary and that legislation similar to my bill but with a few additional provisions would meet its needs. I look forward to continuing to work with the SEC on legislation as well as with

Chairman Frank and the members of this Committee so that we can quickly and effectively address this issue.

Thank you again Chairman Frank and Members of the Committee for holding this hearing and for the opportunity to testify.

Testimony of

Rick Blum

on behalf of

The Sunshine in Government Initiative

Before the
Committee on Financial Services
U.S. House of Representatives

Regarding

Legislative Proposals to Address Concerns Over
the SEC's New Confidentiality Provision

September 16, 2010

Chairman Frank, Ranking Member Bachus, and Members of the Committee,

I am grateful for the opportunity to testify today. I especially want to thank you, Mr. Chairman, for taking the time to hold this hearing to air concerns about Section 929I of the Dodd-Frank Wall Street Reform and Consumer Protection Act (PL 111-203, 124 Stat. 1376, hereafter ("Dodd-Frank").

Simply put, our concern is that under Sec. 929I as it is currently written in the law, journalists and the public will have an even harder time knowing how well (or poorly) the Securities and Exchange Commission (SEC) is doing its job.

About the Sunshine in Government Initiative
I testify today on behalf of the **Sunshine in Government Initiative (SGI)**, a coalition of media associations promoting policies and practices of transparency in the federal government. Members include the **American Society of News Editors**, **Associated Press**, **Association of Alternative Newsweeklies**, **National Association of Broadcasters**, **National Newspaper Association**, **Radio-Television Digital News Association**, **Reporters Committee for Freedom of the Press**, and **Society of Professional Journalists**.

Our members work tirelessly to strengthen the federal Freedom of Information Act (FOIA). From disaster response to food safety to federal spending, democracy lives on the free flow of information. As part of our open government promotion, SGI hosts an online database of news and other stories that relied on FOIA to inform the public. We have over 500 stories in our files which demonstrate FOIA's contribution to democracy, with more coming weekly.

We recognize there are reasons for keeping some information confidential, to protect national security, legitimate trade secrets and law enforcement investigations to name a few. We simply believe that the exemptions to FOIA must be narrow in scope and enacted only after careful consideration. To that end, a significant aspect of our work involves finding and deterring overbroad or unnecessary exemptions written elsewhere into federal law. One of the biggest violators, in terms of overbroad FOIA exemptions, are the laws known as Exemption 3, or "(b)(3)" statutes for the subsection of FOIA that acknowledges them. We have counted over 250 of these, many of which are entirely unnecessary in nature. Sec. 929I of the Dodd-Frank Wall Street Reform and Consumer Protection Act is *just one* of these (b)(3) exemptions.

Before I continue, however, let me be clear: We do not believe this Committee or the SEC was actively concealing the existence of this provision. We understand the SEC wants to protect its ability to gather information and effectively oversee the banks, hedge funds, private equity firms and other financial firms that operate under its authority. Journalists also need to observe and report how effectively the SEC is doing its job, especially when the answer is "not very well at all."

I would like to use my time to highlight four points.

First, the statute as written is facially broad and subject to interpretation.

Second, Sec. 929I's flaws can be remedied only by an act of Congress that clarifies and narrows the statute's scope.

Third, the approaches taken by legislation pending before Congress to fix Section 929I would be better than additional study while Sec. 929I stands.

Fourth, Congress, with the leadership of this and other committees, can help strengthen review of proposed statutory exemptions from FOIA disclosure.

Section 929I is overbroad and should be rewritten

To begin, Sec. 929I is overbroad and should be rewritten.

Chairman Shapiro has noted that Sec. 929I is meant to let the SEC "quickly obtain important information from entities registered with the SEC when performing examinations."

As you are well aware, at its broadest Sec. 929I allows the SEC to withhold records or information provided to the Commission, or information *"based upon or derived from"* such information, in furtherance of the SEC's "regulatory or oversight activities" which may or may not involve risk assessments and surveillance activities.[1]

That is a far broader exemption than the SEC describes in its explanatory letter to this committee.

First, "other regulatory and oversight activities" arguably includes all the Commission's official business, including its approach to oversight, number of open and closed investigations, and other information revealing little about specific trades, trading algorithms, or other information held by hedge funds or investment companies.

Second, Sec. 929I notes examples of the types of information the Commission may withhold but does not clarify the limits of the exemption with examples of what the SEC must still disclose.

Third, the statute gives too much discretion to the SEC to decide what should be disclosed or withheld. This is a key factor the courts look at in determining whether a particular statute qualifies as an Exemption 3 statute under the tests provided in Subsection (b)(3)(A) of FOIA.[2]

Fourth, a narrower provision would provide greater clarity and help avoid unnecessary litigation. One court has already ruled the statute upon which Section 929I is based to be too vague to qualify as a (b)(3) statute.[3] In that case the SEC chose to disclose some documents but withhold similar information. Section 929I is similar: It is a broadly worded statute and it would be subject to the interpretation and discretion of the SEC to decide what to withhold. Further, one news story strongly indicates further litigation on Sec. 929I is likely.[4]

Fifth, while the SEC indicates cooperation is the goal, the result may be quite the opposite. Noting that the law is vague and SEC's implementation is unclear, one firm already recommends that companies stamp "confidential" on documents they previously would have turned over freely.[5]

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[1] Sec. 929I(a), Sec. 929(b) and Sec. 929(c), which refer to the Securities and Exchange Act of 1934 (15 U.S.C. 78x), Investment Company Act of 1940 (14 U.S.C. 80a- 30) and Section 204 of the Investment Advisers Act of 1940, respectively. The phrasing is identical in each subsection.

[2] Long v. IRS 742 F. 2d 1173, 1179 (9th Cir. 1984).

[3] Aguirre v. SEC, 551 F. Supp. 2d 33 - (Dist Court. 2008) (ruling "[b]ecause the Investment Advisers Act gives the SEC unfettered discretion … as to what it can withhold, it cannot qualify as an Exemption 3 statute").

[4] Dunstan Prial, "SEC Says New Financial Regulation Law Exempts it from Public Disclosure," Fox Business, July 28, 2010. Available at: http://www.foxbusiness.com/markets/2010/07/28/sec-says-new-finreg-law-exempts-public-disclosure/. Accessed September 14, 2010.

[5] Kevin J. Harnisch, Paul H. Pashkoff, Michael A. Umayam and Brian T. Sumner, Fried Frank Harris, Schriver & Jacobson LLP, "Deciphering the Dodd-Frank FOIA Flap," August 18, 2010. Available at http://www.lexology.com/library/detail.aspx?g=db9436ba-6cb3-46c6-8b3a-70fcbaa2dbba; accessed August 19, 2010. They write:

> As a matter of practice, regulated entities should expressly identify document productions made pursuant to Section 17(b) of the Exchange Act, Section 204 of the Advisers Act, or Section 31 of the Investment Company Act. As noted above, the protection from public disclosure offered by

Previous efforts to carve out a FOIA exemption to induce cooperation and information sharing with the private sector have not worked. In the wake of 9/11 Congress passed a sweeping exemption from FOIA disclosure for information about the nation's critical infrastructure to encourage the government and private sector to share information and collaborate. It turns out the exemption for Critical Infrastructure Information was seldom invoked.[6] Earlier this year, the Government Accountability Office concluded that to this day, the private sector remains reluctant to share information with the government, hampering security efforts.[7]

Further, the courts are unlikely to help close the gap between narrow intent and broad implementation. Of 140 lawsuits involving Exemption 3, courts ruled for the agency 80 percent of the time, according to one analysis.[8]

For these reasons, we believe Sec. 929I is overbroad and should be rewritten. Let me turn to my second point to note why Congress should act.

Only Congress can remedy Section 929I's flaws.

Only an act of Congress can remedy Sec. 929I's flaws.

Before creating new legislation granting exemptions to disclosure, Congress and the SEC should carefully consider alternatives to secrecy to achieve the Commission's purpose. The SEC could use existing authorities more aggressively to ensure it has the information it needs, but the opportunity for abuse still exists.

Despite assurances from Chairman Shapiro that the law will be applied sparingly, we remain deeply skeptical that the SEC's plan to issue guidance to staff can fix this problem.[9] Even the most disclosure-friendly guidance is not sufficient to address this problem. We have seen agencies interpret statutory exemptions to FOIA as broadly as they see fit when they have discretion.

> Section 929I applies to documents provided to the Commission pursuant to the Examination and Surveillance Statutes. *In practice, however, the specific statutory justification underlying the Commission's request for documents or an entity's production of documents is not always clear. Unless and until Commission guidance dictates a specific procedure, regulated entities producing documents to the Commission should identify all situations where Section 929I appears to apply and submit a written cover letter, together with the documents, expressly referencing the relevant statute and claiming confidential treatment.* (emphasis added)

[6] " DHS Should Take Steps to Encourage More Widespread Use of Its Program to Protect and Share Critical Infrastructure Information," *Government Accountability Office,* GAO-06-383 (April 17, 2006).
[7] "Key Private and Public Cyber Expectations Need to be Consistently Addressed," *Government Accountability Office*, GAO-10-628 (July 2010).
[8] Catherine J. Cameron. 2009. "Fixing FOIA: Pushing Congress to Amend FOIA Section b(3) to Require Congress to Explicitly Indicate an Intent to Exempt Records from FOIA in New Legislation" ExpressO Available at: http://works.bepress.com/catherine_cameron/1; accessed September 10, 2010.
[9] Letter from Mary Shapiro, Chairman, U.S. Securities and Exchange Commission to Chairman Barney Frank, Committee on Financial Services, U.S. House of Representatives, July 30, 2010.

- After the widely publicized landing of a passenger jet in the Hudson River in January 2009, the Federal Aviation Administration argued that its database showing bird strikes on airplanes should be withheld under an exemption that allows the FAA administrator to deny a FOIA request if disclosure would harm aviation safety and security.[10] But disclosing that data set would not increase the likelihood that birds would fly into airplanes, but it might help pilots avoid flying into flocks of birds. Eventually, the Secretary of Transportation intervened and the data were released.

- One statute (41 USC 253b(m)) exempts losing contract bids from disclosure. Access to losing bids would help the public know if the winning contracts were the best possible deals for taxpayers. When first added to the National Defense Authorization Act in 1997, it only applied to the Department of Defense but through the legislative process it was broadened to apply to all agencies.[11] By 2009, 14 cabinet departments and 7 independent agencies reported using this exemption to deny 267 FOIA requests.[12]

I could go on, but the lesson is clear: When Congress writes broad exemptions, the government broadly uses them. The time to ensure that the government makes only narrow exceptions to disclosure is when Congress creates the exceptions.

I'll reiterate: <u>it is not too late to fix this problem</u>. I'd like to turn now to what this Committee and others in Congress can do to help prevent this problem from growing worse than it already is.

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[10] The FAA proposed that information in the Wildlife Hazard Database be exempt from disclosure under FOIA (*Federal Register*, Vol. 74, No. 52, Mar. 19, 2009). The Wildlife Hazard Database includes information regarding encounters between aircraft and birds and other wildlife in the air and on the ground. The FAA proposed that this database be protected under the authority of 49 U.S.C. § 40123, which allows the FAA to withhold voluntarily provided information if the FAA Administrator determines that

> (1) the disclosure of the information would inhibit the voluntary provision of that type of information and that the receipt of that type of information aids in fulfilling the Administrator's safety and security responsibilities; and
>
> (2) withholding such information from disclosure would be consistent with the Administrator's safety and security responsibilities. (49 U.S.C. § 40123)

[11] See Kirsten B. Mitchell, "Open Records Audit: Agencies find a path around data disclosure," Sarasota Herald-Tribune, March 16, 2008. Available at http://www.heraldtribune.com/article/20080316/NEWS/803160786; accessed September 3, 2010.

[12] The year 2009 refers to the federal fiscal year 2009, which began October 1, 2008. This information was compiled from agency annual FOIA reports. The fourteen departments are Agriculture, Commerce, Defense, Energy, Education, Health and Human Services, Homeland Security, Housing and Urban Development, Interior, Justice, State, Transportation, Treasury and Veterans Affairs. The seven independent agencies are the Agency for International Development, Environmental Protection Agency, General Services Administration, National Science Foundation, Nuclear Regulatory Commission, Securities and Exchange Commission, and Tennessee Valley Authority.

Legislative Solutions

Dodd-Frank expanded the SEC's authority to include many new entities. It is unclear how the SEC will approach its new responsibilities and how well the Commission will do its job. Reporters want to ask these questions and provide answers.

We suggest that any statute exempting information from disclosure under FOIA include certain elements. Once a specific, articulable need for an exemption has been expressed, any statute under Exemption 3 of FOIA should include the following elements:

- **A time limit after which disclosure is appropriate.**
- **A sunset**. There should be a fixed ending period.
- **Limited scope.** Limits on what information is disclosed should be clear.
- **An assessment.** An independent entity such as the inspector general should examine the impact on transparency and the SEC's ability to obtain cooperation from regulated entities,
- **Clear criteria or no discretion to decide what to withhold.** Congress should determine what information is exempt, not the Commission.
- **Protections for whistleblowers.**

Legislation currently pending before Congress to resolve this dispute either would repeal Sec. 929I and revert to previous law, or would allow the SEC and the firms it regulates to use FOIA's categorical exemption for "financial institutions" (Exemption 8).

Simple repeal of Sec. 929I would be welcome. I suspect we would only see renewed efforts to shield this information, either through the courts or Congress. The SEC could more publicly identify specific information it seeks to keep confidential, and the specific reasons and context (such as court decisions) preventing it from protecting that information.

Congress could apply FOIA's Exemption 8 to the financial firms now subject to SEC oversight. FOIA's Exemption 8 protects matters

> contained in or related to examination, operating, or condition reports prepared by, on behalf of, or for the use of an agency responsible for the regulation or supervision of financial institutions. 5 U.S.C. 552(b)(8)

A central purpose of this exemption is to promote the economic stability of banks given taxpayer dollars are at stake and to preserve the relationship between the government and banks to encourage information sharing.[13]

Exemption 8 has its flaws. Chiefly, it is broad.[14] But at least we have a history of using this exemption, and this approach avoids enacting broad ad hoc exemptions allowing the SEC to withhold unknown types of information.

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[13] Consumers Union of the United States v. Heimann, 589 F .2d (D.C. Cir. 1978) at 534, as quoted in *Guide to the Freedom of Information Act*, Office of Information Policy, U.S. Department of Justice (2009), p. 661.

Credit unions may be a model for limiting Exemption 8. Congress mandated full disclosure of inspector general reports whenever credit unions fail. Whenever a credit union failure triggers a payout from the federal depository insurance fund, the inspector general of the National Credit Union Administration writes a report, makes that report public, and may not use Exemption 8 to justify withhold any of the report.[15]

The Commission has also sought to avoid responding to third-party subpoenas. This issue is bound with other concerns and interests having little to do with public disclosure under FOIA, and should not be conflated with the FOIA issue.

Third party subpoenas may yield important information to help parties in a lawsuit, or help disclose wrongdoing. Yet the courts and judicial mandates for disclosure should not be abused to gain intelligence about competitors or potential business partners for private advantage. Given their complexities and differences, the FOIA and third-party subpoenas issues should be dealt with separately.

Congress should strengthen the review of Exemption 3 statutes.

I want to use my remaining testimony to note one reason this hearing is being held today. This controversy arose because the process that Congress uses for proposing statutory exemptions to FOIA is flawed, leading to imprecise, overbroad, redundant, and ill-considered federal legislation. The plain fact is, there is no process. Some of these proposals become laws that trim FOIA with a butcher knife rather than a scalpel. This committee fell victim, in a sense, to this weakness.

As I mentioned earlier, we have identified over 250 different Exemption 3 statutes to deny FOIA requests. Sometimes the purpose of these exemptions is clear, such as to protect sources and methods of intelligence gathering (50 U.S.C. § 402). Other times the purpose seems to be special interest, not public interest. Federal statutes protect the identities of honeybee handlers (7 U.S.C. § 4608(g)), watermelon growers (7 U.S.C. § 4908(c)), and the National Death Index. (42 U.S.C. § 242m(d))

Often these proposals become public when it is too late for users of the information to have a seat at the discussion table. For instance, during the conference committee debate over the 2008 "farm bill" reauthorization, a provision was "airdropped" into the final text that exempted from disclosure certain geographic descriptions of farmlands that USDA required farmers to submit to participate in USDA programs.[16] The provision appeared in neither version of the bill that passed the House and Senate, and no one mentioned this

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[14] Given we are operating under a new era of financial reform, it may be worth examining changes to Exemption 8, but only after careful study and long after fixing Section 929I.

[15] 12 U.S.C. 1790 (Section 216(j)) of the National Federal Credit Union Act as amended by Sec. 988 of Dodd-Frank).

[16] Section 1619 of H.R. 6124, the Food, Conservation, and Energy Act of 2008

change to the users who depend on bulk access to the data.[17] They are now urging changes when Congress reauthorizes the farm bill in 2013.

Congress and the executive branch can take modest but vital steps to reduce these overbroad and often unnecessary exemptions. Specifically, Congress could:

- Enforce the OPEN FOIA Act of 2009. All exemptions from disclosure of government records must cite to FOIA section (b)(3). Sec. 929I did, in fact, specifically mention FOIA's section (b)(3).

- Promote early disclosure. Require disclosure of Exemption 3 proposals in searchable form online at the time of *introduction* of any bill or amendment creating an exemption to FOIA, similar to the practices of earmark disclosures.

- Routinely use committee referrals. Any proposed (b)(3) exemption should be referred to the committee with jurisdiction over FOIA (Oversight and Government Reform, Subcommittee on Information Policy, Census & National Archives) and to the committee with subject matter jurisdiction (e.g., transportation records/transportation committee).

- Conduct a "need assessment" for all proposed (b)(3) exemptions.

- Closely scrutinize *every* proposed exemption from disclosure. Notwithstanding the OPEN FOIA Act of 2009, some bill previsions requiring confidentiality of records or information may not specifically be *labeled* as (b)(3) exemptions.

We are confident these steps are feasible and can avoid needless litigation and congressional controversy while reinforcing our democracy's promise that the public should be able to know what the government is up to.

Conclusion

Journalists tell us they are chiefly concerned that the language in Sec. 929I is broader than the SEC says it needs. Experience shows us that once granted, the power to withhold information will be used. Only an act of Congress to rewrite the law will fix this problem.

Congress can also take several modest steps to ensure that the public is appropriately notified any time these statutory exemptions from FOIA are proposed. When they are

[17] AgriData, Inc., "Changes needed in Section 1619 of the 1008 Farm Bill," August 28, 2008. Available at http://www.agridatainc.com/farmbill08/AgridataIncPositionPaper.pdf, accessed September 3, 2010 ("Restrictions upon the release of USDA geospatial data that were included in Section 1619 of the 2008 Farm Bill have resulted in a negative impact upon agricultural professionals, producers, landowners and others who utilize Common Land Unit (CLU) data (field borders) in their professions on a regular basis. A technical corrections bill or an amendment is needed to change Section 1619 to restore public access to CLU data.")

proposed, Congress can ensure they receive proper review for their impact on transparency.

We appreciate the opportunity to testify today on this important matter and would be happy to take your questions.

Thank you.

Testimony of
Angela Canterbury, Director of Public Policy
Project On Government Oversight
before the House Committee on Financial Services
on "Legislative Proposals to Address Concerns Over the SEC's New Confidentiality Provision"
September 16, 2010

Chairman Frank, Ranking Member Bachus, and Members of the Committee, thank you for inviting me to testify today. I am the Director of Public Policy at the Project On Government Oversight (POGO). Founded in 1981, POGO is an independent nonprofit that investigates and exposes corruption and other misconduct in order to achieve a more effective, accountable, open, and ethical federal government.

POGO has a keen interest in ensuring that the public has a way of holding our nation's financial regulatory agencies accountable for protecting the interests of taxpayers, investors, and consumers. The Freedom of Information Act (FOIA) is just such a tool, and is not only a cornerstone for open government but also a hallmark of our democracy. This is why we are deeply concerned about Section 929I of the Dodd-Frank Wall Street Reform and Consumer Protection Act (the Dodd-Frank Act). This provision would provide the Securities and Exchange Commission (SEC, Commission, or agency) with an unnecessary and overly broad exemption to FOIA and a blanket authority to withhold public records.

Section 929I states that the SEC cannot be compelled to disclose records or other information obtained from its registered entities—including entities such as hedge funds, private equity funds, and venture capital funds which will now come under greater regulation by the SEC—if this information is used for "surveillance, risk assessments, or other regulatory and oversight activities" outlined in three statutes: the Securities Exchange Act of 1934, the Investment Company Act of 1940, and the Investment Advisers Act of 1940.[1]

Although we fully understand the need to protect against the disclosure of certain information collected by the SEC, existing FOIA exemptions are more than adequate. In fact, the SEC has a history of wielding these exemptions to withhold more than it discloses. Although President Obama mandated that FOIA be implemented with a presumption in favor of disclosure,[2] the SEC Office of Inspector General (OIG) concluded that SEC FOIA practices "have the effect of

[1] "Dodd-Frank Wall Street Reform and Consumer Protection Act," Pub. L. No. 111-203, Section 929I. http://frwebgate.access.gpo.gov/cgi-bin/getdoc.cgi?dbname=111_cong_bills&docid=f:h4173enr.txt.pdf (Downloaded September 8, 2010)
[2] "Memorandum of January 21, 2009 - Freedom of Information Act," Federal Register, Vol. 74, No. 15, January 26, 2009. http://edocket.access.gpo.gov/2009/pdf/E9-1773.pdf (Downloaded September 8, 2010)

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creating a presumption of withholding."[3] If implemented, Section 929I will further hinder the public's ability to access critical information related to the activities of the SEC.

The public interest stakes in more—not less—transparency and accountability at the SEC cannot be overstated. American families continue to suffer from the financial crisis fueled in part by systemic regulatory failures. The SEC's particularly dramatic failure to fulfill its core mission of protecting investors is exemplified in the Madoff and Stanford cases.[4] If allowed to stand, the 929I secrecy provision could significantly undermine this Committee's work and Congress' intent to provide greater transparency and accountability in the financial regulatory system when it passed the landmark Dodd-Frank Act.

Indeed, limiting disclosure to public information should not be done lightly. The OPEN FOIA Act now requires Congress to explicitly state its intention to provide a statutory exemption to FOIA in new legislation.[5] One of the authors of the OPEN FOIA Act, Senator Patrick Leahy, had raised concerns about the growing number of "so-called 'FOIA (b)(3) exemptions' in proposed legislation—often in very ambiguous terms—to the detriment of the public's right to know." He stated that the OPEN FOIA Act is intended to help "ensure that FOIA remains a meaningful tool to help future generations of Americans access Government information."[6]

FOIA and subsequent amendments require careful crafting of Exemption 3, or information specifically exempted by statute, so that "the matters be withheld from the public in such a manner as to leave no discretion on the issue," or establish "particular criteria for withholding or [refer] to particular types of matters to be withheld."[7] Yet, Section 929I is uniquely broad in that it protects records obtained by the SEC for the purposes of "surveillance, risk assessments, *or other regulatory and oversight activities*" (emphasis added). It is unclear to us how such ambiguous language could qualify as an Exemption 3 statute.

In response to concerns raised by POGO and others, bills have been introduced that would repeal the unnecessary and overly broad 929I provision. Legislation introduced by Representative Edolphus Towns (H.R. 6086)[8] and Senators Patrick Leahy, Charles Grassley, John Cornyn, and

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[3] Securities and Exchange Commission, Office of Inspector General, *Review of the SEC's Compliance with the Freedom of Information Act* (Report No. 465), September 25, 2009, p. 50. http://www.sec-oig.gov/Reports/AuditsInspections/2009/465.pdf (Downloaded September 8, 2010)

[4] Securities and Exchange Commission, Office of Inspector General, *Investigation of Failure of the SEC to Uncover Bernard Madoff's Ponzi Scheme* (Report No. OIG-509), August 31, 2009. http://www.sec.gov/news/studies/2009/oig-509.pdf (Downloaded September 9, 2010); and Securities and Exchange Commission, Office of Inspector General, *Investigation of the SEC's Response to Concerns Regarding Robert Allen Stanford's Alleged Ponzi Scheme* (Report No. OIG-526), March 31, 2010. http://www.sec.gov/news/studies/2010/oig-526.pdf (Downloaded September 9, 2010)

[5] Department of Justice, Office of Information Policy, "Congress Passes Amendment to Exemption 3 of the FOIA," March 10, 2010. http://www.justice.gov/oip/foiapost/2010foiapost7.htm (Downloaded September 9, 2010)

[6] Senator Patrick Leahy, "Leahy-Authored Open Government Provision Set To Become Law," October 20, 2009. http://leahy.senate.gov/press/press_releases/release/?id=84bb8a0f-77f2-4fc4-9699-682af5cfb293 (Downloaded September 9, 2010)

[7] Department of Justice, "Exemption 3," *Department of Justice Guide to the Freedom of Information Act*, p. 207. http://www.justice.gov/oip/foia_guide09/exemption3.pdf (Downloaded September 9, 2010)

[8] 111th Congress, H.R. 6086, introduced by Representative Towns, August 10, 2010. http://frwebgate.access.gpo.gov/cgi-bin/getdoc.cgi?dbname=111_cong_bills&docid=f:h6086ih.txt.pdf (Downloaded September 9, 2010)

Ted Kaufman (S. 3717)[9] would strike the blanket exemptions found in Section 929I, and clarify that Exemption 8 will protect against the release of information contained in the records of entities that will now be regulated by the SEC under the Dodd-Frank Act (a specific concern raised by the SEC). POGO and other good government groups[10] support these bills, which will prevent additional secrecy and send a clear message that public access is vital to accountability. Representatives Darrell Issa, John Campbell, and Ron Paul also have offered supportable legislation to strike Section 929I.[11]

Congress must ensure a proper balance between the need for limited confidentiality for effective financial regulation and the public's right to know. For these reasons, we thank you for your willingness to revisit the blanket FOIA exemptions contained in the Dodd-Frank Act, examine the problematic culture of secrecy at the SEC, and consider H.R. 6086 to repeal Section 929I.

A Shield from Accountability

Although the SEC claims that Section 929I is necessary to protect confidential information provided by its regulated entities,[12] the FOX Business News case raises concerns that the agency could also use its blanket exemptions to cover up its own mistakes—including mistakes from past cases that are no longer open.

FOX Business News reported that the SEC may be seeking to invoke Section 929I in litigation to block the release of records in response to a FOIA request FOX filed in February 2009 seeking "any information related to the agency's response to complaints, tips and inquiries or any potential violations of the securities law or wrongdoing by Stanford."[13]

In response to questions about Section 929I submitted by Representative Darrell Issa, Chairman Schapiro confirmed that SEC counsel in the FOX case "explained in telephone conversations with opposing counsel and the judge's law clerk that Section 929I exists and could provide an additional basis for withholding documents the Commission has already withheld pursuant to other FOIA exemptions."[14]

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[9] 111th Congress, S. 3717, introduced by Senators Leahy, Grassley, Cornyn and Kaufman, August 5, 2010. http://frwebgate.access.gpo.gov/cgi-bin/getdoc.cgi?dbname=111_cong_bills&docid=f:s3717is.txt.pdf (Downloaded September 9, 2010)

[10] Project On Government Oversight, "Groups Support Bipartisan Senate Bill to Strike SEC FOIA Exemptions," August 10, 2010. http://www.pogo.org/pogo-files/letters/financial-oversight/fo-fra-20100810.html

[11] 111th Congress, "SEC Freedom of Information Restoration Act," H.R. 5924, introduced by Representative Darrell Issa, July 29, 2010. http://frwebgate.access.gpo.gov/cgi-bin/getdoc.cgi?dbname=111_cong_bills&docid=f:h5924ih.txt.pdf ; 111th Congress, H.R. 5948, introduced by Representative John Campbell, July 29, 2010. http://frwebgate.access.gpo.gov/cgi-bin/getdoc.cgi?dbname=111_cong_bills&docid=f:h5948ih.txt.pdf; and 111th Congress, "SEC Transparency Act of 2010," H.R. 5970, introduced by Representative Ron Paul, July 29, 2010. http://frwebgate.access.gpo.gov/cgi-bin/getdoc.cgi?dbname=111_cong_bills&docid=f:h5970ih.txt.pdf (All downloaded September 14, 2010)

[12] Letter from SEC Chairman Mary Schapiro to Representative Barney Frank and Senator Christopher Dodd, July 30, 2010. http://voices.washingtonpost.com/market-cop/frank.pdf and http://voices.washingtonpost.com/market-cop/dodd.pdf (Downloaded September 8, 2010)

[13] Dunstan Prial, "SEC Says New Financial Regulation Law Exempts it From Public Disclosure," *FOX Business News*, July 28, 2010. http://www.foxbusiness.com/markets/2010/07/28/sec-says-new-finreg-law-exempts-public-disclosure/ (Downloaded September 9, 2010)

[14] Letter from SEC Chairman Mary Schapiro to Representative Darrell Issa, August 24, 2010, p. 3. http://pogoarchives.org/m/er/schapiro-letter-20100824.pdf (Downloaded September 13, 2010)

There is no way to know exactly what information may be contained in the records requested by FOX. But FOX had previously used FOIA to obtain a 2005 survey that the SEC's Fort Worth Regional Office (FWRO) had sent to Stanford investors. The existence of the survey confirmed that the SEC had suspicions about Stanford for years prior to the fraud being exposed and shut down. In fact, an SEC OIG report found that FWRO examiners were uncovering red flags on Stanford's operations as early as 1997.[15]

The SEC's inability to crack down on the Stanford and Madoff Ponzi schemes over years of leads and evidence exposed serious problems with the agency's operations, including mishandling whistleblower tips and failures to coordinate between different offices within the agency. If these shortcomings are kept hidden from the public, the media, and other outside stakeholders, the SEC will be shielded from external pressure to improve the agency's oversight of its regulated entities.

Standard FOIA Exemptions are More than Adequate

The SEC's failure in the Stanford and Madoff cases did not stem from a lack of information. Of all the problems at the SEC that require a legislative fix, the ability of the SEC to withhold information is not one. Since passage of the blanket FOIA exemptions, Chairman Schapiro has argued that Section 929I is needed to assure registered entities that their sensitive and proprietary information will not be released through FOIA or private litigation.[16]

In Chairman Schapiro's response to Representative Issa, she asserts that "Commission examinations unquestionably have been hindered by registered entities' refusal to produce certain information requested by staff during an examination due to concerns about the Commission's ability to protect the information from compelled third party disclosure."[17] To support this claim, she provides some examples, mostly involving investment advisers, in which regulated entities either refused to provide information or insisted that SEC examiners review certain records on-site without making copies.

What Chairman Schapiro neglected to mention is that the SEC has the power to compel registered entities to provide information and records. Under the Securities Exchange Act of 1934, the SEC has the authority to subpoena witnesses and require the production of any records from its registered entities. If these entities fail to comply, the SEC has the authority to suspend them, impose significant monetary penalties, and refer cases to the Department of Justice (DOJ) for possible criminal proceedings.[18]

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[15] Securities and Exchange Commission, Office of Inspector General, *Investigation of the SEC's Response to Concerns Regarding Robert Allen Stanford's Alleged Ponzi Scheme* (Report No. OIG-526), March 31, 2010, p. 16. http://www.sec.gov/news/studies/2010/oig-526.pdf (Downloaded September 9, 2010)

[16] Letter from SEC Chairman Mary Schapiro to Representative Barney Frank and Senator Christopher Dodd, July 30, 2010. http://voices.washingtonpost.com/market-cop/frank.pdf and http://voices.washingtonpost.com/market-cop/dodd.pdf (Downloaded September 8, 2010)

[17] Letter from SEC Chairman Mary Schapiro to Representative Darrell Issa, August 24, 2010, p. 5 http://pogoarchives.org/m/er/schapiro-letter-20100824.pdf (Downloaded September 13, 2010)

[18] Securities Exchange Act of 1934, Section 21(b)—(d), Section 32. http://www.sec.gov/about/laws/sea34.pdf (Downloaded August 2, 2010).

We certainly understand that the SEC's job is made more difficult when registered entities refuse to cooperate with examinations. But we're not convinced the agency should have to defer to the entities it regulates, especially when it has the power of subpoena.

Furthermore, the existing FOIA exemptions are sufficient to protect against the release of sensitive business information through a FOIA request. It's surprising that the SEC doesn't express more confidence in the existing FOIA exemptions given its track record for withholding information. In fact, the SEC has only provided one specific example in which a court actually overturned the SEC's invocation of Exemption 4, and in that case no confidential registrant information was disclosed.

Chairman Schapiro claims that "existing FOIA exemptions were insufficient to allay concerns [about public disclosure] due in part to limitations in FOIA."[19] In order for Congress to evaluate the need for additional exemptions, I'd like to address this assertion and examine the existing Exemptions 4 and 8.

Chairman Schapiro has raised some questions about the types of firms that are considered to be "financial institutions" for the purposes of Exemption 8.[20] FOIA Exemption 8 protects matters that are "contained in or related to examination, operating, or condition reports prepared by, on behalf of, or for the use of an agency responsible for the regulation or supervision of financial institutions." Although the legislative history of the Government in the Sunshine Act provided some clarity as to the definition of "financial institutions,"[21] Chairman Schapiro questions whether the definition covers other entities that now fall under the SEC's expanded oversight, such as credit rating agencies, transfer agents, and municipal advisers.

It's important to note that the courts have consistently ruled that Congress intended for Exemption 8 to be broad and all-inclusive.[22] In fact, there is sufficient concern that Exemption 8 is too broad, and should be re-examined and more narrowly tailored. The Administrative Conference of the United States made the recommendation that "Agencies should not withhold information on the basis that it is 'related to' operating, condition or examination reports unless they determine that nondisclosure is properly justified."[23]

But if Congress shares the SEC's concern that certain newly regulated entities may not fall under the definition of "financial institutions" for Exemption 8, we believe the appropriate solution would be legislation clarifying that any entity regulated by the SEC will be covered by Exemption 8—as in H.R. 6086.

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[19] Letter from SEC Chairman Mary Schapiro to Representative Barney Frank and Senator Christopher Dodd, July 30, 2010, p. 2. http://voices.washingtonpost.com/market-cop/frank.pdf and http://voices.washingtonpost.com/market-cop/dodd.pdf (Downloaded September 8, 2010)

[20] Letter from SEC Chairman Mary Schapiro to Representative Darrell Issa, August 24, 2010, pp. 3-4. http://pogoarchives.org/m/er/schapiro-letter-20100824.pdf (Downloaded September 13, 2010)

[21] Department of Justice, "Exemption 8," *Department of Justice Guide to the Freedom of Information Act*, p. 659. http://www.justice.gov/oip/foia_guide09/exemption8.pdf (Downloaded September 9, 2010)

[22] Department of Justice, "Exemption 8," *Department of Justice Guide to the Freedom of Information Act*, p. 660. http://www.justice.gov/oip/foia_guide09/exemption8.pdf (Downloaded September 9, 2010)

[23] Florida State University College of Law, *Recommendations of the Administrative Court of the United States* (1 C.F.R. s 305.95-1 Recommendation 95-1, Application and Modification of Exemption 8 of The Freedom of Information Act). http://www.law.fsu.edu/library/admin/acus/305951.html (Downloaded September 9, 2010)

However, further examination and guidance from Congress on the application of Exemption 8 is also needed to prevent expansive use, as there is recent evidence to suggest that the SEC has been abusing Exemption 8. POGO has learned that the SEC recently invoked Exemption 8 to redact the name of a problematic examinations program mentioned in a report by the SEC OIG. As detailed in its semiannual report to Congress, the OIG found that senior officials at the SEC's Fort Worth Regional Office (FWRO) retaliated against two employees who had raised concerns about a new initiative known as the broker-dealer Risk Assessment Verification Examinations (RAVEs) program. These two employees—one of whom had been attempting for years to get the agency to crack down on the Stanford Ponzi scheme—complained to officials in Washington, DC, that the RAVEs program would require examiners to focus too much of their attention on quick-hit, superficial examinations, diverting resources away from in-depth examinations of broker-dealers designed to uncover fraud such as the Stanford scheme.[24]

But even though the OIG had already identified the RAVEs program in its semi-annual report to Congress, which is public, the agency claimed Exemption 8 and redacted any mention of the program when it released the OIG report on allegations of retaliation in the Fort Worth office.[25] The SEC's aggressive interpretation of Exemption 8 in this case suggests that the agency may already be using the existing FOIA exemptions to block the release of embarrassing information, raising concerns about giving the agency a broader authority to withhold records from the public.

Chairman Schapiro has also claimed that FOIA Exemption 4, which protects "trade secrets and commercial or financial information obtained from a person [that is] privileged or confidential,"[26] is insufficient. Chairman Schapiro points out that Exemption 4 provides different levels of protection depending on whether information is submitted voluntarily or whether it is required by the government.[27] When information is required to be submitted, it is protected only if "disclosure of the information is likely to have either of the following effects: (1) to impair the Government's ability to obtain necessary information in the future; or (2) to cause substantial harm to the competitive position of the person from whom the information was obtained"[28] (referred to as the "impairment prong" and the "competitive harm prong").[29] Chairman Schapiro cites a few well-chosen court cases in an attempt to demonstrate that it is exceedingly difficult for agencies or private entities to clear these hurdles. "Given these impediments," she argues, "courts have frequently required disclosure of information that businesses endeavored to keep confidential."[30]

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[24] Securities and Exchange Commission, Office of Inspector General, *Semiannual Report to Congress: April 1, 2009 - September 30, 2009*, pp. 80-82. http://www.sec-oig.gov/Reports/Semiannual/2009/semifall09.pdf (Downloaded September 9, 2010)

[25] Securities and Exchange Commission, Office of Inspector General, *Allegations of Retaliatory Personnel Actions* (Case No. OIG-494A), September 15, 2009. http://pogoarchives.org/m/er/sec-oig-report-20090915.pdf (Downloaded September 9, 2010)

[26] Department of Justice, "Exemption 4," *Department of Justice Guide to the Freedom of Information Act*, p. 263. http://www.justice.gov/oip/foia_guide09/exemption4.pdf (Downloaded September 9, 2010)

[27] Letter from SEC Chairman Mary Schapiro to Representative Darrell Issa, August 24, 2010, p. 5. http://pogoarchives.org/m/er/schapiro-letter-20100824.pdf (Downloaded September 13, 2010)

[28] *National Parks & Conversation Association v. Morton*, 498 F.2d 770 (D.C. Cir. 1974)

[29] Department of Justice, "Exemption 4," *Department of Justice Guide to the Freedom of Information Act*, p. 274. http://www.justice.gov/oip/foia_guide09/exemption4.pdf (Downloaded September 9, 2010)

[30] Letter from SEC Chairman Mary Schapiro to Representative Darrell Issa, August 24, 2010, p. 7. http://pogoarchives.org/m/er/schapiro-letter-20100824.pdf (Downloaded September 13, 2010)

Upon closer examination, however, we believe that Chairman Schapiro is understating the broad protections typically provided by Exemption 4. In fact, Exemption 4 is notoriously favorable to companies, especially after the U.S. Court of Appeals for the District of Columbia ruled that the exemption offers even greater protections for information that is submitted voluntarily.[31] David Vladeck, who was previously at the Georgetown University Law Center, has remarked that this ruling "allows agencies to evade FOIA disclosure whenever they want to keep the information secret; an agency can always agree to accept 'voluntary' submission of information rather than compelling its submission, thus the information becomes off-limits under FOIA."[32]

But even when information is required to be submitted, there are numerous situations in which the information would still be protected under Exemption 4.

In accordance with Executive Order 12,600, the SEC must provide notification to a registered entity when the agency determines that it may be required to disclose sensitive information through FOIA.[33] The registered entity may then request that the information be withheld under FOIA Exemption 4. The executive order requires that "agencies give careful consideration to the submitters' objections and provide them with a written statement explaining why any such objections are not sustained." If the agency decides to invoke Exemption 4, 8, or others, and the decision is challenged in court, the registered entity's request for confidential treatment will then be examined by the court in determining the propriety of the exemption claim.[34]

Chairman Schapiro states that "courts have frequently required disclosure of information that businesses endeavored to keep confidential." Again, she provides only one example in which the courts required the SEC to release information it attempted to withhold under Exemption 4, *Aguirre v. SEC* (2008).[35] In this case, no confidential registrant information was released, but rather damning information about the failure of enforcement. We are not aware of any case where a court has required release of confidential information obtained through examinations.

We urge the Committee to review the Aguirre case in greater detail, since it illustrates how aggressive the SEC has been in attempting to withhold records from the public and the potential consequences for whistleblowers and enforcement at the SEC. The adversarial ruling for the SEC in the case might also provide some additional clues as to why the agency has been seeking the blanket withholding exemptions contained in Section 929I.

Gary Aguirre is a former SEC enforcement attorney who led the agency's investigation into numerous allegations of insider trading involving Pequot Capital Management and its Chairman and CEO, Arthur Samberg. As detailed in an exhaustive investigation by the Senate Finance and Judiciary Committees, Aguirre was fired after he complained about his superiors blocking his attempts to interview Wall Street titan John Mack, who was allegedly involved in one of the

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[31] *Critical Mass Energy Project v. NRC*, 975 F.2d, (D.C. Cir. 1992) (en banc)
[32] David C. Vladeck, "Freedom of Information – Overview," First Amendment Center. http://www.firstamendmentcenter.org/press/information/overview.aspx (Downloaded September 9, 2010)
[33] *Executive Order No. 12,600*, issued June 23, 1987, reprinted in Department of Justice, *FOIA Update*, Vol. VIII, No. 2, pp. 2-3. http://www.justice.gov/oip/foia_updates/Vol_VIII_2/viii2page2.htm (Downloaded September 9, 2010)
[34] Department of Justice, "Exemption 4," *Department of Justice Guide to the Freedom of Information Act*, pp. 306-307. http://www.justice.gov/oip/foia_guide09/exemption4.pdf (Downloaded September 9, 2010)
[35] Aguirre v. SEC, 551 F. Supp. 2d (D.D.C. 2008)

insider trading deals. Shortly after Aguirre was terminated, the SEC closed its investigation into Pequot without filing any charges.[36]

After he was fired, Aguirre sued the SEC seeking records related to his termination and the agency's decision to close the Pequot investigation. The SEC attempted to withhold thousands of pages of documents under FOIA Exemptions 3, 4, 6, and 7(C). In April 2008, the U.S. District Court for the District of Columbia ordered the SEC to disclose these records, and offered a scathing critique of the agency's attempt to withhold information under the FOIA exemptions.

The court rejected the SEC's argument that disclosure would impact the quality or reliability of the information available to the SEC because when the SEC issues a subpoena it informs witnesses that their testimony could be provided to "bar associations, other professional associations, witnesses, private collection agencies, consumer reporting agencies, members of Congress, other government agencies (local, state, national and foreign), the press, and the public." As a result, the court concluded that it is "hard to understand how disclosure under FOIA would constitute any type of impairment" of the SEC's ability to obtain necessary information.

It's worth pointing out that the SEC had also attempted to withhold portions of transcripts under Exemption 3. However, the court found that "the SEC's Exemption 3 litigation theory is at odds with its own Form 1662, in which the agency explicitly warns witnesses that their testimony could be released to many different types of organizations." The court also determined that the SEC's "novel and overly expansive interpretation" of Exemption 3 would result in the agency having "unbridled discretion regarding all information obtained by a subpoena"[37]—a concern that could very well be applied to the Exemption 3 provisions contained in Section 929I.

In a letter to Chairman Frank and Senator Dodd, Aguirre explains how he relied heavily on information obtained through his FOIA case to make an argument before the DOJ, Federal Bureau of Investigation, congressional committees, and the SEC that insider trading charges should be filed against Pequot and Samberg. He eventually succeeded in pushing the SEC to reopen the case, and in June 2010 the agency filed charges against Pequot and Samberg resulting in a $28 million settlement.[38] Aguirre was further vindicated a few months ago when he received a settlement for wrongful termination.[39] However, he states that the court would have likely denied access to the information in his FOIA case if Section 929I had been in effect.[40]

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[36] Minority staff of the Senate Committee on Finance and the Senate Committee on the Judiciary Committee, *The Firing of an SEC Attorney and the Investigation of Pequot Capital Management*, August 2007. http://finance.senate.gov/library/prints/download/?id=f9d94204-7602-49f7-8bab-cb932c05310e (Downloaded September 9, 2010)

[37] Aguirre v. SEC, 551 F. Supp. 2d (D.D.C. 2008)

[38] Securities and Exchange Commission, "SEC Charges Pequot Capital Management and CEO Arthur Samberg With Insider Trading," May 27, 2010. http://sec.gov/news/press/2010/2010-88.htm (Downloaded September 13, 2010)

[39] Zachary Goldfarb, "SEC settles with Gary Aguirre over firing during Pequot Capital Management probe," *The Washington Post*, June 30, 2010. http://www.washingtonpost.com/wp-dyn/content/article/2010/06/29/AR2010062904955.html (Downloaded September 13, 2010)

[40] Letter from Gary Aguirre to Senator Christopher Dodd and Representative Barney Frank, August 4, 2010. http://pogoarchives.org/m/er/aguirre-letter-20100804.pdf (Downloaded September 13, 2010); and Gary Aguirre, "The Dodd-Frank Act: A FOIA Exemption for SEC Misconduct?" *Wall Street Lawyer*, September 2010, Vol. 14, Issue 9, pp. 18-25.

In Section 929I, Congress has provided the SEC with the type of broad withholding authority it had attempted to invoke in the *Aguirre* case in Section 929I, and so has made it more difficult for whistleblowers such as Aguirre to both expose serious flaws and offer recommendations for improving the agency's investigations.

Nearly Universal Evidentiary Privilege

The Commission also has asserted that it must shield the information provided by financial institutions from non-FOIA litigation.[41] Section 929I allows the SEC to claim blanket privilege in third party lawsuits and in suits brought *against* the SEC not related to FOIA appeals. We strongly urge the Committee to reexamine whether it intended for Section 929I to protect against the release of information in non-FOIA litigation.

Did Congress intend to block information requested by subpoena in suits brought *against* the SEC? This could allow the SEC to refuse to provide the court with evidence in cases brought by a whistleblower attempting to prove retaliation or a registered entity seeking review of a penalty or fine. This accountability shield is a recipe for corruption and cover-ups.

We also do not believe that it is in the public interest, or in the service of the SEC's core mission to protect investors, for the SEC to be given the authority to outright refuse nearly every document subpoena from a civil litigant. The harm caused by such vast authority to refuse to provide evidence to the potentially harmed or shield registered entities from being held accountable far outweighs any benefit that might be derived in incentivizing compliance by registered entities. Should defrauded investors, whistleblowers who suffered retaliation, the media seeking to uncover corruption, or any other party be denied access to documents that might make the difference in real justice simply because the SEC does not wish to comply with subpoenas or because registered entities fear disclosure of sensitive information?

Though the SEC is hardly the first agency to argue for immunity from subpoenas in civil litigation, and the question has been tried many times, the U.S. Court of Appeals for the D.C. Circuit found that U.S. government agencies are not immune in *Yousuf v. Samantar*.[42] Even so, whether or not a civil litigant will actually be able to enforce a subpoena on a federal agency is never certain, and can in fact be very difficult. Federal Rule of Civil Procedure 45 expressly provides that the government or other parties can quash a subpoena seeking privileged or trade secret material or claiming the subpoena as unduly burdensome.[43] In addition, agencies have a number of other tools at their disposal to resist subpoenas.[44] The decision about whether or not a

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[41] In her letter to Representative Issa, Chairman Schapiro notes that "Section 929I also provides important protections in non-FOIA litigation, where FOIA exemptions do not apply. The Commission cannot, for example, rely on FOIA exemptions when responding to a subpoena served on it in private litigation." Letter from SEC Chairman Mary Schapiro to Representative Darrell Issa, August 24, 2010, p. 2. http://pogoarchives.org/m/er/schapiro-letter-20100824.pdf (Downloaded September 13, 2010)

[42] Robert R. Vieth and Tara M. Lee, "Can a Third Party Subpoena the Feds?" *Legal Times*, Vol. XXIX, No. 34, August 21, 2006. http://www.cooley.com/files/tbl_s5SiteRepository/FileUpload21/1096/Article%20%20-%20Aug%2006%20-%20Legal%20Times%20-%20ViethLee.pdf (Downloaded September 9, 2010)

[43] United States Courts, *Federal Rules of Civil Procedure*, December 1, 2009. http://www.uscourts.gov/uscourts/RulesAndPolicies/rules/CV2009.pdf (Downloaded September 14, 2010)

[44] Andrew J. Morris and Sharan E. Lieberman, "Contending With Agency Touhy Regulations: Compelling Federal Agencies to Comply With Federal-Court Subpoenas," *Securities Regulations & Law Report*, Vol. 40, No. 16, April 21, 2008.

subpoena should be enforced should be made by the courts on a case-by-case basis, as is the norm.

Also of concern is the use of Section 929I in the administrative law setting. In fact, the SEC has already attempted to invoke Section 929I in an administrative proceeding that had nothing to do with FOIA or the agency's expanded authorities under the Dodd-Frank Act. The case involves a suit filed by the SEC against broker-dealer Morgan Keenan and two of its top employees. A few months ago, the defendants subpoenaed the SEC's Office of Compliance Inspections and Examinations (OCIE) seeking examination records dating back to 2000.

Once the Dodd-Frank Act passed, the OCIE attempted to invoke Section 929I to prevent the release of these records. But in a ruling last month, an administrative law judge found that OCIE "may not claim the protection of Section 929I to resist production of documents in response to an administrative subpoena issued before July 22, 2010."[45] Furthermore, the judge ruled that "OCIE may not assert 'blanket claims' of privilege" in resisting production of the documents.

In rejecting OCIE's claims of privilege, the judge cited a previous case (*Gavin v. SEC,* 2006) in which a district court ruled that the SEC cannot "circumvent its statutory obligations by ping-ponging from one [FOIA] exemption to another"[46]—a concern that could very well apply to the new exemptions contained in Section 929I.

Given its jump to utilize Section 929I, there is reason to believe that the SEC will continue to invoke Section 929I to make dubious claims of evidentiary privilege in non-FOIA litigation, raising additional concerns about leaving this provision in place. POGO believes the SEC should have to argue on a case-by-case basis why certain information is privileged, rather than hiding behind a blanket withholding statute, whether in administrative law proceedings or in federal court.

In addition, the SEC's potential use of Section 929I to claim evidentiary privilege might also prevent state attorneys general (AGs) from accessing key information in order to take action against regulated entities under their jurisdiction. Section 929I states that the SEC cannot withhold any information from other *federal* agencies and departments, but does not specifically disallow withholding from AGs and regulators at the *state* level. It would be a mistake to allow the SEC to withhold information from state regulators, especially since many state regulators have been leading the charge in bringing tough enforcement actions against regulated entities. Just a few months ago, for instance, New York AG Andrew Cuomo sued a Bank of New York Mellon unit for deliberately misleading clients about Madoff-related investments.[47] Prior to that, the top securities regulator in Massachusetts was the first to file charges against one of the Madoff "feeder funds."[48]

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[45] *Administrative Proceeding in the Matter of Morgan Asset Management, Inc., Morgan Keenan & Company, Inc., James C. Kelsoe, Jr., and Joseph Thompson Weller, CPA*, Release No. 659, August 3, 2010. http://www.sec.gov/alj/aljorders/2010/ap659jtk.pdf (Downloaded September 9, 2010)

[46] *Gavin v. SEC*, 2006 U.S. Dist. LEXIS 75,227, at *23 (D. Minn. Oct. 13, 2006)

[47] New York Office of the Attorney General, "Attorney General Cuomo Sues Bank of New York Mellon Unit for Deceiving Clients in Connection with Madoff-Related Investments," May 11, 2010. http://www.ag.ny.gov/media_center/2010/may/may11a_10.html (Downloaded September 9, 2010)

[48] Svea Herbst-Baylis, "Massachusetts regulator sues Madoff feeder fund," *Reuters*, April 1, 2009. http://www.reuters.com/article/idUSTRE5304HS20090401 (Downloaded September 9, 2010)

SEC's Request for Exemptions Has Expanded

This is not the SEC's first proposal for a blanket exemption—as Chairman Schapiro has pointed out, the SEC first proposed language similar to what is contained in Section 929I as early as 2006.

However, it appears the proposal has expanded in scope over time. For instance, language was added to protect "records or information *based upon or derived from*" records obtained from registered entities, and information used in furtherance of the SEC's "other regulatory and oversight activities." We urge the Committee to request further clarification on the SEC's justification for the expanded proposal.

A History of Secrecy and FOIA Abuse

The SEC's track record with FOIA raises additional concerns about giving the agency even more authority to withhold information from the public. The courts have strongly censured the agency for non-disclosure,[49] and last year, an audit conducted by the SEC OIG uncovered a wide range of problems related to the SEC's FOIA operations.

We were particularly troubled by the OIG's finding that the SEC Chief FOIA Officer was not operating in compliance with Executive Order 13392, the Presidential Memorandum of January 21, 2009, or the OPEN Government Act, but rather was operating with a presumption in favor of withholding information. Among other things, the OIG found few FOIA liaisons had written policies and procedures for processing FOIA requests, and there were many cases in which no effort was made to segregate portions of records for disclosure purposes. Alarmingly, there also was a conflict of interest in the Office of the General Counsel (OGC) both consulting on the initial FOIA response and making the appeal determination—in many cases it was the same individual.

The OIG also determined that the SEC's FOIA release rate was "significantly lower when compared to all other federal agencies." Specifically, the OIG found that the SEC made "full grants" and "partial grants" 10.5 and 2.9 percent of the time, respectively. In contrast, all federal agencies made "full grants" and "partial grants" 41.8 and 18.7 percent of the time. Also, the SEC reported "no information found" 56 percent of the time, compared to 13 percent of the time for all federal agencies.[50]

The OIG put forth a number of recommendations for correcting the glaring deficiencies in the SEC's FOIA operations. According to the OIG's most recent semiannual report to Congress for the period leading up to March 2010, the SEC still hadn't taken final action on many of these recommendations, which had been open for more than 180 days.[51] However, Chairman

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[49] *Gavin v. SEC*, 2006 U.S. Dist. LEXIS 75,227 (D. Minn. Oct. 13, 2006) and Aguirre v. SEC, 551 F. Supp. 2d (D.D.C. 2008).

[50] Securities and Exchange Commission, Office of Inspector General, *Review of the SEC's Compliance with the Freedom of Information Act* (Report No. 465), September 25, 2009. http://www.sec-oig.gov/Reports/AuditsInspections/2009/465.pdf (Downloaded September 8, 2010)

[51] Securities and Exchange Commission, Office of Inspector General, Semiannual Report to Congress: October 1, 2009 – March 31, 2010, pp. 98-99. http://www.sec-oig.gov/Reports/Semiannual/2010/semiapr10.pdf (Downloaded August 2, 2010)

Schapiro's response to Representative Issa lists some steps that have been taken by the SEC to implement the OIG's recommendations.[52] We've also learned from the OIG that many of the recommendations are underway. We commend Chairman Schapiro for her leadership in beginning to address the serious problems uncovered by the OIG's audit, but, independent verification by the OIG is needed to assess the extent to which the agency is fulfilling its FOIA obligations.

In addition, the regular redacting and wholesale withholding of OIG reports by the Commission's Office of General Counsel (OGC) is troubling. Determinations of FOIA exemption applicability to OIG reports, particularly regarding investigations, should be independently reviewed by the FOIA office or a FOIA officer within the OIG, not by the Chair or OGC.

We urge this Committee and other committees of jurisdiction to hold the SEC accountable for ensuring that the FOIA Office is operating with a presumption of disclosure as dictated by the Administration's guidance.

Internal Guidance on Implementation is Insufficient

In spite of its history of secrecy, Chairman Schapiro has attempted to assure Congress that the SEC will be narrowly applying the provision in accordance with the President's memorandum by issuing and publishing guidance on its website "instructing staff on when and how to assert the provision so that it is applied consistent with principles of open government and only to address issues regarding sensitive information obtained through the examination process."[53]

We do not believe that internal SEC guidance is sufficient to allay the risks to the public interest in implementation of Section 929I, nor is it an appropriate process. DOJ's FOIA Guide for Exemption 3 cites a court ruling stating that a court "must find a congressional purpose to exempt matters from disclosure in the actual words of the statute (or at least in the legislative history of FOIA)—not in the legislative history of the claimed withholding statute, **nor in an agency's interpretation of the statute**" (emphasis added).[54]

The solution for addressing the uncertainty surrounding Section 929I is not additional guidance. The solution is to repeal Section 929I, as in H.R. 6086 and S. 3717.

Another Blanket Exemption in Section 404

There is another secrecy provision in the Dodd-Frank Act that has largely been overlooked, but that requires attention. Section 404 broadly restricts the disclosure of records obtained from hedge funds and other entities that had previously been exempt from registering under the Investment Advisers Act of 1940.

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[52] Letter from SEC Chairman Mary Schapiro to Representative Darrell Issa, August 24, 2010, pp. 4-5. http://pogoarchives.org/m/er/schapiro-letter-20100824.pdf (Downloaded September 13, 2010)
[53] Letter from SEC Chairman Mary Schapiro to Representative Darrell Issa, August 24, 2010, p. 2. http://pogoarchives.org/m/er/schapiro-letter-20100824.pdf (Downloaded September 13, 2010)
[54] Department of Justice, "Exemption 3," *Department of Justice Guide to the Freedom of Information Act*, p. 208. http://www.justice.gov/oip/foia_guide09/exemption3.pdf (Downloaded September 9, 2010); citing *Reporters Comm. for Freedom of the Press v. DOJ*, 816 F.2d at 735 (D.C. Cir.)

Specifically, Section 404 states that the SEC, the Financial Stability Oversight Council, and other agencies will be exempt from FOIA and other disclosures—presumably in civil litigation—with respect to any reports, documents, records, or information obtained from registered entities.

It would be helpful if the Committee could explain the purpose of Section 404, and if it could clarify how the disclosure restrictions in Section 404 relate to the blanket exemptions in Section 929I. Furthermore, the recently enacted OPEN FOIA Act states that in order for a new statute to qualify as an Exemption 3 statute, it must specifically cite to Exemption 3.[55] However, this citation appears to be missing in Section 404, which would not preclude it from being used to refuse to provide evidence in a civil suit.

Existing Exemption 3 and Privilege-Related Statutes

POGO also recommends that a comprehensive review be conducted to determine which of the other Exemption 3 and privilege-related statutes that existed prior to the passage of the Dodd-Frank Act might also allow the SEC to restrict public access to records. There are several, though most are very narrow and facially seem to meet the criteria for Exemption 3 statutes.[56] Prior to the passage of the Dodd-Frank Act, Section 31(c) of the Investment Company Act of 1940 stated that the SEC cannot be compelled to disclose any "internal compliance of audit records" provided to the SEC, which also would be repealed in H.R. 6086. It has only been invoked once in denying a FOIA request in 2009.[57] However, it is unclear when and how this has been used to block information being provided in civil suits.

The public interest demands a full review of the purpose of these Exemption 3 statutes, the number of times the SEC has withheld records from the public under these statutes, and the ongoing need for these statutes given the Administration's guidance instructing agencies to adopt a "presumption in favor of disclosure."

Recommendations

In conclusion, POGO urges Congress to repeal Section 929I by passing H.R. 6086, which also will narrowly address the SEC's concern regarding sufficient legal authority for using Exemption 8 for all entities regulated by the SEC. We also urge you to repeal the other blanket secrecy provision in the Dodd-Frank Act, Section 404. Congress should examine the use of Exemption 8 and then should supply clear standards for employing it.

Additionally, Congress should request OIG reviews of the SEC's FOIA and disclosure practices. It's time for an audit regarding the SEC's implementation of the OIG's recommendations from the September 2009 report. Also, regular periodic studies on the SEC's use of FOIA exemption

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[55] Department of Justice, Office of Information Policy, "Congress Passes Amendment to Exemption 3 of the FOIA," March 10, 2010. http://www.justice.gov/oip/foiapost/2010foiapost7.htm (Downloaded September 9, 2010)

[56] Some of these statutes can be found in several sections of the Securities Exchange Act of 1934 related to the collection of records on large traders (Section 13(h)(7)), government securities brokers and dealers (Section 15C(b)(2)(F), Section 15C(d)(3)(F) and Section 15C(f)(6)), holding companies tied to brokers, dealers, municipal securities dealers, and investment banks (Section 17(h)(5) and Section 17(j)), and records obtained from foreign securities authorities (Section 24(d)).

[57] Securities and Exchange Commission, *Freedom of Information Act (FOIA) Report for Fiscal Year 2009*, p. 5. http://www.sec.gov/foia/arfoia09.pdf (Downloaded September 9, 2010)

authorities with particular emphasis on how the expanded Exemption 8 has helped SEC with its examinations and investigations are needed. The OIG should review the extent to which the SEC has used existing Exemption 3 statutes and other provisions limiting disclosure in the context of FOIA and in administrative law and federal court proceedings. Congress should examine the problem of censoring and redacting OIG reports by the Office of General Counsel at the SEC and at other agencies and establish independent FOIA review by the OIG or FOIA officer. Naturally, in the spirit of open and accountable government, all OIG audits and reports should be immediately publicly available and posted on the SEC website.

I thank you for the opportunity to testify before you today and for your consideration of this matter of critical importance to bring more accountability and transparency in the regulation of Wall Street and the financial sector in order to protect investors, consumers, and taxpayers.

Susan L. Merrill's Testimony on behalf of SIFMA Concerning Section 929I of The Dodd-Frank Wall Street Reform and Consumer Protection Act

I. INTRODUCTION

Chairman Frank, Ranking Member Bachus, members of the Committee:

I am Susan Merrill, a partner in the Broker-Dealer Group of the law firm Bingham McCutchen. Prior to joining Bingham, I served as Chief of Enforcement at the Financial Industry Regulatory Authority, or "FINRA," and prior to 2007, I served as Enforcement Chief of the New York Stock Exchange Regulation. Thank you for the opportunity to testify today on behalf of SIFMA the Securities Industry and Financial Markets Association, to provide an overview of the securities industry's position with respect to Section 929I of the newly enacted Dodd-Frank Wall Street Reform and Consumer Protection Act.

The securities industry holds a strong interest in maintaining an open, cooperative, and efficient dialogue with the Securities Exchange Commission in the course of SEC examinations. Registered entities being examined understand that it is in no one's interest to hinder the Commission's ability to comprehensively complete its work. However, the industry's practical ability to readily produce certain types of sensitive, proprietary, or confidential information to the SEC was, prior to the Dodd-Frank Act, significantly impeded by the federal laws governing the Commission's legal obligation to publicly disclose such information in certain circumstances, whether the SEC supported such disclosure or not.

Section 929I directly addresses these issues, and because we believe the practical effect of its provisions will lead to greater trust, openness and efficiency between regulators and the industry, we support this new law and oppose the efforts to remove it from the Wall Street Reform and Consumer Protection Act.

My testimony today will first provide a general background of disclosure laws, as framed by the U.S. Freedom of Information Act and other applicable laws prior to passage of the Dodd-Frank Act. Next, I will describe the industry's concerns surrounding the production of its most sensitive information to the SEC under the pre-Dodd-Frank laws. I will then describe how Section 929I effectively alters the dialogue between the industry and its regulators, in terms of the production of sensitive material. Finally, I will discuss the multiple bills that have been proposed to Congress in an effort to repeal Section 929I, and why the industry opposes them.

II. FEDERAL DISCLOSURE LAWS PRIOR TO DODD-FRANK

A. FOIA

The U.S. Freedom of Information Act, often referred to as "FOIA," was passed after several years of Congressional hearings about the need for federal disclosure laws. FOIA was enacted to provide public access to U.S. government records and was designed to establish a presumption of disclosure, meaning that the burden rests with the government, not the public, to provide a reason why information may not be disclosed.

While the purpose of FOIA was to make information received by federal agencies available to the public to the greatest extent possible, Congress recognized the need to balance the interest in public disclosure of information with the interest in protecting certain types of sensitive information from public disclosure. FOIA therefore contained nine exemptions designed to protect from disclosure certain categories of information, including in relevant part:

FOIA Exemption Three, which exempts information that is "[s]pecifically exempted by other statutes[.]"

FOIA Exemption Four, which exempts, "A trade secret[,] or privileged or confidential commercial or financial information obtained from a person."

FOIA Exemption Five, which exempts, "A privileged inter-agency or intra-agency memorandum or letter;" and

FOIA Exemption Eight, which exempts information that is "[c]ontained in or related to examination, operating, or condition reports about financial institutions that the SEC regulates or supervises[.]"

Notably, for the past forty-four years FOIA has always required that, upon written request, agencies of the United States government are required to disclose the information requested **unless** such information may be lawfully withheld from disclosure under an exemption. Section 929I does not alter this framework. Rather, it is designed to address a number of practical issues that necessitated a review of the type of information that the Commission may lawfully withhold from disclosure in order to increase the effectiveness, efficiency, and comprehensiveness of federal regulation of the securities industry and capital markets.

Issues Under Previous FOIA Exemptions

The SEC often requests sensitive or proprietary information from regulated entities in connection with its examination and surveillance efforts. Firms under examination are often hesitant to produce such sensitive information, for fear that the Commission may later be compelled to publicly disclose it. The type of sensitive material at issue here may include, for example, information regarding a firm's funding and credit information, market or liquidity risk information and models, or operational risk information. Public disclosure of this type of information could significantly impact the firm's financial situation and disrupt markets. Such impact would adversely affect both investors and employees of the firm, with the degree of impact directly related to the information released to the public domain.

Another example of information the SEC's examination staff seeks to obtain during its exams is sensitive trading information. This would include information like a firm's proprietary trading algorithms, a firm's trading or hedging strategies, or its client's trading strategies and orders. Public disclosure of this type of data could actually move the markets, depending on the value of the information to market competitors, but would at the very least impact a firm's ability to fairly compete in the market. This would similarly cause harm to those investors affected by the impact to the firm.

Still another type of confidential information that should reasonably be protected from public disclosure would be the material non-public information that is regularly disclosed during SEC examinations. For example, the Commission may receive information about a pending deal, including the chronology of events while the deal is pending, or information concerning a firm's watch list, or a firm's syndicate calendar. Disclosure of this type of information into the public domain could significantly impact the price of an issuer's stock and lead to avoidable and unnecessary market volatility. Both results would also directly harm investors.

Another example of the sort of information the Commission and the industry seek to exempt from compelled public disclosure would be confidential client data that a firm may disclose to regulators during an examination. This might include data such as account statements, written trade confirmations, information concerning a client's tax ID, a client's trading strategies, or related information about a client's financial profile. Again, compelled public disclosure of this type of data could move markets, depending on the firm and the clients whose information was released. At the very least, public disclosure of this type of data would likely result in a negative competitive impact on the firm that disclosed the information to its regulator—which again, would adversely affect investors.

As a result, when the SEC requests information of this type, a company is faced with choice of **either** producing the information requested and exposing itself to the very real possibility that significant proprietary information will be publicly disclosed, **or** facing enforcement action. This is no choice at all, particularly when both the firm and the Commission *want* to maintain an open and cooperative dialogue, but cannot because concerns surrounding possible public disclosure loom over every piece of information that is disclosed.

One logical question in response to these concerns would be, "wouldn't this type of information be protected from public disclosure under the FOIA exemptions?" The answer is not necessarily. The pre-Dodd-Frank Act exemptions were simply too imprecise to allay industry fears regarding public disclosure of certain types of its most critical information. It is this lack of clarity that imedes the flow of necessary information between firms and the SEC staff. And similarly, it is the clarity provided by Section 929I that will faster open communication between firms and the SEC.

For example, FOIA's Exemption Four, which exempts "trade secrets" does not define this. As a result, it was extremely difficult for regulated entities to gauge the real possibility of public disclosure of information that may be proprietary and unique to a firm, but which may not have met the undefined meaning of "trade secret" for purposes of public disclosure. A fair analogy on this point may be that, while it may have been clear that a "trade secret" like the proprietary formula for Coca-Cola or Pepsi Cola may have been exempted from public disclosure—because such sensitive information is critical to each beverage company's ability to meaningfully compete in its market—it was unclear whether the trading strategies and algorithms employed by regulated entities would be similarly exempted.

Exemption Four similarly does not define the terms "confidential commercial information," or "confidential financial information," leaving firms at risk that information they consider confidential will not be found to be protected from disclosure in response to a FOIA request.

Exemption Five exempts "[a] privileged inter-agency or intra-agency memorandum or letter," but information compiled from data produced by a regulated entity to the Commission pursuant to an examination that is then transcribed in an SEC document that is neither a memorandum nor a letter—which could reasonably include spreadsheets, staff notes, tables, charts, summaries, reports, and the like—would not be protected from disclosure under this exemption.

FOIA's Exemption 8 protects from disclosure information "contained in or related to examination, operating, or condition reports about financial institutions that the SEC regulates or supervises." The statute does not specify which regulated entities are to be considered "financial institutions" nor what type of information would be construed as being "about" them. The issues here run deeper than mere semantics. Under this provision, newly regulated entities will have no assurance that they will be considered "financial institutions," and thus had little certainty as to whether information disclosed to the SEC could be subject to public disclosure. Similarly, this exemption did not provide clarity as to whether proprietary information concerning, for example, a regulated entity's parent, subsidiary or affiliate would be subject to public disclosure, because it could arguably be construed as not being "about" the entity being examined.

The lack of certainty surrounding the relevant FOIA exemptions relating to SEC examinations therefore fostered avoidable inefficiencies, requiring the Commission to spend the time and resources needed to seek judicial redress in an enforcement action where it did not

receive information from the entity being examined, and forcing the regulated entity to withhold data that it would otherwise disclose, if exemption from public disclosure were certain. The amorphous nature of the FOIA exemptions also muddied the environment of cooperation and openness that both the regulators and the regulated have continually worked to establish.

In practical terms, these exemptions resulted in a variety of scenarios in which registered entities found themselves holding useful information that they would *want* to disclose to regulators, but could not for the rational fear of eventual disclosure. For example, a registered entity with multiple foreign affiliates may *want* to disclose materials from its foreign affiliates to the Commission during an exam in order to better explain its global business to regulators, yet it would be justifiably hesitant to do so because of reasonable privacy and disclosure considerations. This is an example where the Commission's enforcement power could not be brought to bear to compel disclosure, but where firms may be willing to disclose information voluntarily in the course of an examination to foster a deeper understanding of the risks and challenges facing the business if protection from disclosure were certain.

Another concrete example of the difficulties faced under the prior exemptions the context of examining a registered firm's Regulation S-P procedures. The Commission often requests extremely detailed information regarding the firm's security system. Basically, examiners seek a schematic map of how the firm's security systems work and how they comply with Reg. S-P. Clearly, such information is highly confidential because the systems could easily be compromised, should this information end up in the public domain. Firms often dealt with this situation by asking the SEC to accept an in-person demonstration of the system, with no written information documenting it, because the Commission might ultimately be compelled to publicly disclose such documentation. Convincing the SEC to accept an in-person review, rather than a

written schematic addressing such information has often been difficult for entities being examined, despite the fact that their hesitancy was demonstrably well-founded.

Moreover, under the Dodd-Frank Act, the SEC now has regulatory authority over entities such as hedge funds, private equity funds, and venture capital funds. Are entities of this type "financial institutions" for purposes of compelled public disclosure pursuant to FOIA? It remains unclear, even today. This uncertainty would interfere with the developing relationship between the SEC and the newly regulated entities.

B. Disclosure Laws Surrounding Third Party Subpoenas

FOIA was not the only source of concern prior to the Dodd-Frank Act. Additional federal laws addressing the Commission's obligations with respect to compelled public disclosure relate to the SEC's legal obligation to respond to third party subpoenas. These are requests for information made by private parties other than the entity being examined, who are in litigation in federal or state court. Information produced in response to a third party subpoena generally enters the accessible public domain upon production by the SEC.

The SEC cannot choose to ignore or censor the information requested by subpoena. The FOIA exemptions also do not apply here, because subpoena requests are not made pursuant to the Freedom of Information Act, but are instead made pursuant to the general litigation discovery process.

The procedures for third parties to subpoena information from federal agencies, and for federal agencies to respond, are governed by federal laws known as "*Touhy*" regulations. These laws are so named because they were enacted in light of the United States Supreme Court's decision in *United States ex rel. Touhy v. Ragen*, 340 U.S. 462 (1951).

Touhy regulations basically prohibit federal agencies from engaging in the unauthorized release of information by current, and often former, agency employees. The purpose of these rules is to ensure that federal agencies are not haphazardly disclosing information via current or former employees, but rather have a centralized process for responding to subpoenas. A party seeking information from federal agencies must exhaust the processes outlined in each federal agency's *Touhy* regulations, just as each agency must respond via its own codified regulations.

Some have argued that, instead of employing the language of Section 929I to address public disclosure issues, the SEC should instead seek to expand or "toughen" its *Touhy* regulations. This position misconstrues the practical effect of *Touhy* regulations, which merely provide a procedural framework for *how* the agency will respond to a subpoena or other request for information, and not *what* the agency is permitted to produce or withhold. Unlike the exemptions listed in FOIA, the SEC's *Touhy* regulations do not provide any criteria for the Commission to lawfully withhold information sought pursuant to a third party request that was generated outside the FOIA process. Thus, revising these regulations would do little, if anything, to resolve the issues discussed earlier.

C. Responding to Third Party Subpoenas

The fact that FOIA does not apply to third party subpoenas served upon the SEC is, in the industry's view, an important consideration in weighing the interests served by Section 929I. Because the SEC's obligation to disclose information sought pursuant to a subpoena are not limited by either the FOIA exemption or its *Touhy* regulations, the Commission is left to the general litigation and discovery process in seeking to protect from disclosure the most sensitive information it receives from regulated entities in the course of its examinations.

Practically speaking, this means that if the SEC receives a third party subpoena from a private third party litigant seeking sensitive information that the Commission obtained in the course of examining a regulated entity, the SEC must formally request that the federal court from which it was issued quash the subpoena, which eliminates its legal obligation to produce responsive material.

Any SEC argument for moving to quash a third-party subpoena is governed by Federal Rule of Civil Procedure 45, which offers only four grounds to quash: first, where the party issuing the subpoena fails to offer the subpoena recipient a reasonable time to comply;[1] second, where the non-party subpoena recipient is required to travel more than 100 miles from where such person resides, is employed, or regularly transacts business in person;[2] third, where the subpoena requires "disclosure of privileged or other protected matter, if no exception or waiver applies;"[3] or, fourth, if the subpoena "subjects a person to undue burden."[4]

The third ground references legal privileges and other exemptions, such as material subject to attorney-client privilege or material that would fall within the relatively narrow parameters of the attorney work product doctrine. These grounds rarely apply to information the Commission receives in the course of an examination; rather, this ground is geared towards material generated by SEC staff attorneys themselves.

As a result, the Commission is often left to argue that the production of requested information would be an undue burden on the SEC. While this may be a viable position when a subpoena seeks voluminous productions of electronic or hard copy data, it is much less tenable where the subpoena seeks reports, memoranda, or electronic data that is easily accessible to the

[1] Fed. R. Civ. P. 45(c)(3)(A)(i).
[2] Fed. R. Civ. P. 45(c)(3)(A)(ii).
[3] Fed. R. Civ. P. 45(c)(3)(A)(iii).
[4] Fed. R. Civ. P. 45(c)(3)(A)(iv).

Commission, yet represents the type of confidential information that would do significant harm to the regulated entity if it were released to the public domain. In such circumstances, even where the Commission wants to protect the subpoenaed information from disclosure, it often cannot, if the material is easily accessible, non-privileged, and does not constitute attorney work product.

Because the fear of compelled public disclosure via the third party subpoena process, prior to the passage of the Dodd-Frank Act, was both very real and very significant, regulated entities would understandably hesitate to turn over even information that would be protected under FOIA.

Section 929I resolves this issue completely by codifying reasonable limits on the SEC's obligation to publicly disclose certain information, even in the context of third party subpoenas.

The concerns surrounding prior FOIA exemptions and the threat of disclosure via third party subpoena ultimately created an unworkable regulatory environment in which regulated entities are understandably reluctant to comply with requests for this confidential information not because they sought to impede federal regulators in effectively regulating the market, but rather because they were keenly aware that the SEC may have later been legally obligated to publicly disclose any such information they received.

The federal agencies who regulate the securities industry have long been aware of these issues, and, as Chairman Schapiro has noted, the SEC has long sought language shielding these types of materials from compelled disclosure under FOIA. As early as 2006, SEC Chairman Chris Cox sought language aimed at rectifying these issues using terms not unlike the language of Section 929I. But these concerns were not directly resolved, at least in part, until the recent passage of the Dodd-Frank Act this past July.

III. SECTION 929I OF THE DODD-FRANK ACT

The practical question now, and the reason we are here, is to understand what Section 929I of the Dodd-Frank Act actually does. Most basically, Section 929I revises the criteria under which the SEC may lawfully withhold from public disclosure information obtained in the course of examining or investigating a regulated entity. With respect to *how* Section 929I alters the framework for when the SEC may lawfully withhold sensitive information, the text provides as follows, in sum and substance.

Section 929I revises the Securities Exchange Act of 1934 and the Investment Advisers Act of 1940 by inserting provisions noting that "the Commission shall not be compelled to disclose," first, records or information it obtains pursuant to its examination authority under those statutes, and, second, records or information that are based upon or derived from such information, if such materials have been "obtained by the Commission for use in furtherance of the purposes of [the Exchange Act or Investment Advisers Act,] including surveillance, risk assessments, or other regulatory and oversight activities." In addition, it repealed Section 31 of the Investment Advisers Act, which had protected from public disclosure internal audit and compliance reports, because such specific exemption is no longer needed.

Section 929I also clearly establishes that the SEC may not lawfully withhold information under any circumstances from Congress, from other federal agencies, or from an order issued by a federal court in connection with an action brought by either the United States or the Commission itself.

IV. EFFECT ON FINANCIAL INDUSTRY AND SECURITIES MARKETS

Once the Dodd-Frank Act became law, a controversy erupted almost immediately over the scope of Section 929I and its practical effect in terms of FOIA requests for information from

the SEC going forward. Opponents of Section 929I argue that its terms go too far in providing the Commission with legal authority to withhold sensitive information it receives from regulated entities in the course of its work in regulating the markets. Some holding this view also assert that the FOIA exemptions that were in place prior to the Dodd-Frank sufficiently allayed concerns on the part of the industry that its most sensitive and critical information would be protected from public disclosure if produced to the SEC.

To the contrary, as explained earlier, the securities industry concurs with the Commission's position on this issue: that Section 929I substantively addresses practical, serious concerns that had hampered both the regulators and the regulated from openly sharing information that both parties agree should be accessible to the Commission. The industry's well-founded fear of the possibility that the SEC may be legally obligated to publicly disclose confidential information produced to it, whether the Commission supported such disclosure or not, justifiably informed regulated entities' decisions about whether it could produce certain types of confidential information.

Section 929I squarely addresses this issue. Its provisions function to foster a more open and cooperative dialogue between the securities industry and its regulators. With no risk of possible compelled disclosure looming over the production of information, regulated entities are now able to produce information that all would likely agree that the Commission should have access to, without fear that the Commission will later be legally compelled to publicly disclose it.

In addition, Section 929I resolves the industry's concerns about whether information may be fall within the purview existing FOIA exemptions. For example, the fear that proprietary information may not meet the criteria for a "trade secret" is no longer a concern, since the SEC may lawfully withhold such sensitive information, if the information was produced in connection

with an SEC exam, pursuant to Section 929I, rather than attempting to invoke FOIA's Exemption Four. The practical effect of this is that firms will be more likely to produce such information to the SEC staff quickly and willingly, rather than resisting and withholding it from the staff. More importantly, Section 929I effectively closes the third party subpoena loophole that provided a path to compelled public disclosure of confidential information, even when the FOIA exemptions were met. This also will likely result in greater disclosure to securities regulators, more open dialogue between the regulators and the regulated, and a more transparent relationship between the SEC and the industry it is charged with regulating. There is sound logic in Congress' tacit recognition of the fact that there are certain types of sensitive information that one would not expect a financial institution to disclose to the general public, but which one would likely want them to freely disclose to its regulators.

V. INDUSTRY VIEW ON PENDING LEGISLATION

The immediate reaction to the passage of Section 929I with the Dodd-Frank Act came not only from public factions opposing it, but also from a few members of Congress itself. There are now four pending bills that seek to repeal Section 929I.

On July 29, 2010, seven days after the Dodd-Frank Act became law, Representative Issa and Representative Campbell each introduced bills—H.R. 5924 and H.R. 5948, respectively—that are designed to repeal Section 929I and to re-enact any provisions of law that it repealed, as if it had never been enacted. The securities industry views this approach as counterproductive, in that repealing Section 929I would return the industry to the position it held prior to the Dodd-Frank Act, which is that regulated entities would effectively be incentivized to withhold production of sensitive information that did not clearly fall within one of the FOIA exemptions discussed earlier for fear of its eventual compelled public disclosure. This approach would also

return the Commission to *its* prior position, which is that it would lose the open and unhampered dialogue with registered entities that Section 929I serves to foster, it would likely not receive various types of information that would be useful in meeting its regulatory obligations—which have expanded significantly under other provisions of the Dodd-Frank Act—and it would in many cases not be permitted to legally withhold any information obtained from registered entities, regardless of FOIA, if served with a third party subpoena.

On the same day that Representatives Issa and Campbell introduced their respective bills, Representative Paul introduced a bill, H.R. 5970, that is similar in aiming to repeal Section 929I, but rather than providing the re-enactment of *all* laws repealed under Section 929I, Representative Paul's bill explicitly re-instates Section 31 of the Investment Advisors by protecting from disclosure internal audit and compliance reports, terms which are defined in the bill. Again, the industry would not welcome a return to the status quo ante with respect to the lack of certainty regarding the protections afforded its most sensitive information when in dialogue with its regulators. When registered entities have certainty that they can engage in an unimpeded exchange with the Commission without fear of sensitive material ultimately ending up in the public domain, they are incentivized to more rigorously evaluate their own systems and procedures, knowing that they be disclosing more and more sensitive information during regulatory exams. As with its view of the bills introduced by Reps. Issa and Campbell, the industry does not support the Paul bill, but if Section 929I were to be repealed, the industry would support the re-enactment of Section 31. This Section was only repealed because it was unnecessary given the broader exemptive relief of Section 929I.

More recently, on August 10, 2010, Representative Towns introduced a bill, H.R. 6086, that targets the broad goal of repealing Section 929I, but which differs from the prior bills

discussed. Representative Towns' bill is designed to repeal Section 929I, but to also revise FOIA to include a definition for the term "financial institutions." This bill would not re-enact Section 31 of the Advisers Act, or any other provision of law that was repealed by Section 929I. While we would agree that defining the term "financial institutions" as it is used in FOIA would provide some needed clarity, it does nothing to address the concerns about public disclosure through third party subpoenas. In addition, this bill would not re-enact Section 31 of the Advisers Act, thereby leaving any internal audit and compliance reports produced by registered investment advisers open to the strong possibly of compelled public disclosure. This circumstance would not only return the industry to the status quo ante with respect to its well-founded fears surrounding disclosure that were harbored prior to the Dodd-Frank Act, but would actually leave the industry in a more precarious position, with an even greater of threat of possible disclosure of sensitive information than was experienced before Section 929I was enacted.

Finally, in the Senate, Sen. Leahy introduced a bill in early August, S. 3717, which, in sum and substance, mirrors Representative Towns' bill. For the reasons just described, the securities industry would likewise oppose the positions reflected in S. 3717.

VI. CONCLUSION

The securities industry and financial markets share the Commission's interest in building and maintaining the most open and cooperative regulatory dialogue possible between the industry's registered entities and the SEC. When registered entities were asked to produce the sensitive, confidential information to the SEC, while knowing that there was a likelihood that the SEC would later be legally obligated to publicly disclose such information, they were understandably reluctant to comply, regardless of how cooperative or helpful they were striving

to be. The Commission itself openly acknowledged the significant issues surrounding these disclosure concerns years ago, in an effort to resolve such problems and enhance its ability to protect investors by effectively, efficiently and comprehensively regulating the securities industry. The securities industry holds a strong interest in working to improve the regulatory dialogue and to expand the scope of openness and cooperation surrounding its interactions with the Commission. The enactment of Section 929I goes a long way towards removing the significant impediments facing both the industry and its regulators in achieving this goal.

In closing, Chairman Frank, Ranking Member Bachus and members of the Committee, I thank you again for the opportunity to address this issue on behalf of the Securities Industry and Financial Markets Association.

Written Testimony Submitted by
Steven G. Mintz
Founding Partner
Mintz & Gold LLP
Before the Committee on Financial Services
U.S. House of Representatives
Hearing on "Legislative Proposals to Address Concerns Over the SEC's New Confidentiality Provision"
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Good morning Chairman Frank, Ranking Member Bachus, and Members of the Committee. My name is Steven Mintz and I am the Founding Partner of Mintz and Gold LLP. Thank you for inviting me to testify on this important issue. The views I am expressing today are solely my own, and do not reflect the views of the Firm, or of any its clients. My personal practice areas include securities litigation including SEC and FINRA investigations and enforcement proceedings and Freedom of Information Act litigation. During the past few years, I have served as lead counsel in a number of Freedom of Information Act ("FOIA") lawsuits against the Federal Reserve, the Department of the Treasury and the Securities and Exchange Commission. In that capacity, I have been successful in getting the SEC to handover thousands of documents relating to the regulatory failures that culminated in the Bernard Madoff scandal.

INTRODUCTION

Section 929I of the Dodd-Frank Wall Street Reform and Consumer Protection Act has the unintended consequence of weakening government transparency, which has long been embodied in FOIA[1]. As a practical matter, section 929I gives the Securities and Exchange Commission ("SEC") unprecedented control over the information it has to share with the public.

A central feature of the open government principle established by FOIA is the role of the courts in mediating disclosure disputes between citizens and the executive branch. The framers of FOIA began with the premise that the executive branch should not have unfettered authority to decide which documents the press and the public can see. Consequently, they provided for adjudication by neutral courts of law and specifically directed that controversies between citizens and the government should be decided with a presumption in favor of disclosure.

Section 929I reverses that salutary arrangement by giving the agency the unilateral power to decide whether to withhold or disclose. Because of its extremely broad language, the SEC is entitled to refuse disclosure of any document or record as long as it can say that the document or record was

[1] 5 U.S.C. § 552.

obtained through – or even based on or derived from – the exercise of the agency's surveillance, risk assessment or examination duties. Further, the new provision gives the agency absolute and unreviewable authority to demand and collect information from third parties, such as broker/dealers and hedge funds, without prior review from the Office of Management and Budget. Combined with Section 929I's new "SEC Exemption" under FOIA, this will ensure that the agency can first amass untold records in the examination of persons such as Bernard Madoff and then never have to release them to the public. There is simply no meaningful place for judicial intervention in section 929I's sweeping exception to the rule of disclosure.

While Chairman Schapiro has taken the position in her July 30 letter to the Committee that the new FOIA exemption is required to safeguard the confidential proprietary information and trade secrets of business submitters, such as trading algorithms, trading strategy information, portfolio managers' trading reports and so on, such material has always been protected from disclosure under FOIA Exemption 4, which governs trade secrets and confidential commercial information.[2] Likewise, section 929I is completely unnecessary to prevent interference with the SEC's law enforcement functions, since materials compiled for law enforcement purposes are

[2] 5 U.S.C. § 552(b)(4).

already protected by FOIA Exemption 7(A).[3] By the same token, privileged documents are covered by Exemption 5[4] and records implicating personal privacy interests are covered by Exemption 6.[5]

The record is also clear that the agency has not been timid in using FOIA exemptions when faced with requests for information from the public. For example, according to a report of the SEC's Office of Inspector General ("OIG Report"), the agency invoked Exemption 4 on 132 occasions in 2007 and 160 occasions in 2008. It invoked its law enforcement function under Exemption 7(A) 518 times in 2007 and an additional 705 times in 2008.[6] It has invoked other FOIA exemptions as well.

Thus, the adequacy of existing exemptions under FOIA is not the problem. To date, the SEC has not pointed to a single instance in which it has been denied the use of an existing FOIA exemption because of statutory language that is overly narrow. Rather, the problem appears to be one of manpower, not a deficiency in the statute. Both my own experience with the SEC and the findings contained in the OIG Report suggest that the SEC is

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[3] 5 U.S.C. § 552(b)(7)(A).

[4] 5 U.S.C. § 552(b)(5).

[5] 5 U.S.C. § 552(b)(6).

[6] OIG Report at p. 11.

struggling with FOIA compliance not because of the inadequacy of the existing exemptions, but rather because it does not have the resources it needs to collect and review material that has been requested by citizens and then make careful and individualized assessments of the applicability of statutory exemptions that can later be defended in court.

There is considerable evidence that the SEC has been solving its resource problem by aggressively citing FOIA exemptions. The OIG's report revealed in particular that the agency has frequently relied upon the law enforcement exemption under section 552(b)(7)(A) without examining the documents it sought to withhold, and without regard to whether the investigation was open or closed.[7] It now seems, however, that the agency will not need to rectify its overly aggressive use of exemption 7(A) to avoid its FOIA obligations. Under Section 929I, the agency will no longer have to task employees with the review of documents to see whether a real law enforcement exemption actually applies, or defend its use of such an exemption before the OIG or a court; instead, it now has a broad categorical exemption.

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[7] Indeed, the OIG Report also found that, in 2008, the SEC granted in full *only* 10.5% of processed FOIA requests, as opposed to 41.8% for all federal agencies. Similarly the SEC partially granted 2.9% of requests in 2008, whereas federal agencies as a whole granted 18.7% of requests in part during the same period. OIG Report at p. 10.

Section 929I provides the agency with a "get out of jail free" card, enabling it to invoke Exemption 3[8] without actually conducting a document-by-document review. Instead, the agency can get by the strictures of the FOIA statute by simply labeling the requested documents as material obtained pursuant to its regulatory authority (or even as material derived therefrom).

I respectfully submit that such an evisceration of FOIA is neither necessary nor appropriate. Accordingly, section 929I needs to be repealed in its entirety. If the SEC is having difficulty complying with FOIA the solution is not to lower – or completely eliminate – the bar, but rather to adopt legislation that ensures that the agency will have the personnel, resources and internal systems to accomplish the disclosure that is required in an open society.

I. The Breadth of § 929I

FOIA establishes the public's and media's right of access to all government records unless one of nine specifically delineated "exemptions" applies. Over the past 44 years, the federal courts have developed an ample and sophisticated body of case law construing and applying the exemptions to ensure that the public's right of access is balanced against any genuine

[8] 5 U.S.C. § 552(b)(3).

need for secrecy in the executive branch. Yet, instead of seeking relief in the courts through a case-by-case adjudication – and without identifying any particular shortcoming of the existing FOIA exemptions – the SEC came to Congress and obtained a sweeping new exemption to shield it from the disclosure obligations that apply to virtually every other executive agency.

Notwithstanding the agency's effort to portray section 929I as something less than a "blanket" exemption for SEC documents,[9] a straightforward reading of the provision demonstrates that it actually encompasses virtually everything the agency does in connection with its core surveillance and examination functions. The section 929I exemption applies not only to records and information obtained under section 17(b) of the Securities Exchange Act of 1934,[10] section 204 of the Investment Company Act of 1940[11] and section 31 of the Investment Advisers Act of 1940[12], but also to records based upon or derived from such records or information. Those are the provisions that implement the SEC's basic

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[9] Letter from Hon. Mary L. Schapiro (Chair, SEC) to Hon. Barney Frank (Chair, Committee on Financial Services, U.S. House of Representatives), dated July 30, 2010 ("Schapiro Letter"), p. 2.

[10] 15 U.S.C. § 78q.

[11] 15 U.S.C. § 80a-30.

[12] 15 U.S.C. § 80b-10.

examination and surveillance functions and serve as the agency's authority for monitoring the integrity and soundness of entities such as those maintained by Bernard Madoff, R. Allen Stanford, Kenneth Ira Starr, and many others. Thus, as a practical matter, section 929I permits the agency to withhold from the public[13] all documents in its possession that it obtains or generates in connection with its regulatory activities.

Section 929I actually confers on the SEC two separate statutory exemptions that, in combination with each other, shield the agency's surveillance function from meaningful public scrutiny. First, with regard to broker-dealers, investment companies and investment advisers, the statute creates a special FOIA exemption for the SEC under 5 U.S.C. § 552(b)(3)(B) authorizing the agency to withhold the records it gathers from regulated entities. While FOIA would ordinarily require the SEC to establish a reason to withhold the documents under other exemptions, such as the exemption for trade secrets under section 552(b)(4) and the exemption for ongoing investigations under section (b)(7)(A), the new "SEC Exemption" under 929I and section 552(b)(3) is categorical in its scope.

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[13] Section 929I does have "carve-out" provisions that prevent the agency from refusing to disclose where the material has been requested by other agencies or Congress or material required to be disclosed by court order issued in legal actions brought by the United States government. However, these "carve-outs" do nothing to protect the right of the public or news media to have access to government information.

Then, immediately after creating this new FOIA exemption, Section 929I goes on to recite that the collection of information from each regulated entity "shall be an administrative action involving an agency against specific individuals or agencies pursuant to section 3518(c)(1) of title 44, United States Code". This language refers to the Paperwork Reduction Act,[14] which confers upon the Director of the Office of Management and Budget the statutory authority to review every federal agency's proposed collection of documents from the public.

Section 3518(c) of the Paperwork Reduction Act had historically exempted from OMB review the collection of information in cases specifically involving, among other things, criminal matters as well as any "investigation involving an agency against specific individuals or entities." Now that *all* information gathered by the SEC in its regulatory capacity has been swept into this exemption through section 929I, the SEC has been given a powerful double layer of secrecy. This undesirable result has been accomplished by first giving the agency unreviewable authority to demand documents and records from both registrants and third parties and then sweeping all such documents into a complete and total FOIA exemption. As a result of these dual exemptions, the SEC has been quietly delegated the

[14] 44 U.S.C. §§ 3501-3520.

unilateral authority to make its own rules regarding the dissemination of information that it collects in its surveillance function.

II.

Agency Construction of § 929I Is Not An Adequate Safeguard to Protect the Public's and Media's Right of Access to Government Records

Even the SEC has tacitly acknowledged that the FOIA exemption represented by section 929I is impossibly broad. Indeed, the agency has indicated its intention to ameliorate that defect by publishing "guidance to [its] staff that ensures the provision is used only as it was intended."[15] Assuming that the agency follows through with this promise, there are several obvious problems with this approach.

First, beyond the language of section 929I, there is no meaningful evidence of underlying congressional intent that can be used by the agency to craft relevant "guidance." As the Members who introduced the various corrective measures recognized, section 929I was included in the much larger Dodd-Frank Act without any particularized discussion or debate on this specific language. Indeed, at the time section 929I was adopted, Congress was focused almost entirely on the need to provide enhanced regulation of the securities markets and correspondingly enhanced

[15] Schapiro Letter, p. 3.

protections for consumers. It is thus reasonable to posit that, in actuality, there was no particular conscious intent on Congress's part at all when it adopted this very specialized and seemingly insignificant provision of massive regulatory reform measure. Viewed in that light, any attempt by the SEC to draft guidelines to ensure that the provision "is used only as intended" would be, at best, an exercise in futility and, at worst, an impermissible exercise in legislating by an administrative agency.[16]

Second, the SEC has already demonstrated that it is more than willing to invoke section 929I to the greatest extent permitted by its language. Before the ink was even dry on the Dodd-Frank Act, the agency tried (albeit unsuccessfully) to use section 929I retroactively to prevent enforcement of a subpoena served on its Office of Compliance Inspections and Examinations ("OCIE") by a brokerage firm, that was seeking examination records to

[16] I am aware that several members of the Senate Judiciary Committee have officially urged the SEC Chair to "narrowly interpret and apply the FOIA Exemption in Section 929I" in light of "the overwhelming public interest in restoring stability and accountability to our financial systems." Letter from Hon. Patrick Leahy, Hon. Charles E. Grassley, Hon. John Cornyn and Hon. Edward E. Kaufman to Hon. Mary L. Schapiro, dated August 4, 2010. With all due respect to the Judiciary Committee members, we believe that authorizing the SEC to "interpret" section 929I without providing an intelligible principle to guide the agency's "interpretation" could well result in an improper delegation of legislative authority.

assist in its defense against the agency's charge of fraud.[17] The following week, the agency once again indicated that it was planning to invoke the new provision in a pending FOIA action, again retroactively, in order to avoid having to give my own client, a news media outlet, documents relating to a 2004 and 2005 examination of the Bernard Madoff firm. It is worth noting that, in my own case, the agency withdrew its threat to use section 929I for this purpose shortly after its position was exposed, prompting several members of Congress to take a second look at the statute and to call for its repeal.

Third, and most importantly, the SEC's track record in implementing FOIA suggests that the agency cannot be trusted to formulate guidelines that are sufficiently protective of the public's right of access. My own recent experience in litigating FOIA claims has been that, of the three federal agencies that have played the biggest role in the recent financial crisis (the Treasury Department, the Board of Governors of the Federal Reserve and the SEC), the SEC is – by far – the most reluctant to comply with even the most basic obligations imposed by FOIA, including the obligation to conduct a reasonably adequate search for responsive documents, the

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[17] *Matter of Morgan Asset Mgt., Inc., et al.*, Admin. Proceedings Rulings Release No. 659/Aug. 3, 2010, File No. 3-13847, Order Denying Reconsideration, etc. (hereinafter "*Matter of Morgan Asset*, Order Denying Reconsideration").

obligation to conduct a serious review to ensure that only genuinely exempt documents are withheld and the obligation to provide the Court and the FOIA requester with enough information about the withheld documents to determine whether they are truly covered by the statutory FOIA exemptions. In contrast, although the Treasury Department and the Board of Governors opposed certain aspects of the various FOIA requests, those agencies by and large conducted meaningful "searches" and reviews for the requested material and limited their objections to narrow grounds based on their principled views of the FOIA exemptions that they deemed relevant.

My experience with the SEC's cavalier attitude toward the public's right of access is far from unique. The same noncompliant behavior drew considerable unfavorable comment from the Administrative Law Judge in *Matter of Morgan Asset*[18] and prompted a U.S. District Court in Minnesota to complain that "[t]he SEC ha[d] continually and deliberately stalled in fulfilling its obligations to conduct a document-by-document review of

[18] ALJ James T. Kelly specifically complained that the OCIE (a) had "failed to show that it made a good faith effort to conduct a search for the records sought," (b) had adopted a narrow view of the "relevance" of subpoenaed documents that was irreconcilable with the agency's own precedent, (c) had made "blanket" privilege claims without specifying particular privileges and, finally, (d) had advanced ever-shifting justifications for withholding the subpoenaed documents. *Matter of Morgan Asset*, Order Denying Reconsideration, pp 4-5.

material it seeks to withhold pursuant to [FOIA] Exemption 7(A)," "ha[d] attempted to play by its own rules and [had] disregard[ed] the law."[19]

These observations are echoed in the OIG Report referred to above. In the Report, the OIG Audit Office found that (a) the agency had not implemented most of the recommendations that had been made two years earlier, (b) the agency was not in compliance with Executive Order 13392 (requiring agencies to provide maximum transparency) and the OPEN Government Act, and (c) had not made adequate personnel or policy arrangements for carrying out the duties mandated by FOIA.

In summary, I respectfully submit that the solution to section 929I's excessive breadth is not additional rulemaking or "guidance" by an agency that has shown itself unable or unwilling to adhere to FOIA's requirements and goals in the past. Instead, the remedy is to simply repeal the measure, with the understanding that the agency remains free to seek Congress's assistance if it can identify a specific and concrete problem with the application of the existing exemptions to its operations. On the other hand, if (as appears to be the case) the real problem is that the agency does not have the resources to devote to the task of meaningful document search and

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[19] *Gavin v. SEC*, No. 04 Civ. 4522 (PAM/JSM), 2006 WL 1738417 (D. Minn. June 20, 2006).

review, then the solution also lies in a request to Congress for additional funding for that purpose. SEC might need more manpower; it does not require more secrecy.

III.

There Is No Legitimate Need for an Agency-Specific Exemption From FOIA's Disclosure Obligations

The sweeping protection from the SEC's disclosure obligation that section 929I represents is not needed to protect any legitimate government interest. To the contrary, to the extent that they are valid at all, the concerns that the agency has are already amply addressed by the exemption provisions that have been built into FOIA itself. These carefully crafted provisions represent Congress's best judgment as to how the public's considerable interest in governmental openness should be weighed in relation to the privacy concerns of individuals and businesses and the legitimate needs of the executive branch to conduct some of its business away from public scrutiny. The exemption provisions should not now be expanded in the context of legislation that focuses primarily upon regulatory reform and, ironically, has increased transparency in the marketplace as one of its central goals.

A. The Efficacy of Exemption 4 (5 U.S.C. § 552[b][4])

To date, the SEC has attempted to justify the broad exemption provided by section 929I by making broad-brush assertions without any supporting facts. Among these assertions is the agency's claim that the threat of disclosure of "sensitive and proprietary" information (such as customer information, trading algorithms, internal audit reports, trading strategy information, portfolio manager trading records and exchanges' electronic trading and surveillance specifications and parameters) has made it difficult for the agency to collect the information it needs to perform its regulatory responsibilities.[20] Notably, the agency has not, to date, provided any examples of cases in which it has been forced to disclose sensitive proprietary information either through a FOIA request or a subpoena issued in a judicial or administrative action.

Furthermore, the suggestion that the agency needs a new exemption from its FOIA obligation in order to assure its registrants' compliance with their responsibility to make records available for inspection and produce them to the agency[21] is disturbing on many levels. Taken at face value, the

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[20] Schapiro Letter, pp. 1-2.

[21] *See* 15 U.S.C. §§ 78q(b), 80a-30, 80b-4.

agency's argument constitutes an admission that the SEC cannot now ensure that its own rules are enforced.

To begin with, the Committee should adopt a healthy skepticism to the agency's position. First, the agency's ability to request information even from an unregistered entity is always implicitly backed up by the possibility of a subpoena down the road. Second, as a result of other provisions of the Dodd-Frank Act, entities that previously were outside the scope of SEC registration requirements, such as hedge fund advisors, will now be required to maintain books and records and be subject to the inspection regime governing investment advisers. Third, in the case of Mr. Madoff, the problem in obtaining records was not the result of FOIA, but failures by the agency in the execution of its surveillance function.

Thus, FOIA was never a serious obstacle to the agency's ability to gather needed information and will be even less of an obstacle due to Dodd-Frank. In any event, the solution would not be to entice those entities with further promises of secrecy but rather to adopt additional regulations and penalties to ensure that the law will, in fact, be obeyed.

Moreover, regardless of whether they are traditional regulated entities such as broker-dealers or are instead within the class of newcomers such as hedge funds, any legitimate concerns that regulated firms have about their

proprietary data should be wholly allayed by the existing FOIA exemption for "trade secrets and commercial or financial information obtained from a person [that is] privileged or confidential" ("Exemption 4").[22] In fact, SEC Rule 83[23] provides a specific procedure through which a regulated entity submitting information may request confidential treatment for material it submits to the agency and may thereby assure itself of an opportunity to be heard when and if a FOIA request affecting the information is made.

In fact, where confidentiality has been requested, the FOIA statute provides a system for a private entity that perceives itself aggrieved to challenge disclosure through a "reverse" FOIA proceeding.[24] The same is true for proprietary information sought through subpoenas. In such cases the SEC's own regulations provide specific mechanisms to protect information that it obtains in the course of investigations and examinations from disclosure through subpoenas. *See, e.g.,* 17 C.F.R. §§ 240.0-4 and 240.24b-2. Not only do the regulations provide that such information is confidential and non-public, they also require the SEC to respond to any such subpoena by appearing in court to challenge disclosure.

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[22] 5 U.S.C. § 552(b)(4).

[23] 17 CFR § 200.83.

[24] *Chrysler Corp. v. Brown*, 441 U.S. 281 (1979); 5 U.S.C. §706.

Having extensively researched and litigated the applicability of Exemption 4 in the context of the financial industry, I can state with complete confidence that any internal information given to a regulatory agency will be protected from disclosure under FOIA if it is genuinely proprietary in nature and its disclosure would cause the business submitter any demonstrable competitive harm. It seems clear that most of the categories of information that the Schapiro Letter cites (*e.g.*, trading algorithms, customer information, etc.) fall comfortably within these criteria. To the extent that they do not, it is difficult to see what justification there could be for protecting the information from public disclosure.

Indeed, the SEC has so far not offered any concrete examples of proprietary information that could be submitted by a regulated entity but would not be covered by the Exemption 4 privilege. Instead, it has merely speculated about the risk that some of the data obtained from regulated trading firms might be "deconstructed" or "merged into central databases" and then inadvertently disclosed under FOIA.[25] This stated concern is particularly far-fetched. The Board of Governors of the Federal Reserve System, with which I have engaged in extensive FOIA litigation, collects data from the 12 regional Federal Reserve Banks and then aggregates the

[25] Schapiro Letter, p. 2.

data for "daily term reports" and other purposes. In my experience, that agency has had no difficulty in tracing back the aggregated data to its source and then explaining why material, even in aggregated form, should be deemed too commercially "sensitive" for public release. There is no reason that the SEC cannot do the same. In fact, the very language of section 929I, which extends the exemption to "records or information *based upon or derived from*" the information obtained from regulated entities, presupposes that the SEC is capable of identifying the sources of information that has been "deconstructed" or "merged" in central databases. Once again, it is not unreasonable to expect the agency to justify its conclusion that the information in question remains commercially sensitive even in its "deconstructed" or "merged" form -- rather than affording it a blanket exemption that other, similarly situated agencies (including the Board of Governors) do not have.

B. The Efficacy of Exemption 8 (5 U.S.C. § 552[b][8])

Exemption 8 also provides a safe haven for information and records that are "contained in or related to examination, operating, or condition reports" prepared by or for agencies responsible for regulating "financial institutions." As in the case of Exemption 4, the SEC has not articulated a sound reason why Exemption 8 is not sufficient to satisfy its own and its

registrants' legitimate needs for confidentiality.[26] In fact, the agency invoked Exemption 8 seventeen times in 2007, an additional 42 times in 2008, and has not pointed to a single recent case in which an effort to rely on Exemption 8 was rebuffed by the courts.

I would note parenthetically that I question whether Exemption 8 even has a valid role to play in our modern system of open government. Most economists would argue that the financial markets are better served by transparency and that there is no longer a valid reason to conceal the results of regulatory agencies' examinations of the financial institutions that they supervise. Indeed, at the height of the recent economic crisis, the Treasury Department and the Federal Reserve conducted "stress tests" on the nation's largest banks and chose to disclose the results rather than invoking Exemption 8. Neither the banks nor the economy sustained noticeable harm.

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[26] Chairwoman Schapiro has expressed a view that Exemption 8 might not be applicable to some of the entities that are now within the SEC's purview. While one early decision held that securities exchanges and broker-dealers are not "financial institutions" within the meaning of Exemption 8. *M.A. Schapiro & Co. v. SEC*, 339 F. Supp. 467, 470 (D.D.C. 1972), that narrow view of the Exemption was long ago discredited and replaced with a view that defines covered "financial institutions" very broadly to include broker-dealers, securities exchanges and even investments advisers, *Mermelstein v. SEC*, 629 F. Supp. 672, 673-675 (D.D.C. 1986); *see Public Citizen v. Farm Credit Admin.*, 938 F.2d 290, 293-294 (D.C. Cir. 1991); *Feshbach v. SEC*, 5 F. Supp. 2d 774, 781 (N.D. Cal. 1997); *Berliner*, 962 F. Supp. at 1351 n.5, 1352.

In any event, there is no apparent reason why the entities regulated by the SEC should enjoy a privilege of confidentiality beyond the privileges that are enjoyed by banks, credit unions and other business entities that are subject to regular examination and review.

C. The Efficacy of Exemption 7(a) (5 U.S.C. § 552[b][7][A])[27]

Exemption 7(A) is always available to protect the SEC from having to make disclosure where such disclosure would be harmful to an active law enforcement investigation or proceeding. The SEC has not been shy about invoking this exemption in the past. In 2007, the SEC used Exemption 7(A) in 67 percent of all of its FOIA denials in fiscal year 2007 and in 66 percent of its denials in fiscal year 2008. OIG Report, p 11. Indeed, far from having difficulty in shielding its law enforcement documents, the SEC's FOIA staff frequently uses blanket Exemption 7(A) claims inappropriately, without actual visual inspection of the documents and sometimes even when the documents have already been made available to the public. *Id.* at 13.

Once again, it is apparent that the agency's problem is not that it has insufficient means through the existing exemptions to protect sensitive

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[27] Also deserving of mention is Exemption 5, which furnishes the agency with a privilege for documents reflecting its own deliberative processes, as well as for documents qualifying for the attorney work-product privilege. I would note that, in my own experience in litigation with the SEC, the agency has made liberal use of this exemption.

material from disclosure, but rather that it has insufficient resources to handle its FOIA duties.

The Need for Immediate Repeal

Section 929I must be repealed. This provision, which gives the SEC unilateral decision-making power over its disclosures, is directly contrary to the goal of transparency that the Dodd-Frank Act itself was supposed to advance.

"A democracy requires accountability, and accountability requires transparency."[28] "A government by secrecy benefits no one. It injures the people it seeks to serve; it injures its own integrity and operation. It breeds mistrust, dampens the fervor of its citizens, and mocks their loyalty."[29] On the other hand, opening the operations of government to public view leads to a well-informed citizenry, with greater confidence in its public institutions.[30] It is those principles that prompted the original enactment of FOIA in 1966. And, it is those principles that have impelled Congress and the courts ever since to protect FOIA's core value by limiting the exceptions to those that

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[28] Memorandum for the Heads of Executive Departments and Agencies, issued by President Barack Obama.

[29] S. Rep. No. 89-813, at 45 (1965).

[30] *U.S. Dep't of Justice v. Reporters Comm. For Freedom of the Press*, 489 U.S. 749, 750 (1989).

are strictly necessary to address specific private and governmental concerns.

As discussed above, the existing FOIA exemptions are more than sufficient to protect the legitimate needs of the agency to shelter sensitive information from the public view. In the final analysis, section 929I should be repealed because its enactment sets a very bad precedent.

In my experience as a FOIA litigator, I have become acutely aware of how many executive branch agencies believe that a policy of nondisclosure would best serve their administrative interests. Indeed, the Board of Governors of the Federal Reserve has recently taken a position that is virtually identical to that of the SEC. Like the SEC, the Board has argued that enforcement of existing disclosure rules will hamper its ability to gain the cooperation of the private entities with which it deals. Also like the SEC, the Board has argued that the obligation to make disclosure under FOIA should give way to its programmatic goals.

If the SEC is permitted to obtain its own "agency exception" to FOIA based solely on its view of the degree of secrecy needed to advance its program goals, then there would be no reason that the Board of Governors, the Treasury Department or any other government agency would not be prompted to do the same. The result would be a significant deterioration in

the open government framework that has prevailed during the 44 years since FOIA's passage.

Finally, there are presently a number of bills pending that, in some form or other, would repeal or minimize the effect of section 929I. While all the bills that have been introduced are well intentioned, the bills that would simply repeal section 929I and restore the law to what it was before section 929I are, in my mind, preferable to those that would leave the new exemption intact and simply tinker with its scope.

Thank you again for giving me this opportunity to testify. I look forward to answering any questions that you may have.

Harvey L. Pitt
Testimony on Legislative Proposals to Address Concerns over the SEC's New Confidentiality Provision
Before the United States House of Representatives Committee on Financial Services

(Sept. 16, 2010)

Chairman Frank, Ranking Member Bachus, Members of the Committee:

I am pleased to have this opportunity to testify regarding §929I of the Dodd-Frank Wall Street Reform and Consumer Protection Act ("Dodd-Frank"), and pending legislative proposals that would modify or eliminate that provision as enacted less than two months ago. My background, as it is relevant to this hearing, begins with the period 1968-1978, when I was privileged to serve on the Staff of the Securities and Exchange Commission ("SEC" or "Commission").

From 1975-1978, I served as the Commission's General Counsel. Over the more than ten years I worked at the SEC, I worked closely with seven SEC Chairmen from both political parties. As the Commission's General Counsel, I came in daily contact with legal issues surrounding third-party requests or demands for information residing in the SEC's files. These requests or demands were made under either the Freedom of Information Act ("FOIA") or pursuant to judicial subpoenas, discovery demands, or non-FOIA initiatives.

After leaving the Commission in 1978, I was a senior corporate partner at Fried, Frank, an international law firm, for nearly a quarter of a century. In my legal practice, I represented all major entities regulated by the Commission, publicly-held corporations, boards of directors, trade associations and others involved with, or having issues arising under, the federal securities, banking, administrative procedure and disclosure laws, as well as corporate laws. Among other things, I frequently was called upon to assist clients who wished, or were required, to produce proprietary information to the SEC or other agencies, without incurring the risk that such

information would wind up in the hands of competitors and other third parties.

From 2001-2003, I was honored to serve a second tour of duty at the SEC, as its 26th Chairman. Among other things, I oversaw the reopening of our nation's capital markets after the 9/11 terrorist attacks, instituted a program of "real time" enforcement, and oversaw the adoption of dozens of rules to implement Sarbanes-Oxley. Since 2003, I have been the CEO of Kalorama Partners, LLC, and Kalorama Legal Services, PLLC. The former is a global strategic business consulting firm, specializing in corporate governance, risk/crisis management, compliance and transparency issues. Kalorama Legal Services is the law firm affiliate of Kalorama Partners. The Kalorama firms do not engage in adversarial efforts vis-à-vis the SEC; rather, they assist companies that want to enhance their fidelity to important fiduciary and governance principles.

As a result of my professional experiences, I am familiar with the FOIA and non-FOIA disclosure issues the SEC faces on a daily basis. Although the Commission has the power to compel the production of a broad swath of information from an extensive group of corporations, business organizations and individuals, resorting to compulsory production can often be time consuming, and delay the Commission in responding quickly and efficaciously to matters affecting the public interest. It is a well-recognized axiom of effective regulation that promoting cooperation from those subject to the laws the SEC administers is preferable to requiring that the agency litigate its right either to obtain sensitive information, or withhold disclosure of that information when sought for inappropriate purposes, or purposes inconsistent with the public interest.

I appear today at the Committee's request, in my private capacity. Neither I nor my firms are involved on behalf of clients or others in any aspect of the current debate about §929I. Accordingly, my testimony today represents solely my own views. No one has suggested what I should or should not say with respect to the issues that are of concern to this Committee, and I have not been compensated, or otherwise received (or been promised) any benefit,

in return for my testimony. The views I offer today do not represent the views of any client of my firms, nor have I discussed my testimony with any Kalorama client.

Summary

At the outset, I want to stress that I believe there is, and should be, a strong presumption in favor of ensuring the accountability and transparency of government agencies and their formal decisions. Congress and the press, among others, need broad access to government data, to ensure such accountability. This is an important precept to which this Committee has appropriately always paid close attention. One of the most effective ways to ensure the accountability of government agencies is to provide for the public availability of a broad variety of government data, subject to appropriate restraints. Particularly once decisions have been taken, Congress, the press and the public have the right to satisfy themselves that government acted in a manner consistent with its mandates, and solely for the public interest.

But, §929I has nothing to do with transparency or accountability. Starting in 1934, with the creation of the SEC and the passage of §24 of the Securities Exchange Act, Congress has always recognized that the need for accountability must be tempered by efforts to ensure against compromising either the ability of government to make rational decisions in the first instance, or its ability to obtain whatever information it deems appropriate in deciding how to respond to various matters within its jurisdiction. The broad confidentiality of private parties' proprietary data was enacted as part of the Investment Company and Investment Advisers Acts of 1940, as well.

Dodd-Frank, as this Committee is well aware, establishes jurisdiction over a variety of entities that, heretofore, were not subject to SEC jurisdiction or regulation. The existing confidentiality provisions of the federal securities laws did not address information the Commission can be expected to receive from these newly-regulated entities as the SEC fulfills its important new statutory mandates. Nor could it be assumed that existing FOIA exemptions—

and particularly Exemption 8, relating to financial institutions—would necessarily enable the Commission to protect confidentiality of private parties' data. Thus, the fact that Dodd-Frank includes a provision—§929I—that enables the SEC to protect the confidentiality of private parties' proprietary data is neither unusual nor surprising, although some opponents of §929I have claimed otherwise.

Many who have favored or opposed §929I tend to speak in absolute terms, but that simply is not a sound basis for analyzing the issues raised by this provision. It cannot be argued that all information that comes into the possession of the SEC can be shielded from public disclosure, any more than it can be argued that none of that information should be capable of being withheld by the SEC. Rather, one must look at the types and sources of information the SEC is likely to posses, and then analyze the government's interest in protecting confidentiality against the public's right to know.

In general, government files are comprised of two broad categories of information—information generated by the government itself, meaning information that informs formal agency action, and information that reflects an agency's internal deliberations, and externally-generated private sector information gathered by the government as part of its regulatory and enforcement initiatives. There is no absolute position regarding the availability or confidentiality of government-generated information, but as a general proposition, information that forms the basis for formal agency action is usually not shielded from disclosure, whereas documents reflecting internal deliberations and legal advice often are protected against mandatory public disclosure.

The second category of information—private sector data—can also serve as predicates for formal agency action, including materials required by statute or regulation to be filed by private sector entities, as well as materials gathered to enable the government to explore a specific issue. In my experience in the private sector, I learned early on that specific government data requests can be overly broad, and capture a variety of personal and proprietary information that we would all regard as entitled to

protection against compelled disclosure. Included in this category is information about customers, trading strategies, personal income, and the like. Government may have a legitimate need for this kind of information, but the disclosure of this information could cause personal and institutional harm, while revealing absolutely nothing about government performance or accountability. In some cases, it may only be the timing of disclosure that is problematic, whereas in other circumstances the information is too sensitive and personal to warrant any disclosure.

Because of the vast variety of information and sources that the government obtains, it cannot be said that *any* information it obtains must always be produced, even in name of transparency and accountability. Even many of those concerned about §929I concede that the government must have the ability to protect certain information, at certain times, and under certain circumstances. In my opinion, §929I of Dodd-Frank strikes an appropriate balance between protecting proprietary information and assuring government transparency and accountability.

Section 929I traces its origins to years of SEC experience with confidential information, and has been supported by Chairmen from both political parties. For example, in 2006, former SEC Chairman Christopher Cox submitted a proposal to the Committee containing language similar to §929I. In September 2008, the House of Representatives passed, with broad bipartisan support, the Securities Act of 2008 (H.R. 6513) that contained similar language to §929I, although H.R. 6513 never became law. And, in 2009, current SEC Chairman Mary Schapiro resubmitted legislative proposals designed to achieve the same goal that were posted on the House Capital Markets Subcommittee website, and that language served as the base text for what ultimately became §929I. To the extent some of the advocates for repeal of §929I claim surprise or lack of notice of its substance, the legislative history conclusively demonstrates otherwise.

During my tenure as SEC General Counsel, from 1975-1978, I was very concerned that the SEC's ability to protect sensitive proprietary private data from compelled disclosure was not as

extensive as the ability long enjoyed by bank regulators to protect comparable information. Section 929I effectively gives the SEC the same ability to protect sensitive proprietary private data as has long been enjoyed by federal bank regulators. Given the requirements of Dodd-Frank—both with respect to the new responsibilities imposed upon the SEC, and the greater collaboration required among all financial services regulators (including information sharing), it was prudent for Congress to equalize the status of proprietary data that comes into the hands of the SEC with proprietary data in the hands of banking regulators.

Another distinction that must be drawn—but that frequently is overlooked by those who are troubled by §929I—relates to the mechanisms by which data in the government's possession can be sought. The FOIA provides one basis—but not the exclusive basis—for seeking access to materials in the SEC's possession. While there is a sound foundation available in Exemptions 4, 7 and 8 of the FOIA to cover many situations in which disclosure of confidential information would be premature or inappropriate, those exemptions have not always provided the clarity the SEC needs to perform its functions effectively and withhold documents sought under the FOIA. Indeed, there have been questions regarding the extent to which certain of these exemptions apply, and the circumstances under which they may be claimed, and bank regulators have not always been subject to the same uncertainties. Thus, §929I would clarify ambiguities in the law under FOIA, and put the SEC on more of an even footing with bank regulators.

But, documents can be sought outside the FOIA—for example, by the issuance of subpoenas in litigation—and when that occurs, the exemptions provided by the FOIA are not relevant in assessing the SEC's ability to withhold confidential proprietary private data. For example, bank regulators have long enjoyed a bank examiner privilege constructed by the judiciary. The SEC has not had the same extensive protection for its examination materials. Today, and particularly after Dodd-Frank, all financial services regulators must work collaboratively, share information, and make reasoned decisions regarding those subject to their jurisdiction. It only makes sense to ensure that the critical new functions entrusted to the SEC

and be performed effectively, and that should be everyone's goal. Section 929I effectively addresses the SEC's new responsibilities under Dodd-Frank (including new authority over hedge funds, private equity funds and venture capital funds). Further, §929I recognizes the obstacles and difficulties confronting the SEC when it tries to obtain proprietary data. It promotes SEC effectiveness.

Finally, given the interest in this provision, the Commission yesterday articulated the operative guidance pursuant to which the agency and its Staff will apply and utilize §929I. Under that guidance, in responding to FOIA requests and FOIA litigation, Staff may rely on §929I *only* in circumstances where an absence of case law holding that the entity at issue is a "financial institution" could restrict the application of FOIA Exemption 8 in protecting materials obtained by the Commission pursuant to an examination. In responding to discovery requests, Staff will *not* rely on §929I in any non-FOIA case in which the Commission is a party and in other cases, will use §929I *only* with respect to information gathered by the Commission pursuant to its examination authority and that would be withheld pursuant to a FOIA request. The guidance directs that Staff is not *required* to withhold information in third party litigation; where the public need outweighs the confidential interest(s) of the examined entity, Staff can release the information.

I believe the guidance is a very salutary approach, and one that reflects the best government traditions. By taking this initiative, those who worry about extreme possibilities have assurance that the SEC's actual use of this provision will not prevent transparency and accountability. I believe the Committee should consider the guidelines, and observe how they operate in practice, before attempting to dismantle an important statutory provision that only became law less than two months ago.

Discussion

The adoption of §929I was the considered and careful response of Congress to a number of problems confronting the SEC, and was not the first time that the entire House, with bi-partisan support, had passed comparable legislation. This proposal has nothing to do with

the SEC's transparency or accountability, a fact the SEC today has reinforced by its issuance of sensible guidelines regarding the uses to which §929I will be put. This provision would apply to *both* document requests made under FOIA, and to document requests made outside of FOIA.

Among the problems that necessitated the adoption of §929I were legitimate concerns about the coverage of the FOIA's existing exemptions, and the SEC's ability to provide appropriate confidentiality for sensitive information entrusted to the agency by SEC-regulated entities. Exemption 4 of FOIA *should* protect information provided to the SEC by regulatees that can be characterized as trade secrets and confidential commercial or financial information, but it does not necessarily extend to information provided to the SEC involuntarily. It is concerning to me, as a former regulator, that the SEC might inadvertently be precluded from protecting sensitive data simply because it issued a subpoena. From a law enforcement perspective, there are many salutary reasons why the SEC should not be compelled to negotiate over its ability to obtain information, or to prematurely signal its interest in specific types of information. Conversely, if voluntarily produced documents do not receive the same protection, the SEC could be forced to litigate over its right to obtain proprietary information, simply because counsel for a private party wants to ensure the full protection of the FOIA exemption.

Congress should want to promote voluntary cooperation with regulatory efforts, and §929I would permit that. Repealing it would reduce everything back to a contested litigation process, wasting valuable staff resources, and depriving the public of the efficient ability of the SEC to shut down ongoing frauds, and prevent the waste of corporate assets.

FOIA Exemption 7, which protects records or information compiled for law enforcement purposes, is fine for enforcement-generated information, but the SEC obtains documents in many non-enforcement roles. Moreover, simply because a law enforcement purpose has concluded should not signal the need for the SEC to return sensitive data it might wish to utilize in the future. Exemption

8, which protects records related to examination, operating, or condition reports provided by "financial institutions" to their regulators, doesn't clearly apply to all the entities subject to SEC regulatory oversight, especially in the wake of the SEC's expanded responsibilities. And, of course, FOIA only applies to requests for information made directly of the SEC; FOIA exemptions do not apply to litigation demands for data from the SEC.

When confronted with a subpoena, in order to protect confidential information of regulated entities who may not even be a party to the litigation, the SEC is forced to challenge those subpoenas on "common law" grounds such as relevance. Chairman Mary Schapiro appropriately pointed this out in her letters this past July to Senator Dodd and Representative Frank. Most notably, the SEC does not have a specific "common law" exemption that it can rely upon to protect factual information (which can pose the most harm to regulated businesses should the information become public) contained in its examination reports. In contrast, bank regulators have a "bank examiner privilege" that protects them from releasing information that can cause runs on banks, namely agency recommendations and opinions contained in bank examiner reports (the privilege does not protect purely factual information). The "bank examiner privilege" is a common law creation of the courts, and has long been relied upon by banking regulators as a significant protection from third party subpoenas. Courts have held that the bank examination privilege is rooted in practical necessity, including the need to foster communication and continuous flow of information between banking regulators and regulated entities. In contrast, the SEC's efforts to claim a similar examination exemption have not been universally successful, nor have they been co-extensive with the exemption available to bank examiners.

To be sure, §929I does *not* implicate the SEC's transparency and accountability. The information covered by §929I is third party data submitted to the SEC regarding its statutory and regulatory responsibilities. While this data could have transparency and/or accountability implications, it is unlikely. Rather, without §929I there is a fertile basis for companies to attempt to learn the proprietary data of their competitors. There is also a fertile basis for companies

to invade the personal privacy of competitors, including customer lists, internal audit reports, trading strategy information and trading algorithms, to name a few. Of course, §929I expressly excludes Congress from its purview, thereby ensuring that Congress is unimpeded in its function to ensure the accountability of government agencies.

From my perspective, the issue, simply put, is do we want the SEC to be effective, markets to be efficient, and investors to be protected? Since we do, we should give the SEC the necessary tools to ensure those results. Information is the lifeblood, and key, to effective and efficient capital markets. Our goal should be to encourage those who have data the SEC needs, to make that data available to the SEC, voluntarily and with a minimum of fuss and bother, so the SEC can perform its critical functions.

To me, the various criticisms that have been raised regarding §929I are not well taken; the provision is a not a "blanket" exemption from FOIA, and existing FOIA exemptions (4, 7, 8) are indeed insufficient for the SEC to protect the proprietary information of its regulated entities. The proposed guidance that the SEC has today issued is an extraordinary example of government operating at its best, and certainly is not evidence of statutory over-breadth. Further, the precursors of §929I have garnered bi-partisan support for over four years, which is a strong indication that the provision is a tool that the SEC needs to adequately perform its functions.

Potential Benefits

There are several critical benefits that flow from the adoption of §929I. First, because §929I provides greater certainty that information submitted to the SEC can be protected from compulsory third party disclosure, it encourages regulated entities to cooperate with SEC data requests. Second, §929I promotes the effectiveness of the SEC by giving it timely access to the information it needs to properly perform its examination, enforcement and oversight duties. Third, it promotes the SEC's efficiency by improving its ability to quickly gather important information from regulated entities when performing examinations; the SEC no longer will need to expend time

and resources to, for example, send Staff on premises to review hard copies because a regulated entity fears public disclosure. This latter example is not a hypothetical; it occurs frequently.

Fourth, §929I provides a finite exemption for the SEC to rely upon in preventing the release of regulated entities' proprietary information, and avoids needless sparring and litigation over the appropriate grounds for the SEC to decline a FOIA request or object to a third party subpoena in non-FOIA litigation. Fifth, §929I resolves the ambiguities presently extant (*e.g.,* whether certain regulated entities qualify as "financial institutions" under FOIA Exemption 8) and clarifies that information received by the SEC during its examination process is protected from compelled disclosure in both a FOIA and non-FOIA context. And, §929I gives the SEC more equal stature with bank regulators, which have long enjoyed a common law exemption from the release of bank examiner reports pursuant to both FOIA requests and third party litigation.

Potential Drawbacks

The Committee's invitation asked that I address potential drawbacks that might inhere in §929I. There are several potential drawbacks that §929I opponents have raised. First, there is the potential for rote invocation, or for the SEC to use §929I beyond its intended purpose of encouraging regulated entities to cooperate with SEC data needs. Second, as is true of any statutory authority, the SEC theoretically could over-use or misapply §929I to avoid disclosing a broad range of documents, including information that is neither sensitive nor proprietary. But, these potential drawbacks are effectively precluded by the SEC's issuance of guidance the SEC Staff will employ in utilizing §929I as it was intended to be used.

Need for Regulated Entity Cooperation

One of the questions posed in the Committee's invitation is whether it is really necessary for the SEC to have the authority conferred by §929I since the SEC has the power to enforce or compel the production of information from regulated entities. The issue, however, is not simply whether the SEC can obtain data, but

rather how quickly, and at what cost, it can obtain it. Contested document demands waste valuable SEC Staff resources and time, and divert the Staff's attention from more critical functions. Because the nature of the documents sought is worth fighting over, regulated entities have the incentive to slow the process down and seek judicial intervention. The addition of §929I avoids the ambiguities inherent in FOIA case law that turns on whether information is provided voluntarily or involuntarily, and enables the SEC to devote its energies to utilizing necessary information the statute allows the agency to obtain expeditiously.

Sufficiency of §929I Exclusions for Congress, Courts and Other Regulatory Agencies

Questions have been raised regarding the sufficiency of §929I's carve-out, which provides that the SEC cannot use the provision to withhold information from Congress, other regulatory agencies or from a court pursuant to an action brought by the SEC or the United States. The focus of Congress, courts and other agencies is to ensure that there is proper oversight of the SEC's functions, and that focus is clearly preserved under §929I. For example, Congress still has access to any data pertinent to its oversight of the SEC, and regulatory agencies still can obtain relevant data from the SEC.

Impact of §929I in Non-FOIA Contexts; Necessity of §929I

The impact of §929I is greatest in the area of non-FOIA document requests or third-party subpoenas pursuant to litigation. As discussed earlier, refusing a third party subpoena for sensitive information belonging to regulated entities has presented significant difficulties for the SEC, given the vagaries of common law. In my view, particularly in the context of subpoenas, §929I is necessary.

Effect of §929I on Clients

Kalorama consistently advises clients to share information with the SEC and other regulators. Section 929I serves to allay any concerns about this advice by outside counsel who frequently feel compelled to resist the sharing of such information.

View of Pending Bills—Especially H.R. 6086

I am not in favor of the pending bills that attempt to repeal §929I, namely H.R. 5970, H.R. 5924 and H.R. 5948. I am also not in favor of pending bill H.R. 6086, which strikes §929I's FOIA exemptions, provides that SEC-regulated entities are "financial institutions" for purposes of FOIA exemptions, and clarifies that the SEC can protect sensitive records obtained under its examination authority by using existing Exemption 8. While H.R. 6086 does provide some relief to the SEC by elucidating that all SEC-regulated entities are covered by FOIA Exemption 8, the rest of the bill could affirmatively harm the SEC. The need to protect sensitive information of regulated entities extends to non-FOIA requests too, which are not addressed by H.R. 6086. And the bill's deletion of a provision in the Investment Company Act of 1940, limiting the SEC's disclosure of internal compliance records and audit records belonging to regulated entities, would leave the SEC *worse* off than it was before §929I.

Additional/Concluding Thoughts

For all the foregoing reasons, I believe the need for §929I is manifest. At risk are the SEC's effectiveness and efficiency, as well as privacy issues. Section 929I poses no threat to the SEC's transparency or accountability. The appropriate limits of §929I have been set forth in SEC guidance released today, which should mitigate any apprehension regarding the provision. At a minimum, I believe it ill-behooves this Committee to recommend the repeal of a provision it passed less than two months ago, especially without ascertaining whether the guidance provided by the SEC addresses the concerns of those who are troubled by §929I.

Testimony Before the
United States House of Representatives Committee on Financial Services

"Legislative Proposals to Address Concerns Over
the SEC's New Confidentiality Provision"
Thursday, September 16, 2010
by
Chairman Mary L. Schapiro
U.S. Securities and Exchange Commission

Chairman Frank, Ranking Member Bachus, and members of the Committee:

Thank you for the opportunity to testify today on behalf of the Securities and Exchange Commission concerning Section 929I of the Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank Act). Section 929I was designed to eliminate a substantial and longstanding impediment to our examiners' ability to obtain vital examination information on a timely basis by providing clarity to regulated entities that the Commission can protect the confidential and proprietary information they provide to Commission examiners.

Overview

The Commission is responsible for examining in excess of 17,000 entities, including investment advisers, broker-dealers, credit rating agencies, self-regulatory organizations, clearing agencies, transfer agents and municipal advisors, among others. There are significant differences among these highly specialized regulated entities. Given the vital role they play in the nation's securities markets, the Commission must routinely access important and potentially sensitive information on a timely basis. Unfortunately, some regulated entities have in the past expressed concern about the level of protection available to examination materials provided to the Commission.

Though the Freedom of Information Act (FOIA) does provide important protections for examination materials obtained from "financial institutions," courts have not yet addressed whether every entity the Commission examines is a "financial institution" for purposes of these FOIA protections. In addition, these protections do not apply in non-FOIA contexts such as third-party litigation. Accordingly, Commission examinations, in some cases, have been hindered by registered entities' refusal to produce in a timely way certain information requested by examination staff due to concerns about the Commission's ability to protect the information from compelled third-party disclosure.

Section 929I enhances the Commission's ability to examine regulated entities by making clear that the Commission may protect, in appropriate circumstances, information gathered in the examination process from the many entities it regulates, supervises or examines. This provision will better enable the Commission's examination staff to access important information to monitor markets, identify risks, discover fraud and other securities law violations, and more efficiently focus its in-depth examinations – in short, to better protect investors and maintain efficient capital markets.

I understand there are questions about the scope of Section 929I. To address these concerns, Commission staff was instructed to not use Section 929I pending promulgation of Commission guidance that makes clear that Section 929I should be used in accordance with the principles of FOIA. That guidance, which the Commission recently promulgated, is both attached[1] and described in more detail below.

Prior Congressional Action

The Commission has raised these issues with Congress for many years. At least as far back as July 2006, then-SEC Chairman Cox provided legislative language that sought the same substantive protections for examination documents as the current Section 929I to the Chairmen and Ranking Members of the House Financial Services Committee and Senate Banking Committee, among others. As noted then, the proposed language sought to ensure the confidentiality of sensitive business records that the staff obtained during examinations, indicating that while such records:

> generally are protected from disclosure under [FOIA] by Exemptions 4 and 8 . . . [i]n other proceedings, such as pursuant to a court-issued subpoena, the staff must contest any production of records on grounds such as relevance and the application of common law privileges. In the absence of the [requested] provision, a judge taking an expansive view of relevance or a narrow view of possible privileges could order the production of sensitive records to a firm's competitor. Such disclosures could cause significant harm to the businesses whose records are disclosed, and the integrity of the supervisory process.

Chairman Cox provided the same legislative proposal and explanation to the Chairmen and Ranking Members of the same committees in May 2007, and re-referenced it again in May 2008.

On September 11, 2008, the House of Representatives passed the Securities Act of 2008 by voice vote. The bill was introduced by Chairman Kanjorski and was co-sponsored by seven Democrats and eight Republicans. Section 15 of that bill contained language that was virtually identical to the language Chairman Cox had provided.

Dodd-Frank Wall Street Reform and Consumer Protection Act

In July 2009, I provided a list of forty-two legislative proposals to the Chairmen and Ranking Members of the relevant House and Senate Committees and Subcommittees. Included was language that, while not identical, was substantively the same in its protection of examination documents as what Chairman Cox had provided[2] and which ultimately became Section 929I.

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[1] *See* Guidance to Staff on the Application of Section 929I of the Dodd-Frank Act, located at http://www.sec.gov/news/section-929i-guidance.htm.

[2] The operative language of Chairman Cox's proposal stated "Notwithstanding any other provision of law, the Commission shall not be compelled to disclose any information, documents, records or reports that relate to an examination of a person subject to or described in" three sections of the securities laws – Section 17 of the Exchange Act, Section 31 of the Investment Company Act, and Section 204 of the Investment Advisers Act. In my July 2009 proposal, the operative language included was "the Commission shall not be compelled to disclose records or

In November 2009, this Committee reported out the Investor Protection Act of 2009, Section 409 of which was very similar to what passed the House in 2008. This language was included in the Wall Street Reform and Consumer Protection Act that passed the House on December 11, 2009.

Finally, the base text for the Conference Committee's consideration of the financial reform bill included the current Section 929I. The provision was not amended during the conference's consideration of the legislation.

The importance of certainty in this area has been heightened by the passage of the Dodd-Frank Act, which mandates new responsibilities for the Commission, including new authority over, for example, municipal advisors, credit rating agencies, and clearing agencies that clear securities-based swaps. Fulfilling these responsibilities will require that the Commission expand and improve its examination capabilities, including its surveillance and risk assessment capabilities, to provide the type of risk-focused regulatory oversight necessary to protect investors. Accordingly, it is critical that examined entities freely share relevant and potentially sensitive information without concern that the information will later be made available to competitors or other third parties. Such disclosures may occur in response to a FOIA request or a subpoena served on the Commission in non-FOIA litigation. Section 929I was sought to address these issues.

Why the Existing FOIA Exemptions Alone Are Insufficient

Some have questioned why it is that the Commission needs Section 929I, arguing that existing FOIA Exemptions 8 and 4 should provide comfort to regulated entities that sensitive materials they provide to the Commission during examinations will not ultimately be disclosed to third parties. FOIA Exemption 8 applies to matters that are "contained in or related to examination, operating, or condition reports prepared by, on behalf of, or for the use of an agency responsible for the regulation or supervision of financial institutions," while FOIA Exemption 4 applies to "trade secrets and commercial or financial information obtained from a person [that is] privileged or confidential."

FOIA Exemption 8

With respect to FOIA Exemption 8, neither the text nor the legislative history of FOIA defines the term "financial institution" or otherwise sheds light on what Congress intended that term to encompass. The courts have looked to the Government in the Sunshine Act (Sunshine Act) for guidance, holding that FOIA and the Sunshine Act are *in pari materia*, or "upon the same matter or subject." Although the text of the Sunshine Act also does not define the term "financial institution," the legislative history includes an illustrative list of types of institutions that Act was intended to encompass. The case law applying Exemption 8 to the Commission has extended the

information obtained pursuant to [the same three sections of the Exchange Act, Investment Company Act and Investment Advisers Act], or records or information based upon or derived from such records or information, if such records have been obtained by the Commission for use in furtherance of the purposes of this title, including without limitation surveillance, risk assessments, or other regulatory and oversight activities."

exemption to those entities specifically named in the legislative history to the Sunshine Act.[3] Despite this, other types of entities the Commission is responsible for supervising, regulating or examining (e.g., credit rating agencies, transfer agents, municipal advisors) are not specifically named in the Sunshine Act legislative history and, indeed, may not even have existed when the Sunshine Act was passed three decades ago.

Although the Commission believes that all entities it regulates, supervises or examines are encompassed by the term "financial institution" and that, as a result, all entities subject to examination by the Commission should be covered by this exemption, it cannot be presumed that the courts will find that every entity the Commission examines is necessarily a "financial institution." For example, before the Sunshine Act was passed, the governing case law rejected the argument that national securities exchanges and broker-dealers were "financial institutions."[4]

Section 929I eliminates any legal uncertainty concerning FOIA Exemption 8 by making it clear that information obtained in examinations from any covered regulated entities would be protected, even if there is uncertainty as to whether they are "financial institutions" covered by Exemption 8.

FOIA Exemption 4

The Commission also believes that FOIA Exemption 4 should protect all information provided to the Commission in examinations that constitutes trade secrets and confidential commercial or financial information, but again, it cannot be presumed that courts necessarily will agree. While this exemption provides broad protection for trade secrets and confidential commercial or financial information submitted voluntarily to the government, information that is required to be submitted to the government enjoys more limited protection.[5] Because the Commission's examination authority allows it to require entities to produce information in examinations, there is a possibility that the broad protection for voluntarily submitted information might not apply to information obtained in an examination.[6]

When information is required to be submitted, it is protected only if "disclosure of the information is likely to have either of the following effects: (1) to impair the Government's ability to obtain necessary information in the future; or (2) to cause substantial harm to the competitive position of the person from whom the information was obtained."[7] To satisfy the

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[3] *See, e.g., Mermelstein v. SEC*, 629 F. Supp. 672 (D.D.C. 1986) (securities exchanges); *Feshbach v. SEC*, 5 F. Supp. 2d 774 (N.D. Cal. 1997) (broker-dealers and self-regulatory organizations), and *Berliner, Zisser, Walter & Gallegos v. SEC*, 962 F. Supp. 1348 (D. Colo. 1997) (investment advisers).

[4] *M.A. Schapiro & Co. v. SEC*, 339 F. Supp. 467, 470 (D.D.C. 1972).

[5] *See, e.g., Nat'l Parks & Conservation Ass'n v. Morton*, 498 F.2d 765, 767-70 (D.C. Cir. 1974), *as clarified by Critical Mass Energy Project v. NRC*, 975 F.2d 871, 878 (D.C. Cir. 1992) (en banc); *see generally* Department of Justice Guide to the Freedom of Information Act (*FOIA Guide*) at 276.

[6] *See Center for Auto Safety v. Nat'l Highway Traffic Safety Admin., 244 F.3d. 144,149 (D.C. Cir. 2001).*

[7] *Nat'l Parks & Conservation Ass'n v. Morton*, 498 F.2d 765, 770 (D.C. Cir. 1974).

first prong, the government cannot simply argue that forced disclosure could impair its ability to quickly and efficiently obtain similar information in the future; instead it must show that disclosure "will result in a diminution of the 'reliability' or 'quality' of what is submitted."[8] Courts rarely have found the first prong met, rejecting arguments about potential harms to reliability and quality as too speculative.[9]

Courts have limited the definition of "competitive harm" in the second prong to "harm flowing from the affirmative use of proprietary information by competitors" and have explained that this "should not be taken to mean simply any injury to competitive position, as might flow from customer or employee disgruntlement."[10] Beyond this, there are stringent requirements to establish a "competitive harm," including in some cases a line-by-line analysis and justification of potentially thousands of pages of documents. Given these impediments, courts have frequently required disclosure of information that businesses endeavored to keep confidential.[11]

Non-FOIA Litigation

Of course, neither FOIA Exemption 8 nor 4 is available in non-FOIA litigation. The Commission cannot, for example, rely on FOIA exemptions when responding to a subpoena served on it in private litigation. When faced with such subpoenas, the Commission has had to rely on arguments of undue burden, relevance, or common law privileges to protect the information provided by the registered entities.[12]

Section 929I addresses this issue by providing important protections in non-FOIA litigation, clarifying that sensitive information received from third parties in examinations should be protected from forced disclosure to outside persons in both the FOIA and non-FOIA contexts, thereby removing a substantial barrier to the Commission's ability to obtain critical information in a timely fashion via our examination and surveillance efforts.

Rather than use the Commission to gain access to the third-party information, private litigants should seek the documents from the registered entities themselves. This approach is in many

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[8] *See, e.g.*, *Critical Mass*, 975 F.2d at 878; *FOIA Guide* at 301 (and cases cited therein).

[9] *See, e.g., Niagara Mohawk Power Corp. v. DOE*, 169 F.3d 16, 18 (D.C. Cir. 1999); *Aguirre v. SEC*, 551 F. Supp. 2d 33, 52-53 (D.D.C. 2008); *FOIA Guide* at 301.

[10] *See, e.g., Pub. Citizen Health Research Group v. FDA*, 704 F.2d 1280, 1291 n.30 (D.C. Cir. 1983).

[11] *See, e.g., N.C. Network for Animals v. USDA*, No. 90-1443, slip op. at 8-9 (4th Cir. Feb. 5, 1991) (finding "evidence presented by" agency "insufficient to support" its burden, noting absence of sworn affidavits or detailed justification for withholding from submitters); *Lee v. FDIC*, 923 F. Supp. 451, 455 (S.D.N.Y. 1996) (rejecting competitive harm when submitter failed to provide "adequate documentation of the specific, credible, and likely reasons why disclosure of the document would actually cause substantial competitive injury"); *see generally FOIA Guide* at 305-47.

[12] Indeed, earlier this year the Commission received a third-party subpoena in a civil action involving only private parties broadly seeking all documents provided by three registered entities in connection with a 2007 sweep examination, as well as all internal work product based on those documents. One of the three registered entities is not a party to the litigation.

cases preferable to seeking the documents from the SEC, as the registered entities are best positioned to articulate the sensitivity of the information.

Post-Enactment Concerns and Commission Guidance

Shortly after enactment, concerns were expressed about Section 929I. The Commission shares the commitment to accountability and transparency embodied by FOIA and recognizes that Section 929I reflects a balancing of competing interests, specifically, the public's right to gain access to certain documents and information, with the need for a robust Commission examination program that encourages open communication and unfettered Commission access to information that best protects investors and contributes to orderly markets.

To ensure that these important and competing interests were fully realized, soon after passage of the Dodd-Frank Act I determined that Commission guidance for using Section 929I was necessary and instructed staff to not invoke Section 929I until such guidance was issued. Recently, the Commission published guidance instructing staff on when and how to assert Section 929I. In my view, that guidance will provide the clarity we need for a more robust examination program in a manner consistent with principles of open government. A copy of that guidance is attached. The guidance is clear and unequivocal, and states that Section 929I is:

> designed to protect the confidential and proprietary information of regulated entities and foster an open examination process – not to protect the Commission or any Commission employee. Public oversight and transparency are essential and the staff may not invoke Section 929I to withhold information to protect the Commission or a Commission employee.

The guidance defines the few circumstances in which Section 929I may be invoked, and then only to address potential gaps in the pre-Section 929I law aimed at alleviating concerns among regulated entities about the Commission's ability to protect certain information from disclosure. Specifically, the guidance addresses the extent to which the Commission will rely on Section 929I in the context of both FOIA requests and discovery requests served on the Commission. In response to FOIA requests and in FOIA litigation, the Commission will rely on Section 929I only to address situations where the absence of case law holding the entities at issue to be "financial institutions" could limit the application of FOIA Exemption 8 pertaining to examination-related materials. In response to discovery requests, the Commission will not rely on Section 929I in any non-FOIA case in which it is a party, and in other cases will invoke Section 929I only with respect to information obtained pursuant to the Commission's examination authority that would be withheld in response to a FOIA request. The Commission will, however, continue to produce documents in third-party litigation where the party requesting the documents has demonstrated a "substantial need" for them that outweighs the confidentiality interest of the examined entity.

Pending Legislation

Four bills have been introduced in the House that explicitly or effectively would repeal Section 929I: H.R. 6086 by Chairman Towns, H.R. 5948 by Congressman Campbell, H.R. 5924 by

Congressman Issa, and H.R. 5970 by Congressman Paul. I am concerned that, as currently drafted, these bills may not provide certainty to regulated entities concerning the protection of their proprietary information, thereby undercutting the Commission's ability to obtain in a timely manner the sensitive or confidential information needed for comprehensive examinations.

Though H.R. 6086 seeks to address the ambiguity in FOIA Exemption 8 relating to "financial institutions," this proposal currently would not provide any clarity to address the risk of compelled disclosure in private litigation, i.e., those instances in which third parties seek through third-party subpoenas to compel the Commission to produce documents provided to the Commission in examinations. As stated above, when responding to a subpoena served on it in private actions, the Commission is not able to rely on FOIA exemptions and instead must rely on common law arguments such as undue burden or lack of relevance. Failure to make clear that sensitive information received from third parties in examinations is protected from forced disclosure in both FOIA and non-FOIA matters will continue to inhibit the Commission's ability to obtain critical, timely information through the exercise of our examination authority.

In addition, Section 929I struck Section 31(c) of the Investment Company Act, which provided that the Commission could not be compelled to disclose – in response to a FOIA request or otherwise – any internal compliance or audit records provided to the Commission by a registered investment company. The need for Section 31(c) was obviated by the broader Section 929I. The current draft of H.R 6086, however, essentially strikes Section 929I but does not restore Section 31(c), potentially resulting in fewer protections for these entities' documents than was the case prior to Dodd-Frank.

H.R. 5948, H.R. 5924 and H.R. 5970 all would repeal Section 929I and restore Section 31(c) of the Investment Company Act, effectively returning the Commission to the pre-Dodd-Frank status quo when our examinations were impacted by registered entities' concerns about our ability to protect sensitive information from compelled disclosure. I believe a more careful balance could be reached if any legislation not only restored prior protections but also addressed the unnecessary legal ambiguities in this area, in particular (1) the "financial institution" issue concerning FOIA Exemption 8, and (2) the non-FOIA instances in which private litigants seek to compel the Commission to produce documents via third-party subpoenas.

Response to Commission's Office of the Inspector General Report on FOIA

On September 25, 2009, the Commission's Office of the Inspector General (OIG) issued a report entitled "*Review of the Securities and Exchange Commission's Compliance with the Freedom of Information Act*". The review was conducted by the OIG as part of its continuous efforts to assess management of the Commission's programs and operations and was based on the OIG's audit plan. The report contained ten recommendations developed to strengthen the Commission's FOIA function and process, including recommending that the Chairman's Office affirm the importance of FOIA to its mission and ensure the Chief FOIA Officer has sufficient Commission-wide support to fulfill the responsibilities contained in the Open Government Act.

In response, a significant number of actions have been undertaken to address the findings and recommendations made by the OIG. In summary, the significant actions taken in response to the report include:

- Hiring a new Chief Freedom of Information Act/Privacy Act Officer in October 2009;
- Requiring that a staff attorney be contacted to verify whether an open enforcement investigation is active or inactive before asserting FOIA Exemption 7(A);
- Issuing new procedural guidance that provides clear and concise processing guidance to all FOIA/Privacy Act liaisons and Commission staff tasked with involvement in FOIA responses;
- Implementing a policy that, in general, a decision on a FOIA appeal may be made only by a senior officer who did not participate substantively in processing the initial FOIA request;
- Restructuring the FOIA/Privacy Act Office to improve management oversight of quality and consistency of responses, adherence to policy and procedure, and workload volume and backlog management;
- Increasing training opportunities for FOIA staff and liaisons, including annual 3-day seminars led by the former Co-Director of the Department of Justice's Office of Information Policy (the office responsible for providing guidance to all agencies on FOIA-related questions);
- Emphasizing the importance and seriousness of every staff member's obligation to assist with making timely FOIA responses through my sending of an agency-wide email;
- Reinstating a web-based resource for all FOIA and Privacy Act matters that can be accessed by any staff member through the Commission's intranet; and
- Improving technology and office equipment resources for the FOIA/Privacy Act Office, including upgrading the software, server support and performance that is at the center of the Office's work.

Significantly, action has been taken on all ten recommendations. Nine of the ten recommendations made in the report have been closed by the OIG, and we hope to have closure on the remaining item in the very near future.

Conclusion

Section 929I is central to our ability to develop a robust examination program that better protects investors. Though we recognize the competing policy interests it raises, a return to the pre-Section 929I status quo will perpetuate circumstances that have limited the efficacy of our examination program.

I believe the Commission's guidance strikes an appropriate balance by addressing the primary issues that existed prior to Section 929I while simultaneously protecting against its application to a broader than-intended swath of information. It will allow the SEC to gain access in a timely fashion to information and data that it otherwise may not receive, thereby further enhancing our ability to maintain an efficient and effective compliance program, while also ensuring that the provision is not used to protect the Commission or its employees. It will provide certainty to registrants by clarifying that the sensitive information the Commission receives in its examination or surveillance efforts can be protected from compelled disclosure, while maintaining the commitment to transparency and accountability that FOIA promotes. In short, it will improve our ability to fulfill our mission in a manner that is consistent with the principles of open government.

Thank you again for allowing me to be here today to discuss Section 929I. I look forward to working with Congress and interested parties to ensure that these importance interests are fully achieved.

Appendix

GUIDANCE TO STAFF ON APPLICATION OF SECTION 929I OF THE DODD-FRANK ACT

Introduction. The Commission is committed to accountability and transparency in government as embodied by the Freedom of Information Act (FOIA). FOIA provides a broad framework for disclosure of government documents, subject to particular exemptions that recognize compelling public policy interests including the effective examination and supervision of financial institutions.

A fundamental element of an effective oversight and examination regime is the ability to obtain access to sensitive information from regulated entities. In FOIA Exemption 8, Congress recognized that if details from examinations were made available to the public or to competitors of financial institutions, those institutions might "cooperate less than fully with federal authorities." *Consumers Union of United States, Inc. v. Heimann*, 589 F.2d 531, 534 (D.C. Cir. 1978).

In recent years, some entities subject to examination have resisted sharing potentially sensitive information with the Commission in light of concerns about the Commission's ability to protect certain information from disclosure. These concerns arise in both FOIA and litigation contexts.

In the FOIA context, while the Commission believes that all entities it regulates, supervises or examines are "financial institutions" within the meaning of FOIA Exemption 8, a court could reach a different conclusion.

In the non-FOIA context, sensitive information obtained pursuant to the Commission's examination authority remains subject to discovery in litigation.

The uncertainty about the Commission's ability to protect sensitive information can cause delay and undermine the open dialogue and review essential for a thorough examination. These problems could be magnified as the Commission's role expands and the types of entities regulated, examined and supervised by the Commission increase. Although the Commission has considerable statutory authority to compel access to sensitive information over the objections of a regulated entity, a supervisory regime where regulated entities provide timely access to sensitive information to regulators because they are confident the information will remain protected from mandatory disclosure ensures more efficient and often more productive examinations.

Section 929I of the Dodd-Frank Consumer Financial Protection and Wall Street Reform Act (Public Law 111-203) gives the Commission clear authority to protect, in appropriate circumstances, all information gathered in the examination process from many of the entities it regulates, supervises or examines. It is an important provision that will better enable the staff to access important information to monitor markets, identify risks at regulated entities, and more efficiently focus its in-depth examinations.

Summary of the Guidance. The Commission should use Section 929I in a manner that recognizes the importance of both open government and an effective examination process. This guidance instructs the staff on when and how to assert Section 929I so that it is applied consistently with the provision's intent and the principles of open government. The guidance addresses to what extent the Commission will rely on Section 929I in the context of both FOIA requests and discovery requests served on the Commission. In response to FOIA requests, the Commission will rely on Section 929I only to address situations where the possibility that some of the entities the Commission examines may not be deemed "financial institutions" could limit the application of Exemption 8. In response to discovery requests in non-FOIA cases, the Commission will not rely on Section 929I in any case in which it is a party, and in other cases will invoke Section 929I only with respect to information obtained pursuant to the Commission's examination authority that would be withheld in response to a FOIA request. The Commission will, however, continue to produce documents if the party requesting the documents has demonstrated a "substantial need" for them that outweighs the confidentiality interest of the examined entity.

Application in Response to FOIA Requests. In response to a FOIA request, staff will invoke Section 929I only for information obtained pursuant to the Commission's examination authority, and only to information provided by entities not already clearly covered as "financial institutions" under FOIA Exemption 8. Because FOIA Exemption 8 protects materials related to examinations of "financial institutions" – but does not define the term "financial institution" – staff should invoke Section 929I in response to a FOIA request only:

(1) where the request seeks information obtained pursuant to the Commission's examination authority from an entity the Commission is responsible for regulating, supervising or examining;

(2) the examined entity may not be clearly recognized as a "financial institution" under Exemption 8; and

(3) Exemption 8 would protect the information if the entity were clearly deemed a "financial institution."

Application in Response to Discovery Requests where the Commission or the United States Is a Party. In non-FOIA litigation, staff should *not* invoke Section 929I in response to discovery requests where the Commission or the United States is a party.[13] As noted above, Section 929I was designed to protect information obtained pursuant to the Commission's examination authority where parties in litigation are using the discovery process to seek from the Commission information about their competitors or about other unrelated entities.

Application in Response to Third-Party Discovery Requests (where the Commission or the United States Is Not a Party). In response to discovery requests in litigation in which neither the Commission nor the United States is a party, Section 929I may be invoked only if:

[13] When the Commission is a defendant in FOIA litigation, staff should be guided by the Application in Response to FOIA Requests.

(1) the information sought was obtained pursuant to the Commission's examination authority from an entity the Commission is responsible for regulating, supervising or examining,

(2) the information would be withheld if sought in a FOIA request; and

(3) the requesting party has not demonstrated a "substantial need" sufficient to overcome the need to maintain confidentiality.

In deciding whether a "substantial need" has been shown, the staff should consider (i) the relationship of the information to the issues raised by the litigation in which the discovery is being sought; (ii) the requestor's need for the information to prepare or present its case; (iii) the reason why the requestor cannot obtain the information from any other source; and (iv) the requestor's commitment to obtain a protective order acceptable to the Commission from the judicial or administrative tribunal hearing the action. The need to maintain confidentiality is paramount when the information at issue is a trade secret or confidential commercial information within the meaning of FOIA Exemption 4, and confidentiality of such information should be maintained in private litigation except in extraordinary circumstances.

Discretionary Disclosures. Section 929I and FOIA do not *require* the Commission to withhold information. Even if Section 929I or a FOIA exemption may provide a basis for withholding information, the Commission should make disclosures, where permitted by law, when the need for confidentiality is outweighed by the public's interest in accountability and transparency.[14]

As noted, these provisions are designed to protect the confidential and proprietary information of regulated entities and foster an open examination process – not to protect the Commission or any Commission employee. Public oversight and transparency is essential and the staff may not invoke Section 929I to withhold information to protect the Commission or a Commission employee.

Application in Administrative Proceedings Brought by the Commission or the United States. Section 24(f) of the Exchange Act (as renumbered pursuant to Section 929I(a) of the Dodd-Frank Act), Section 31 of the Investment Company Act of 1940 (as amended by Section 929I(b) of the Dodd-Frank Act), and Section 210 of the Investment Advisers Act of 1940 (as amended by Section 929I(c) of the Dodd-Frank Act) confirm that the Commission cannot assert Section 929I as a basis for refusing to "comply with an order of a court of the United States in an action brought by the United States or the Commission." The staff should interpret "a court of the United States" as including administrative proceedings brought by Commission divisions or offices.

[14] The Commission cannot make a discretionary release pursuant to Section 929I or FOIA if another provision of law prohibits disclosing the information at issue (*e.g.*, if the Privacy Act or the Trade Secrets Act requires that the information be withheld). In addition, before making any discretionary disclosure of information that is subject to a confidential treatment request, the staff should first follow the procedures detailed in the Commission's regulations. *See* 17 C.F.R. 200.83.

No Private Right. This guidance does not create any right or benefit, substantive or procedural, enforceable at law or equity by any party against the Commission.

If you any questions about this Guidance, please contact Richard Humes, Associate General Counsel for Litigation and Administrative Practice.

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September 15, 2010

The Honorable Mary Schapiro
Chairman
U.S. Securities and Exchange Commission
100 F Street Northeast
Washington, D.C. 20549

Dear Chairman Schapiro:

Thank you for your August 24, 2010, response[1] to my August 6, 2010, letter[2] concerning Section 929I of the Dodd-Frank financial regulation legislation ("Dodd-Frank").[3] I continue to believe the exemptions from the Freedom of Information Act ("FOIA") granted to the Securities and Exchange Commission by Section 929I are inappropriate. First, Section 929I's scope is unprecedented. Its new exemptions arguably insulate nearly all of the Commission's supervisory work from transparency under FOIA. Second, the new exemptions allow the Commission unrestrained discretion to decide when, if ever, to comply with FOIA requests. This discretion has already been misused, which leads me to doubt that the Commission will restrain itself in the future – even after issuing internal guidance, as you have proposed. Third, FOIA's existing exemptions are sufficient to protect the entities that the Commission regulates from fear that their sensitive information will be revealed in response to FOIA requests. Finally, you have argued that Section 929I is also needed to address regulated entities' concerns that their information might be turned over in response to subpoenas in third-party litigation. But Congress should address those separate concerns without affecting the rights of the American people to request information from the Commission under FOIA.

Section 929I's Scope is Unprecedented.

As you know, Section 929I provides that the Commission "shall not be compelled" – in response to a FOIA request or a third-party subpoena – to disclose records or information it obtains from regulated entities under three key provisions of the

[1] Letter from Mary Schapiro to Darrell Issa, Aug. 24, 2010.
[2] Letter from Darrell Issa to Mary Schapiro, Aug. 6, 2010.
[3] Pub. L. No. 111-203 (July 21, 2010) at §929I.

securities laws. Those provisions are Section 17 of the Securities Exchange Act,[4] which covers exchanges, broker-dealers, ratings agencies, *etc.*; Section 31 of the Investment Company Act,[5] which covers registered investment companies and subsidiaries; and Section 204 of the Investment Advisers Act,[6] which covers all investment advisers. Section 929I also covers records or information "based on or derived from" these materials.[7] It is hard to imagine any information related to the Commission's regulation and supervision of these types of entities that would *not* fall within Section 929I's sweeping exemptions.

Section 929I is particularly troubling because the scope of its exemptions is not defined by objective criteria. Rather than apply only to regulated entities' trading strategies, internal audit reports, customer information, employee records, or other sensitive categories, these exemptions cover *all* information that regulated entities disclose to the Commission under the three key securities law provisions, and everything based on such materials. The information that the regulated entities must disclose under the securities laws is determined by the Commission itself, via administrative rulemaking.[8] In other words, if the Commission wishes to expand the Section 929I FOIA exemptions, it can do so at will, by modifying its own rules. Section 929I, then, grants the Commission an immunity to FOIA that is universal, expandable, and impervious to challenge.[9]

In your August 24 letter, you defended Section 929I by claiming that the Commission asked Congress to enact "similar" statutory language "as far back as 2006."[10] But a review of the correspondence you cited shows this is not the case. In 2006 and 2007, Chairman Christopher Cox proposed the following language in his annual letters to the relevant Congressional committees:

> [T]he Commission shall not be compelled to disclose any information, documents, records, or reports *that relate to an examination of a person* subject to or described in [Section 17 of the Securities Exchange Act, Section 31 of

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[4] 15 U.S.C. §78q.
[5] 15 U.S.C. §80a-30.
[6] 15 U.S.C. §80b-4.
[7] Pub. L. No. 111-203 (July 21, 2010) at §929I.
[8] *See* 15 U.S.C. §78q(a) (requiring regulated entities to "make and keep for prescribed periods such records, furnish such copies thereof, and make and disseminate such reports as the Commission, *by rule*, prescribes as necessary or appropriate in the public interest, for the protection of investors, or otherwise in furtherance of the purposes of this title") (emphasis added); 15 U.S.C. §78q(b) (making such records subject to examination by the Commission); 15 U.S.C. §80a-30(a), (b) (similar); 15 U.S.C. §80b-4(a) (similar).
[9] *See* Gary J. Aguirre, "The Dodd-Frank Act: A FOIA Exemption for SEC Misconduct," WALL STREET LAWYER, Sept. 2010, at 18, 20. Furthermore, Section 929I insulates the Commission's rulemaking under the key securities law provisions from OMB review by defining it as "an administrative action involving an agency against specific individuals or agencies" under 44 U.S.C. 3518(c)(1). Pub. L. No. 111-203 at §929I(a)(3), (b)(1), (c); *see also* Aguirre at 20.
[10] Letter from Mary Schapiro to Darrell Issa, Aug. 24, 2010.

> the Investment Company Act, and Section 204 of the Investment Advisers Act].[11]

In other words, the Commission previously requested FOIA exemptions that were limited to its *examinations* of regulated entities under three key securities law provisions – a much narrower class of information.[12] By contrast, Section 929I applies to *everything* that the Commission might receive from regulated entities. In addition, the exemptions that were requested in 2006 and 2007 would not have permitted the Commission to expand them at will through its own rulemaking, as the Section 929I exemptions do. To sum up, the previously-requested exemptions may well have been broad – and, if enacted, they might have roused similar protests to those that have greeted Section 929I[13] – but to claim that they are "similar" to Section 929I is, at best, misleading.

Section 929I Has Already Been Misused, And Internal Guidance Is An Insufficient Safeguard.

Because its exemptions cover the Commission's entire program of regulation and supervision,[14] Section 929I can easily be used for purposes unrelated to the goal you cited in your letters to Congress – namely, to encourage regulated entities to comply quickly with Commission requests for "sensitive and proprietary information."[15] Records revealing the Commission's regulatory and management failures, such as its botched

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[11] Letters from Christopher Cox to Richard Shelby, Christopher Dodd, Barney Frank, Michael Oxley, Richard Baker, Paul Sarbanes, and Chuck Hagel, July 5, 2006, with attached legislative proposals, at xvi-xvii, "Protecting Confidentiality of Materials Submitted to Commission" ("Cox 2006 Proposals"); Letters from Christopher Cox to Christopher Dodd, Richard Shelby, Barney Frank, Spencer Bachus, May 15, 2007, with attached legislative proposals, at xv-xvi, "Protecting Confidentiality of Materials Submitted to Commission" ("Cox 2007 Proposals") (identical proposals; emphasis added).

[12] The Commission noted in 2006 and 2007 that the records covered by its request were generally already protected from FOIA requests by FOIA Exemptions 4 and 8. *See id.* at Explanation. By contrast, all parties concede that Section 929I insulates a far greater universe of documentation from FOIA requests than would be protected under FOIA's existing exemptions. (The exemptions proposed in 2006 and 2007 would also have protected information related to "the financial or operational condition" of entities examined under the Securities Exchange Act – a similarly limited category. *See id.*)

[13] *See* Letter from American Library Association, American Association of Law Libraries, Citizens for Ethics and Responsibility in Washington, Essential Information, Government Accountability Project, Liberty Coalition, OMB Watch, OpenTheGovernment.org, Project on Government Oversight, Public Citizen, and Sunlight Foundation to Sen. Christopher Dodd and Rep. Barney Frank, Aug. 3, 2010, *available at* http://www.pogo.org/pogo-files/letters/financial-oversight/fo-fra-20100803.html ("Transparency Organizations' Letter"); *see also* Daniel Schuman, "Dodd and Frank asked to repeal FinReg FOIA exemption," Sunlight Foundation, Aug. 3, 2010, *available at* http://blog.sunlightfoundation.com/2010/08/03/dodd-and-frank-asked-to-repeal-finreg-foia-exemption/.

[14] Section 929I's exemptions may not cover the Commission's receipt and review of securities disclosure filings by public companies, but do cover all of the Commissions activities relating to the entities designated by the key securities law provisions, *see supra*.

[15] Letter from Mary L. Schapiro to Barney Frank and Christopher Dodd, July 30, 2010, *available at* http://voices.washingtonpost.com/market-cop/frank.pdf and http://voices.washingtonpost.com/market-cop/frank.pdf ("Frank / Dodd Letter"), 1-2.

investigations into insider trading by Pequot Capital Management[16] and Ponzi schemes by Bernard Madoff[17] and R. Allen Stanford,[18] could be withheld under Section 929I's exemptions.[19]

You have proposed to address Section 929I's breadth, and the danger of misuse, with official Commission guidance that will "instruct[] [Commission] staff on when and how to assert the provision so that it is applied consistent with principles of open government and only to address issues regarding sensitive information obtained through the examination process."[20] But your promise misses the point. Section 929I ensures that the Commission will never lose a FOIA case. As I have pointed out, the very need for guidance on how Section 929I is to be used by the staff demonstrates that the provision is overbroad. The Commission should not have been given such wide statutory discretion in the first place.

In my August 6 letter, I pointed out that the Commission had already invoked Section 929I in a manner inconsistent with "principles of open government." Immediately after Dodd-Frank's passage, Commission counsel cited Section 929I in a telephone conversation with opposing counsel in a lawsuit brought by FOX News under FOIA seeking information about the Madoff investigation.[21] Clearly, withholding Madoff-related documents is not "open government," nor is such stonewalling necessary to reassure regulated entities that their sensitive information will be protected. You note, in your August 24 letter, that Commission counsel had not yet "formally asserted" Section 929I in court filings, but instead merely "explained ... that Section 929I exists and could provide an additional basis for withholding documents that the Commission has already withheld pursuant to other FOIA exemptions."[22] But Section 929I need not be "formally asserted" in a legal brief to be misused. Simply by mentioning it, Commission counsel sought to chill future FOIA requests[23] for information about the Madoff case – an episode in which full accountability and transparency are crucial to the Commission's legitimacy and credibility.

Furthermore, you have not attempted to defend your staff's improper invocation of Section 929I in the *Morgan Asset Management* case, which I described in my August 6

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[16] *See* U.S. Senate Committee on Finance, Print No. 110-28, *The Firing of an SEC Attorney and The Investigation of Pequot Capital Management*, Aug. 3, 2007.
[17] *See* U.S. Securities and Exchange Commission Office of Investigations, Report No. OIG-509, *Investigation of Failure of the SeC to Uncover Bernard Madoff's Ponzi Scheme*, Aug. 31, 2009.
[18] *See* U.S. Securities and Exchange Commission Office of Investigations, Case No. OIG-529, *Investigation of the SEC's Response to Concerns Regarding Robert Allen Stanford's Alleged Ponzi Scheme*, March 31, 2010.
[19] *See* Aguirre, *supra*, at 18 and *passim*.
[20] Letter from Mary Schapiro to Darrell Issa, Aug. 24, 2010, at 2.
[21] *See* Dunstan Prial, "SEC Says New Financial Regulation Law Exempts it from Public Disclosure," *FoxBusiness*, July 28, 2010, *available at* http://www.foxbusiness.com/markets/2010/07/28/sec-says-new-finreg-law-exempts-public-disclosure/ ("Fox Article").
[22] *See* Letter from Mary Schapiro to Darrell Issa, Aug. 24, 2010, at 2-3.
[23] *See* Fox Article, *supra*.

letter.[24] Instead, your letter points out that the staff's attempt to use Section 929I in court to avoid disclosing broad categories of documents "preceded my directive that staff not utilize [Section 929I] until after the Commission issues guidance."[25] The Commission attorneys who decided to raise Section 929I in *Morgan Asset Management* were seeking to avoid the disclosure of broad categories of documents, many of which were not "sensitive information obtained through the examination process."[26] They clearly believed that Section 929I might insulate all of the Commission's examination activities from compulsory disclosure.

Despite your assurances, the Commission has already begun to use Section 929I to avoid embarrassment and hide evidence of its regulatory and management failures, and has also invoked it to insulate categories far broader than "sensitive information obtained through the examination process." We cannot trust the Commission will begin to self-police its use of Section 929I through internal guidance – which will be subject to change and interpretation without oversight by Congress or anyone else.

FOIA's Exemptions are Sufficient to Protect Regulated Entities' Sensitive Information.

You have argued that "[e]xisting FOIA exemptions were insufficient" to allay regulated entities' concerns that their sensitive and proprietary information would be revealed in response to FOIA requests.[27] These concerns, you have argued, have made it difficult for the Commission to quickly obtain such information when performing examinations.[28] When pressed for supporting arguments,[29] you stated that (1) Exemption 8 does not clearly apply to all the entities regulated by the Commission;[30] and (2) courts have sometimes refused to apply Exemption 4 to information provided to the government on a mandatory basis.[31] Further, in response to my request that you describe types of

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[24] Letter from Darrell Issa to Mary Schapiro, Aug. 6, 2010, at 2. In *In the Matter of Morgan Asset Management, Inc., et al.*, SEC File No. 3-13847, an SEC administrative proceeding against financial firms and individuals, the respondents served a subpoena on OCIE seeking "(1) examination or inspection records for [the respondents and their investment funds] ... (2) documents related to OCIE's examination or review of fair value procedures of the same entities during the same period, (3) documents pertaining to the pricing or valuation of the 389 securities at issue [in the case]; and (4) materials relating to a sweep discussed by a senior Commission official in a newspaper article." *Morgan*, Order Granting in Part and Denying In Part Motion to Quash Subpoena, July 20, 2010, *available at* http://www.sec.gov/alj/aljorders/2010/ap658jtk.pdf, at 1. OCIE attempted to argue that "Section 929I protects from compulsory disclosure *all* the documents sought by Respondents' subpoena." *Morgan*, Order Denying Reconsideration, Certification, and a Stay, Aug. 3, 2010, *available at* http://www.sec.gov/alj/aljorders.shtml, at 2. The Administrative Law Judge held that OCIE could not claim the protection of Section 929I because the provision was not retroactive. *Id.*

[25] *See* Letter from Mary Schapiro to Darrell Issa, Aug. 24, 2010, at 3.

[26] Letter from Mary Schapiro to Darrell Issa, Aug. 24, 2010, at 2.

[27] Frank / Dodd Letter, *supra*, at 2.

[28] *Id.* at 1-2.

[29] Letter from Darrell Issa to Mary Schapiro, Aug. 6, 2010, at Requests Nos. 3, 6.

[30] Letter from Mary Schapiro to Darrell Issa, Aug. 24, 2010, at Answer No. 3.

[31] *Id.* at Answer No. 6.

information that regulated entities have withheld from the Commission *and* that was not covered by any FOIA exemption,[32] you provided four examples.[33]

First, Exemption 8 provides that FOIA cannot be used to force the disclosure of information covered in regulators' examinations of financial institutions.[34] You argue that "it has not been clearly established by the courts that certain entities regulated by the Commission ... are 'financial institutions' within the meaning of FOIA Exemption 8."[35] However, every court that has addressed the application of this particular exemption to SEC-regulated entities since 1972 has found that it does, in fact, apply.[36] In any event, if the application of Exemption 8 is indeed uncertain, Congress could have clarified it without enacting Section 929I's extraordinarily broad exemptions.

Second, you argue that Exemption 4, "while it provides broad protection for trade secrets and confidential commercial or financial information submitted *voluntarily* to the government," is more limited when applied to information that must be submitted on a mandatory basis.[37] For one thing, this argument proves too much: if the Commission has the power to compel regulated entities to turn over their information, then it should simply exercise that power. I understand that Commission examiners frequently negotiate with regulated entities regarding which information they will turn over, rather than immediately asking the Commission to issue a binding subpoena. But your argument does not justify Section 929I's broad exemptions – which hide *all* information about the Commission's regulatory programs from FOIA requests. Moreover, the Commission seems to have had no difficulty asserting Exemption 4 in the courts: in over four decades since FOIA's first enactment, its interpretation of Exemption 4 has been overruled only once.[38]

Third, your four examples[39] do not justify Section 929I's broad exemptions. In your first and fourth examples, Commission examiners faced *delays*, not out-and-out refusals, in receiving requested information from regulated entities.[40] After negotiating

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[32] Letter from Darrell Issa to Mary Schapiro, Aug. 6, 2010, at Request No. 5.
[33] Letter from Mary Schapiro to Darrell Issa, Aug. 24, 2010, at Answer No. 5.
[34] 5 U.S.C. § 552(b)(8) ("This section does not apply to matters that are ... contained in or related to examination, operating, or condition reports prepared by, on behalf of, or for the use of an agency responsible for the regulation or supervision of financial institutions").
[35] Letter from Mary Schapiro to Darrell Issa, Aug. 24, 2010, at Answer No. 3.
[36] *See* Aguirre, *supra*, at 21.
[37] Letter from Mary Schapiro to Darrell Issa, Aug. 24, 2010, at Answer No. 6 (emphasis original). *See also* 5 U.S.C. § 552(b)(4) ("This section does not apply to matters that are ... trade secrets and commercial or financial information obtained from a person and privileged or confidential").
[38] Aguirre, *supra*, at 21-22.
[39] Letter from Mary Schapiro to Darrell Issa, Aug. 24, 2010, at Answer No. 5.
[40] *Id.* ("[First example:] During an examination of an investment adviser registered with the Commission that manages several large funds that pursue a quantitative trading strategy, the adviser refused to turn over the details of its strategy to the Commission because the adviser feared that the information would be revealed to the public pursuant to a FOIA request or otherwise. Specifically, the registrant asserted that the Commission could not have the proprietary strategies because there was too much risk that the information would be disclosed to third parties, thereby harming the adviser's business. Without assurances by the staff

with the regulated entities, the examiners presumably were able to obtain sufficient information to conclude their examinations. These delays might be addressed by further streamlining the Commission's internal subpoena issuance process, but they are not a reason for Congress to dismantle FOIA. In your second and third examples, you state that regulated entities have sometimes asked Commission staff to review internal audit reports and employees' personal trading records on-site, rather than making copies.[41] These materials, based on your description, seem to fall squarely within the scope of Exemption 4 and other FOIA exemptions.[42] In fact, none of your examples are information of the kind that I asked you to describe: "information that was actually withheld from an SEC examiner under the circumstances described by your July 30, 2010 letter [to Senator Dodd and Chairman Frank] and was not covered by any FOIA exemption."[43]

Finally, you claim, in passing, that Section 929I "eliminates any legal uncertainty that may exist" concerning the application of FOIA to sensitive information that regulated entities turn over to the Commission.[44] In my opinion, the opposite is true. Section 929I allows the Commission staff to treat FOIA requests on a case-by-case basis, unconstrained by Congress, and guided only by internal policies that are subject to change without notice. Regulated entities may well find changeable internal guidance a less certain guide than statutes and case law when predicting which of their information might become public and which will remain secret. At best, your arguments and examples might justify strengthening or clarifying FOIA's existing exemptions, but they

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guaranteeing confidentiality of the information, that adviser refused to provide the staff the requested information. After extended discussions with the staff, the adviser eventually agreed to turn over certain information in response to narrowed requests. ... [Fourth example:] During a recent exam of a high-frequency trading firm, the Commission encountered several objections and substantial delays in receiving documents and information because of confidentiality fears related to the firm's trading strategies and profit / loss reports").

[41] *Id.* ("[Second example:] Registered investment advisers ask that Commission staff not take copies of internal audit reports because the firms fear that the staff cannot safeguard the information. Staff often will be permitted to view the internal audit reports onsite, but will not be provided with copies ... [Third example:] Investment advisers sometimes refuse to turn over personal trading records of investment management personnel, instead requiring the staff to review hard copies that the staff cannot take with them off premises. To address these concerns, staff has resorted to taking notes and then manually reviewing the personal trading against the firm's trade blotter.")

[42] Internal audit reports clearly fall within Exemption 4 to FOIA. Moreover, the internal audit materials of registered investment companies had their own specific FOIA exemption before Dodd-Frank was enacted. *See* 15 U.S.C. §80a-30(c) prior to Dodd-Frank ("Notwithstanding any other provision of law, the Commission shall not be compelled to disclose any internal compliance or audit records, or information contained therein, provided to the Commission under this section"). Meanwhile, employees' personal trading records arguably implicate several FOIA exemptions, including Exemption 6. *See* 5 U.S.C. §552(b)(6) ("This section does not apply to matters that are ... personnel and medical files and similar files the disclosure of which would constitute a clearly unwarranted invasion of personal privacy.") Finally, the regulated entities' concerns that you describe in your second and third examples would seem focused on a fear that Commission staff might leak, steal, or misuse the documentation – not that the Commission might be compelled in court to disclose it.

[43] Letter from Darrell Issa to Mary Schapiro, Aug. 6, 2010, at Request No. 5.

[44] Letter from Mary Schapiro to Darrell Issa, Aug. 24, 2010, at 4.

do not support what Section 929I has done – which is to exempt the Commission entirely from FOIA's provisions, exemptions, and case law.[45]

Congress Should Consider Third-Party Subpoena Protection Without Destroying FOIA.

Throughout your correspondence with Members of Congress, you argue that Section 929I is intended to address regulated entities' fears that their sensitive information will be revealed in one of two ways: either in response to a FOIA request or in response to a subpoena served on the Commission in third-party litigation.[46] These two concerns are actually very different from one another. FOIA exists to allow news media, watchdog groups, and the American people access to their government's records so that they can hold it properly accountable; in third-party litigation, private firms often seek rivals' records in order to gain a competitive edge. It is surely possible to protect regulated entities from having their sensitive information disclosed by the Commission in response to unwarranted third-party subpoenas without restricting Americans' freedom of access under FOIA.[47] But Section 929I does not distinguish between the very different considerations that should apply to these different situations. Neither do your letters to Congress.

I would welcome your suggestions on how Congress might protect regulated entities' sensitive information against abusive third-party subpoenas without affecting FOIA. Any legislative solution would need to be well-justified by the Commission's previous experiences with third-party subpoenas, be narrowly tailored to prevent the Commission from self-serving secrecy, and hew closely to well-developed common-law principles. Above all, such a statute would require careful consideration and public hearings by the appropriate committees of Congress – scrutiny that Section 929I never faced.

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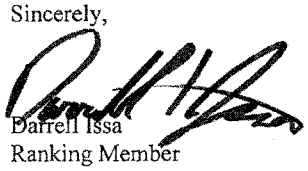
[45] As noted *supra*, Section 929I's exemptions may not cover the Commission's receipt and review of securities disclosure filings by public companies, but do cover all of the Commission's activities relating to the entities designated by the key securities law provisions.

[46] *See, e.g.*, Letter from Mary Schapiro to Darrell Issa, Aug. 24, 2010, at 2.

[47] In fact, it seems likely that the narrower exemptions that the Commission proposed in 2006 and 2007 were intended to protect regulated entities' sensitive information from third-party subpoenas without affecting the disposition of FOIA requests. *See* Cox 2006 Proposals and Cox 2007 Proposals, at Explanation ("This provision would amend Section 17(j) [of the Securities Exchange Act, with parallel amendments to the Investment Company Act and the Investment Advisers Act] to also protect the confidentiality of other sensitive records and information that the staff obtains during the supervisory process. *These records generally are protected from disclosure under the Freedom of Information Act (FOIA), by Exemptions 4 and 8.* In other proceedings, such as pursuant to a court-issued subpoena, the staff must contest any production of records on grounds such as relevance and the application of common-law principles.")(emphasis added). Judging from the explanation that accompanied the 2006 and 2007 proposals, the Commission was seeking only to insulate from third-party subpoenas information that already would have been protected from FOIA requests by Exemptions 4 and 8. By contast, Section 929I encompasses *everything* received by the Commission from regulated entities and *all* records based on or derived from that information, regardless of whether subject to Exemptions 4 and 8 or not.

If you have any questions regarding this letter, please contact Hudson Hollister with the Committee staff at (202) 225-5074.

Sincerely,



Darrell Issa
Ranking Member

cc: The Honorable Edolphus Towns, Chairman,
Committee on Oversight and Government Reform
The Honorable Barney Frank, Chairman,
Committee on Financial Services
The Honorable Spencer Bachus, Ranking Member,
Committee on Financial Services

UNITED STATES
SECURITIES AND EXCHANGE COMMISSION
WASHINGTON, D.C. 20549

THE CHAIRMAN

October 27, 2010

The Honorable Mel Watt
U.S. House of Representatives
Committee on Financial Services
2304 Rayburn House Office Building
Washington, D.C. 20515

Dear Representative Watt:

At the September 16, 2010 House Committee on Financial Services hearing concerning Section 929I of the Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank Act), you asked that I provide you with my thoughts on the May 18, 2010 Minority Staff Report of the House Committee on Oversight and Government Reform (Minority Staff Report).

When I joined the Commission early last year, we were just emerging from an economic crisis that threatened our financial system and the entire American economy. Since then, we have taken significant steps to make the SEC more vigilant, sharp, and responsive, and focus the agency squarely on its mission to protect investors, maintain fair and orderly markets, and facilitate capital formation. We brought in new leaders across the agency. We streamlined our procedures. We worked to reform the ways we operate. We began modernizing our systems. We set out to regulate more effectively. We fully engaged in the debate on regulatory reform, and we initiated one of the most significant investor-focused rulemaking agendas in decades. While we have made real progress, restoring investor confidence and rebuilding the trustworthiness of financial institutions and markets will require a sustained regulatory commitment. The coming years will be critical in our continuing efforts to reinvigorate the Commission and its programs.

Below is information responding to the findings in the Minority Staff Report.

Summary Finding Concerning Bernard Madoff Fraud

In August 2009, the SEC's Office of the Inspector General (OIG) published a report on the numerous missed opportunities to uncover the Bernard Madoff fraud. The OIG report traces the SEC's shortcoming in a number of areas. As we said when the report was published, it is clear that no one can or should defend, excuse, or deflect responsibility for the SEC's handling of this matter.

Well before the report was issued in September 2009, the agency already had begun instituting extensive reforms, including vastly expanding our training programs, hiring staff with new skill sets, streamlining management, revising our enforcement and examination procedures,

restructuring processes to ensure better sharing of information, leveraging the knowledge of third parties, revamping the way we handle the large volume of tips we receive annually, and improving our risk-assessment techniques so that examiners are knocking on the right doors and delving into the right issues.

Progress on these initiatives has continued since the issuance of the OIG Report. For example, as the minority staff report notes and as described in more detail below, the Division of Enforcement recently has undergone a fundamental restructuring. The Division has adopted a more streamlined organizational structure in order to place additional seasoned investigators on the front lines of investigations, and has created five specialized investigative units dedicated to high-priority areas of enforcement. The Division also has established an Office of Market Intelligence, which, among other things, now serves as a central office for the handling of complaints, tips, and referrals that come to the attention of the Division.

In our examination program, we are placing greater reliance on risk assessment procedures and techniques to better identify areas of risk to investors; requiring examiners to routinely verify the existence of client assets with third party custodians, counterparties, and customers; more rigorously reviewing information about firms before sending examiners out to the field, so that we can use our limited resources more effectively and to target those firms with the greatest risks; recruiting senior examiners with specialized industry knowledge; enhancing training to improve the knowledge and skills of current examiners; and re-focusing on basics such as exam planning, tracking, and accountability. Further, at my request, our new Director of the Office of Compliance Inspections and Examinations has led a top-to-bottom assessment (similar to the assessment conducted by the Enforcement Division) that identified several key reforms to strengthen the examination program. Through this assessment, he is now working with senior leaders across the program to implement these reforms.

Summary Finding Concerning the CSE Program

Beginning in 2004 and through September 2008, the SEC was the consolidated supervisor for the five large independent investment banks under its Consolidated Supervised Entity (CSE) program. During 2008, the CSE institutions failed, were acquired, or converted to bank holding companies which enabled them to access government support. The CSE program was discontinued in September 2008 by former Chairman Christopher Cox.

The CSE program was created, in part, as a way for U.S. global investment banks that lacked a consolidated holding company supervisor to voluntarily submit to consolidated regulation by the SEC. The SEC had no statutory authority to regulate these holding companies, and thus prior to the CSE program they were not subject to any consolidated supervision or capital requirements.

The CSE program was viewed as an effort to fill a significant gap in the U.S. regulatory structure that was left when the Gramm-Leach-Bliley Act failed to require investment bank holding companies to be regulated at the holding company level. It also was intended to improve the Commission's oversight of broker-dealers. In retrospect, the program created classic

regulatory arbitrage – a system in which a regulated entity was permitted to select its regulator. The arbitrage was facilitated by a prevailing regulatory consensus at the time of the program's inception that focused on meeting regulatory objectives while being careful not to undermine the competitiveness of American financial institutions and capital markets vis-à-vis their overseas, more lightly regulated, counterparts. In addition, the program was implemented at a time when many believed that the inherently self-correcting nature of markets would prevent institutions from taking on excessive risk, including in the origination or trading of exotic financial instruments.

Under the CSE regime, the holding company was required to provide the Commission with information concerning its activities and risk exposures on a consolidated basis; submit its non-regulated affiliates to SEC examinations; and compute on a monthly basis, risk-based consolidated holding company capital in general accordance with the Basel Capital Accord, an internationally recognized method for computing regulatory capital at the holding company level. In connection with the establishment of the CSE program, the largest U.S. broker-dealer subsidiaries of these entities were permitted to utilize an alternate net capital (ANC) computation. Other large broker-dealers, whose holding companies were subject to consolidated supervision by banking authorities, also were permitted to use this ANC approach.

Under the CSE program, the SEC undertook for the first time the consolidated oversight of the five largest U.S. investment banks, whose operations were global in scope and extended well beyond the types of products and business lines typically found in a registered broker-dealer. Participation by the CSE firms in this regime was voluntary, and the consolidated oversight of these holding companies was more prudential in nature than the SEC's traditional rule-based approach for broker-dealer regulation. In brief, this program reflected a profoundly different approach to oversight and supervision for the Commission. Properly executing the program called for a correspondingly significant expansion in human, financial, managerial, technological and other resources devoted to the oversight and examination of CSE holding companies and their subsidiaries.

The SEC believed at the time that it was stepping in to address an existing gap in the oversight of these entities. Once the agency took on that responsibility, however, it had to follow through effectively. Notwithstanding the work of its staff, in hindsight it is clear that the program lacked sufficient resources and staffing, was under-managed, and at least in certain respects lacked a clear vision as to its scope and mandate.

Summary Finding Concerning the SEC's Securities Disclosure Processes

The SEC's Division of Corporation Finance selectively reviews filings made under the Securities Act of 1933 and the Securities Exchange Act of 1934 to monitor and enhance compliance with the applicable disclosure and accounting requirements. As required by the Sarbanes-Oxley Act of 2002, the Division undertakes some level of review of each reporting company at least once every three years and reviews a significant number of companies more frequently. In addition, the Division selectively reviews transactional filings, i.e., the documents

companies file when they engage in public offerings, business combination transactions, and proxy solicitations.

In their reviews, Corporation Finance staff members evaluate compliance with the applicable disclosure requirements. In this regard, a major focus of the Division's effort is to review the disclosure from a potential investor's perspective and ask questions that an investor might ask when reading the document. When the staff notes instances where it believes a company can enhance its disclosure or improve its compliance with the applicable disclosure requirements, it provides the company with comments.

Integrating additional technology into our processes has enhanced the work that we do at the Commission, and will continue to do so in the future. Not only has technology improved investor access to public company filings, it also has increased staff access to that information as well. Our staff can use text searches to seek information across company filings and across internal documents relating to our reviews of those filings. Staff is encouraged to take advantage of the broad span of information available through commercially-available resources in order to use this information to be better informed about the companies under review and to help form critical questions that are raised by alternative viewpoints.

In addition, the Commission is taking technological advances into consideration when proposing new rules. As further described below, the Commission has proposed rules for disclosures involving asset-backed securities (ABS) that would require the filing of tagged, standardized loan-level information in computer readable form, along with a downloadable computer program investors would be able to use to demonstrate the effect of the ABS contractual cash flow provisions (often referred to as the "waterfall").

Looking forward, it is imperative that we take advantage of the tools available to analyze the data filed with us. Our top priority in this regard has been to create a system that can track, classify and correlate the thousands of tips and investigative leads we receive every month, which can help us better prevent, identify, and punish fraud. Our staff is working to develop an automated system that utilizes many sources of information, including current financial data, to evaluate and prioritize incoming tips and complaints.

Summary Finding Concerning Detecting Fraud, SEC Self-Governance, and the Implementation of Recommended Reforms

Throughout the SEC's history as an enforcement agency, we have pursued innumerable significant cases involving fraud and other misconduct harmful to innocent investors. We initiate cases based on our own surveillance efforts, potential misconduct identified by our examination staff, information provided by other regulators, and complaints and tips from investors and other members of the general public. We look to all sources for leads and information about misconduct that is potentially appropriate for enforcement action. In fact, because our 1,285 enforcement staff nationwide are responsible for investigating and prosecuting enforcement actions involving any of the more than 30,000 registrants we regulate – as well as those actions involving <u>any</u> person who may have committed securities fraud – we must rely on

all available sources to identify the most egregious and significant misconduct. Regardless of the source of our cases, the SEC leads the investigations, prosecutes the cases, pursues the wrongdoers, and seeks to ensure maximum recoveries to harmed investors.

At the same time, we recognize that the best enforcement programs are ones that identify fraud and misconduct as early as possible, thus minimizing the number of harmed investors and maximizing the funds available to repay those who were defrauded. To that end, we have taken significant steps to make the SEC more vigilant and responsive. Specifically, with respect to the Division of Enforcement, I brought in new leadership whose mandate was to reinvigorate the Division and restore investor confidence. Accordingly, the Division has implemented a series of dramatic structural reforms designed to improve the performance and responsiveness of the Division. Highlights of the initiatives currently being implemented include:

Specialization. The Division has created five new national specialized investigative groups dedicated to high-priority areas of enforcement: Asset Management (hedge funds and investment advisers), Market Abuse (large-scale insider trading and market manipulation), Structured and New Products (various derivative products), Foreign Corrupt Practices Act violations, and Municipal Securities and Public Pensions. These groups conduct a "deep dive" into their respective subject matter areas, thus increasing their knowledge of products, markets, transactions and practices where fraud and misconduct are most likely to occur. With this knowledge, they will be better able to detect patterns and trends that lead to wrongdoing and investor harm, and make it less likely that wrongdoers can conceal their misconduct in complex structures or practices. To accomplish this goal, the groups are utilizing enhanced training, hiring persons with specialized industry experience and skills, and targeting investigative approaches to better detect links and patterns suggesting wrongdoing.

Management Restructuring. The Division has adopted a flatter, more streamlined organizational structure under which it has reallocated a number of staff who were first line managers to the mission-critical work of conducting front-line investigations. Although a layer of management has been eliminated, the Division is maintaining staff-to-manager ratios that will allow for close substantive consultation and collaboration, resulting in a management structure that facilitates timeliness, quality and staff development. The Division also hired its first-ever Managing Executive, who is focusing on the Division's administrative, operational, and infrastructure functions, thus freeing up valuable investigative resources for mission-critical work.

Office of Market Intelligence. As mentioned above, the Enforcement Division has established an Office of Market Intelligence to serve as a central office for the handling of complaints, tips, and referrals that come to the attention of the Division; coordinate the Division's risk assessment activities; and support the Division's strategic planning activities. In short, this office will allow the Division to have a unified, coherent, coordinated response to the huge volume of complaints, tips, and referrals we receive every day, thereby enhancing the Division's ability to open the right investigations, bring solid cases, and effectively protect investors. In addition, we will harvest this information to identify emerging threats to investors

and markets, which will in turn inform how we employ our limited enforcement resources in order to maximize investor protection and deterrence.

Elimination of Unnecessary Process. Overall, we have improved our law enforcement capabilities and sent a clear signal to our staff that we value toughness and speed by removing procedural roadblocks impeding their investigations. For example, we delegated to senior staff the authority to issue subpoenas, so investigations can be launched without the prior – and time-consuming – approval of the Commission. We also have eliminated duplicative and unnecessary approvals for certain routine settlement discussions, Wells notices and the opening of initial matters under investigation. In addition, we have abolished the requirement that staff obtain Commission approval before entering into settlement talks involving civil monetary penalties against public issuers.

Cooperation Program. We have added a host of measures to encourage corporate insiders and others to come forward with evidence of wrongdoing. These new cooperation initiatives establish incentives for individuals and companies to fully and truthfully cooperate and assist with SEC investigations and enforcement actions. This program will encourage "insiders" with knowledge of wrongdoing to come forward early, thus allowing us to shut down fraudulent schemes earlier than would otherwise be possible.

In addition, we have created and staffed a new division – the Division of Risk, Strategy, and Financial Innovation (RiskFin) – with a mission to provide the Commission with sophisticated analysis that integrates economic, financial, and legal disciplines. By collaborating with RiskFin, the Enforcement Division will be better able to respond to new products, trading practices, risks, and frauds and be more proactive in its enforcement mission.

Since I became Chairman, the SEC's enforcement activity has increased significantly. We have brought a number of cases involving issues arising in the financial crisis, including cases alleging accounting fraud at subprime lenders, misrepresentation of complex investments as appropriate for retail investors seeking safe financial products, fraud in connection with collateralized debt obligation marketing materials, and misleading investors about exposure to subprime investments. Our cases have included actions against Goldman Sachs and Co.; ICP Asset Management; Lee Farkas, former Chairman of TBW Mortgage; State Street Bank and Trust Company; American Home Mortgage; officers of Countrywide Financial Corp.; New Century Financial; Brookstreet Securities; and Morgan Keegan. We also have continued to bring cases in our traditional program areas, including recent cases against Dell Inc. for alleged financial fraud, against investment adviser Kenneth Ira Starr for allegedly stealing client money for his personal use, and against two Spanish nationals for alleged insider trading in Potash Corp., an action brought within 48 hours of the suspicious trading.

With respect to self-governance, we view reports and recommendations from the GAO and the SEC OIG as important components of our efforts to improve our enforcement program. We review and analyze each report and each recommendation, making changes to our program designed to address the concerns that are identified. For example, from 2007 through 2009, our OIG issued 14 reports with recommendations relating to the Division of Enforcement. The

reports contained a total of 81 recommendations. At this time, 76 of those recommendations have been closed or submitted to the OIG for closing. Corrective action is underway on the remaining five recommendations and on track for completion by the end of the year. Also since 2007, the GAO has issued four audit reports focused on Enforcement operations. To date, the agency has closed eight of the nine Enforcement-related recommendations contained in those reports. We continue actively to work to address the remaining open OIG and GAO recommendations.

In addition, I have taken significant steps to improve the agency's coordination, follow-up, and resolution in response to GAO and OIG reports.

- In September 2009, I established a new internal rule, SECR 30-2, to strengthen oversight of and accountability over the agency's follow-up actions with respect to audit reports. Among other things, the rule requires offices to submit formal Corrective Action Plans (CAP) within 45 days of the issuance of an audit report; prepare quarterly reports on progress in implementing corrective action; submit a formal closure request and appropriate documentation after corrective action is complete; and requires office heads to prepare a written justification to the Chairman if corrective action is expected to take more than one year.

- Subsequently, in April of this year, I instituted a policy requiring that follow-up actions on non-personnel investigative recommendations be handled according to the same general procedures in SECR 30-2 that apply to audit recommendations (*e.g.*, preparation of a CAP within 45 days; quarterly status reports to the Office of the Executive Director; submission of formal closing requests; and written justification to the Chairman if corrective action is expected to take more than one year).

- Finally, with regard to personnel-related recommendations stemming from GAO or OIG reports, I implemented heightened oversight and reporting on these matters directly to my office, with special emphasis on any matter that is older than 60 days.

Summary Finding Concerning the SEC OIG Report on Allen Stanford

The SEC OIG report on the Stanford matter recounts events that occurred at the Commission between 1997 and 2005. Since that time, much has changed and continues to change regarding the agency's leadership, its internal procedures, its structure, and its culture of collaboration. Among other things, as described above, we have established escalation procedures on enforcement matters, revamped our process for handling tips and complaints, changed performance metrics so that quantity does not trump quality, streamlined our approval procedures for issuance of formal orders of investigation and adopted a flatter, more streamlined enforcement organizational structure, including the elimination of an entire layer of management. The OIG report makes seven recommendations. The Division of Enforcement has taken action on all seven recommendations, and on July 20, 2010 submitted a closing memorandum to the OIG. We are working with the Inspector General and hope to receive his concurrence on closing the recommendations as soon as possible.

Summary Finding Concerning SEC Funding

The inconsistent levels and the volatility of SEC funding between 2000 and 2010 have had a significant impact on the SEC's ability to perform its mission over the past decade. Although the SEC's funding has increased over the decade, the funding has been highly variable during that time period. For example, the SEC's funding level was flat or declining during the 2005-2007 period. As a result, the SEC had to reduce its staffing levels by ten percent and its investments in new technologies by 50 percent. With budget increases during the last two fiscal years, the SEC's overall workforce is only just now returning to the staffing levels of five years ago.

Recently, the SEC has successfully sought additional funding to hire more examiners who can go into more financial firms to see whether those firms are in compliance with the law, as well as more enforcement staff who can bring more enforcement cases when fraud and other violations of the law are found. In addition, under the Dodd-Frank Act, the agency now has a modified budget process and will be able, starting in 20012, to access a contingency fund each year when in need.

Summary Finding Concerning SEC Silos

A key focus for me has been efforts to break down any information-sharing and cooperation silos that may exist within the Commission.

I have brought on board new senior managers who are playing a vital role in our efforts to transform the agency. This new leadership team is committed to a culture of collaboration, information exchange and idea sharing. To encourage that culture, I have established several cross-functional teams to focus on issues such as target date funds, life settlements and the development of a consolidated audit trail.

As mentioned above, the Enforcement Division has undertaken initiatives that will improve coordination and communication. Specialized units will discourage the existence of separate regional silos that could develop based solely on a regional organization. Senior Enforcement management has re-emphasized to staff the importance of consulting with other SEC offices and divisions early and often to identify and resolve issues. The Division also utilizes a formal process by which it seeks review and comment from other offices and divisions before it submits an enforcement recommendation to the Commission, a resource it will continue to benefit from in the future.

Our Office of Compliance Inspections and Examinations (OCIE) also has made strides to enhance its collaboration with other parts of the Commission. For example, the examination program has expanded opportunities for examiners to cross-train with other divisions or offices and has increased the coordination between broker-dealer and investment management staff on their examination plans. In addition, OCIE has begun to include experts from other parts of the

Commission in its examination processes to better leverage sources of internal expertise and knowledge.

We also have taken steps to break down silos with respect to the handling of tips, complaints, and referrals. As described above, having an effective process to identify the most important tips can give the agency an early jump on frauds and other violations of securities laws, help guide compliance exams, and provide important information across the agency to aid staff working to protect investors and maintain market integrity. We have completed the first phase of this tip and complaint effort, which was to centralize into a single, searchable database all our existing tips and complaints that were previously in multiple databases. Additionally, we released for the first time a set of agency-wide policies and procedures to govern how employees should handle the tips they receive. Future phases of this project will include implementing a new intake system that will capture more information about tips and complaints and track them across the agency through investigations and examinations, and adding risk analytics tools to help us quickly and efficiently identify high value tips and search for trends and patterns across the data. An agency-wide body will oversee the handling of tips, complaints, and referrals for the SEC as a whole.

Summary Finding Concerning the Commission's Employment of Lawyers

Without a doubt, the most critical element to success in improving the Commission's operations is the quality, knowledge and experience of the agency's staff.

As described above, with the establishment of the new RiskFin Division, the SEC has brought in a number of well-known experts in financial innovation, risk management, derivatives/structured products, and modern capital market transactions. In addition, under our new Senior Specialized Examiner program, we have recruited several highly skilled professionals to bring enhanced expertise to the examination program. Senior Specialized Examiners recruited to date have had extensive experience in equities trading, options trading, credit ratings, and structured products, among other things. We also have recruited many individuals with industry experience to fill regular examination vacancies opened by normal attrition.

To better enable our staff to conduct oversight of complex trading strategies and products that exist in today's markets, we will continue to recruit professionals with specialized industry expertise throughout the organization.

We also are committed to improved training and education of agency staff in order to close competency gaps and expand knowledge of industry activities and trends. Training needs to be current, continuous, and mandatory, and it needs to equip the SEC's workforce with the tools they need to enforce the federal securities laws and protect investors.

Last year, we launched an effort to ensure that employees throughout the agency receive timely and relevant training that will allow them to fulfill the agency's mission. This agency-wide initiative includes a new integrated structure to identify training needs and to approve

professional education and leadership development programs. The new training initiative also seeks to improve collaboration with other regulators and has enabled hundreds of employees to take advantage of external professional certification programs. While it will take time to fully implement all the components of our new training initiative, we are already seeing good results from this increased focus on staff development.

Summary Finding Concerning the Impact of Unionization

The Agency's workforce was unionized in 2000 by the National Treasury Employees Union (NTEU). The current Collective Bargaining Agreement (CBA) covers approximately 3,000 staff members. SEC management's relationship with NTEU is professional and productive. For example, with the recent major re-structuring of the Division of Enforcement, management and the union were able to enter into an informal memorandum of understanding, thus avoiding a lengthy formal negotiation process. In addition, the union has engaged in a productive manner with OCIE as it has undertaken a similar comprehensive assessment of its operations.

The Commission, as well as all other federal agencies, is in the process of implementing the requirements of Executive Order 13522 requiring labor-management partnerships. The intent of these partnerships is to create more opportunities for informal collaboration in the labor-management context.

We also are in the process of implementing a new performance management system that moves from the current pass/fail system to a five level pay for performance system. We expect this system will be implemented across the Commission by the end of the year.

Regarding employee removals, the Commission recently has had an increase in removals or resignations in lieu of removals. Articles 34, 35 and 36 of our CBA address disciplinary, adverse and performance-based actions, respectively. These Articles are based on and reflect the requirements of Title 5, Chapters 43 and 75 of the U.S. Code. The union has the right to represent bargaining unit employees in this process, and does so accordingly. This representational role has not prevented the Commission from pursuing appropriate disciplinary action. Indeed, in 2009, almost as many permanent employees were terminated as in the previous four calendar years combined.

Summary Finding Concerning Disclosure Rules and Forms

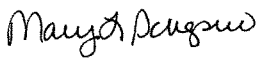
The Commission continually evaluates whether our rules result in disclosures that enable investors to make informed investment and voting decisions. Our Division of Corporation Finance has begun a comprehensive review of our basic disclosure requirements to determine whether there are requirements that we can eliminate and whether we need to add new disclosure requirements to elicit the information that investors need in today's rapidly changing markets.

As mentioned above, in April 2010 the Commission took action to provide investors with greater transparency in a critical segment of the market with its proposals to revise the offering

process, disclosure and reporting for asset-backed securities. The proposals would significantly change the way ABS are registered, offered and sold. They include provisions to require the filing of tagged, standardized loan-level information in computer readable form, along with a downloadable computer program that demonstrates the effect of the "waterfall." The waterfall dictates how borrowers' loan payments are distributed to investors in the ABS, how losses or lack of payment on those loans is divided among the investors, and when administrative expenses such as servicing those loans are paid to service providers. Though currently a narrative description of the waterfall must be disclosed to investors in the prospectus, the proposed computer program would allow users to input the loan level data that would also be required to be provided, thus giving investors and the markets better tools to analyze an ABS offering. The proposals also would increase transparency in the private structured finance market by requiring that, if an issuer relies on a safe harbor (such a Rule 144A or Regulation D), the issuer must agree to provide investors, upon request, the same information that would be required if the offering were registered or if the issuer were a reporting company.

Thank you for the opportunity to comment on issues raised by the Minority Staff Report. Please call me at (202) 551-2100 or have your staff call Eric Spitler, Director of the Office of Legislative and Intergovernmental Affairs, at (202) 551-2010 if you have any questions or comments.

Sincerely,



Mary L. Schapiro
Chairman

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