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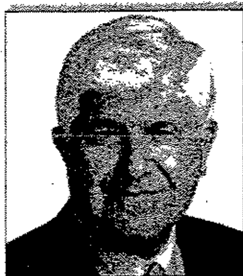
SEC Examination Privilege Rejected

A pair of recent decisions by a Securities and Exchange Commission administrative law judge reflect the efforts of the staff of the Commission's Office of Compliance Inspections and Examinations to create a new unqualified "SEC Examination Privilege" to justify not producing documents to a respondent. In what he described as a matter of first impression, the administrative law judge declined to recognize any such privilege and ordered the disputed documents to be produced. The day following the second of the judge's decisions, and apparently before the disputed documents were produced in response to the subpoena, the Commission announced a settlement of the underlying litigation.

It remains to be seen whether the SEC staff will in other cases seek to reassert its claims of privilege; but, in any event, the rationale of the assertion is worth analyzing.



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Background

In October 2003, the Commission initiated an administrative proceeding against Putnam Investment Management, LLC concerning mutual fund market timing. On Nov. 13, 2003, a partial settlement order was announced which imposed a censure, and granted certain injunctive relief, leaving unresolved questions of a civil monetary penalty and disgorgement, which were reserved for future settlement or hearing.[1]

In March 2004, in preparation for the unresolved phase of the proceedings, Putnam requested the judge to issue a subpoena to the staff seeking eleven categories of documents from various divisions and offices of the Commission. After narrowing the request, the judge signed the subpoena which directed the staff, among other things, to produce communications with other investment companies, investment advisers and broker dealers concerning "market timing" and "excessive short term trading."[2]

Office of Compliance's Motion to Quash

In response to the subpoena, the Office of Compliance (represented by the SEC's Office of General Counsel) filed a motion to quash, seeking to withhold from production fourteen staff deficiency letters addressed to institutions other than Putnam in response to various field examinations.[3] The Office asserted that the documents should be insulated from disclosure by a new "SEC Examination Privilege," arguing that "[p]rotection of documents related to examinations is crucial because...disclosure of materials related to examinations could change and harm the examination process."[4] The staff argued that "[t]he examination process requires ongoing confidential communications between the Commission's examination staff and regulated entities about a variety of issues and requires Commission staff to work with those regulated entities to identify and cure weaknesses in their operations."[5] According to a declaration filed by the Office, "[w]hen communications are confidential, registered entities are more likely to recognize past problems and work with the Commission to seek appropriate methods to comply with laws, rules and regulations."[6]

To support its claim of privilege, the Office of Compliance relied heavily on Exemption 8 of the Freedom of Information Act, which exempts from disclosure information "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 of supervision of financial institutions." 5 USC 552(b)(8). The staff acknowledged that the Act's exemption does not establish a privilege, per se, but suggested that it provided strong policy support for the assertion of a privilege here, citing several cases that examine the policy rationale behind the Act's exemption.[7] Of those, *Consumers Union of United States, Inc. v. Heimann*, 589 F2d 531, 534 (DC Cir 1978) provides an insightful examination of the legislative intent and history of Exemption 8. Heimann, one of the first appellate cases to discuss the exemption, addressed whether certain documents concerning compliance with the Truth in Lending Act were protected from disclosure. Concluding that Exemption 8 applied, the court noted that, while the primary concern of the exemption was to ensure the security of financial institutions, a secondary purpose was to "safeguard the relationship between the banks and their supervising agencies. If details of the bank examinations were made freely available to the public and to banking competitors, there was a concern that banks would cooperate less than fully with federal authorities." See also *Berliner Zisser Walter & Gallegos, P.C. v. SEC*, 962 FSupp 1348 (DColo 1997) (citing *Heimann* in considering the type of institutions covered by Exemption 8, the court stated that one purpose of Exemption 8 is to "foster an environment of full cooperation").

The staff also invoked Article 31(c) of the Investment Company Act, which provides in part:

> Notwithstanding any other provisions 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.

Acknowledging that it had no responsive documents provided to the Commission by a "subject person" as defined in the Act, the Office of Compliance attempted to extend the application of this provision to protect documents created by the Commission itself.[8]

Finally, the staff sought support by analogy in the so-called bank examination privilege, which has been recognized thus far by two circuit courts of appeal. The bank examination privilege affords protection to reports of bank examiners, and is "firmly rooted in practical necessity." *In re: Subpoena Served Upon the Comptroller of Currency*, 967 F2d 630, 633 (DC Cir 1992). Because supervision of banks is "an iterative process," success-

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"depends vitally on the quality of communication" between the regulator and the regulated entity. Id. The privilege is grounded in the fact that "[b]ank management must be open and forthcoming in response to the inquiries of bank examiners, and the examiners must in turn be frank in expressing their concerns about the bank. These conditions simply could not be met as well if communications between the bank and its regulators were not privileged." Id. at 634. See also *In re: Bankers Trust Co.*, 61 F3d 465 (6th Cir 1995). Even where accepted, this privilege does not apply to purely factual matters, and is regarded as a qualified privilege, subject to being overridden by a showing of substantial need.

Notably, the analogous privilege sought by the SEC staff would be an absolute privilege and also protect "even purely factual information obtained during an examination."[9]

The Privilege is Rejected

In two related opinions, the administrative law judge rejected the staff's request to establish a new SEC Examination Privilege, making clear that the substantial burden to establish a new privilege had simply not been met.

Addressing the Office of Compliance's reliance on Exemption 8 to the Freedom of Information Act, the judge recognized that the Act's exemption does not create an evidentiary privilege: the fact that a document is exempt from disclosure to the general public under the Freedom of Information Act does not mean that it is also privileged from disclosure to a party in litigation. The judge also declined to accept the Act's exemption as policy support for assertion of the proposed examination privilege here, and, as well, rejected the Office of Compliance's reliance on Section 31(d) of the Investment Company Act, noting that the Office of Compliance offered no support for the "sweeping" proposition that Section 31(d) applied to documents created by the Commission.

The judge similarly rejected the staff's reliance on the bank examination privilege as a basis for establishing a new privilege here reasoning, in part, that unlike the proposed SEC Examination Privilege, the bank examination privilege does not apply to purely factual information, and, in any event, is not absolute. Rather, it is a qualified privilege that requires a balancing of the competing interests of the party seeking disclosure and the government.

Addressing the ultimate question of whether a privilege should be created, the judge stressed that, although the Federal Rules of Evidence allow for the creation of new privileges, courts have exercised that power sparingly. The judge concluded that if an SEC examination privilege were to be created, it would have to be qualified and, like the bank examination privilege, should not apply to purely factual information. Noting that the boundaries to the Office of Compliance's proposal were not well defined, the judge cautioned that if the Office wants to assert such a privilege, "it must persuade the Commission to announce that the privilege exists and define its limits." Finally, the judge stressed that a motion to quash is not the appropriate or ideal forum to assert a new privilege.[10]

Analysis

We do not know whether the Office of Compliance will attempt to assert the SEC Examination Privilege again in another administrative proceeding or request that the Commission announce this new privilege and delineate boundaries for its application, as the judge suggested. Nevertheless, the attempt to assert this privilege raises several interesting issues.

While the staff's memoranda of law in support of its motion to quash are not expansive with respect to the rationale behind this newly proposed privilege, in relying on cases supporting the bank examination privilege and Freedom of Information Act Exemption 8, it is clear that the Office of Compliance believes the protection of materials exchanged between Office and registrants will promote candor and cooperation in the examination process. Such cooperation would, it argues, allow the Office of Compliance and the registrant to "identify and cure weaknesses" in the registrant's operations. If we accept that rationale as a desirable aspect of the regulatory and self-regulatory scheme and of sufficient importance to support a "privilege" with respect to communications between the regulator and the regulated entity, then such a privilege also should be exercisable by regulated parties vis-à-vis third party civil litigants. If the goal is to promote frank discussions between the regulators and the regulated (*In re: Subpoena*, 967 F2d at 633-34; *Heimann*, 589 F2d at 534), then it should not matter which party to the candid communication seeks to protect the communication. Nor should it matter whether the record of the candid communication is located in a file room of the Commission or the registrant.

Moreover, if the goal is to protect the process of regulation so as to improve the operations of regulated parties, then we might also extend the privilege to cover materials which would reveal the negotiations, thought processes and give-and-take associated with regulatory examinations and investigations. To do so, regulated persons should be able to resist efforts by civil litigants who, rather than particularizing discovery requests, instead demand all materials previously produced to regulators. Forced production in response to such requests necessarily invades the relationship between the SEC and regulated parties and good faith attempts to resolve differences that might arise in the examination or investigation process.

Similarly, the rationale of fostering candid and thorough dialogue between the industry and the SEC argues in favor of adopting the concept of limited or selective waiver of the attorney-client and work product privileges. Under this doctrine, otherwise privileged materials could be shared with regulators without waiving the privilege as to third parties, such as plaintiffs in civil litigation.[11] Indeed, the Commission itself has recognized the benefits of limited waiver, using

arguments similar to those now advanced by the Office of Compliance in asserting the examination privilege. In February 2003, the Commission, pursuant to provisions of the Sarbanes-Oxley Act, adopted certain professional conduct standards for attorneys who appear and practice before the Commission on behalf of issuers. The Commission considered (although ultimately did not adopt) a proposed rule that would have recognized the doctrine of limited waiver, noting, among other things, that it would enhance the Commission's ability to conduct expeditious and efficient investigations.[12] Congress is now considering a bill introduced by U.S. Representative Richard H. Baker (H.R. 2179) which would codify the doctrine of limited waiver in connection with documents provided to the Commission pursuant to confidentiality agreements.

Finally, we believe the policies that would support an SEC Examination Privilege might well be extended to encompass recognition of a broad self-critical analysis privilege in the hands of regulated entities, which would shield internal investigations and audits from disclosure to regulators and civil litigants alike. This privilege, discussed in more detail in this column previously, *A Privilege for Self-Critical Analysis*, New York Law Journal, Nov. 30, 1987, has been said to serve "the public interest by encouraging self-improvement through uninhibited self-analysis and evaluation." *In re Ashanti Goldfields Sec. Lit.*, 213 FRD 102, 103 (EDNY 2003).[13] Yet the self-examination privilege has generally been rejected or severely limited by the courts. See Id.; *Cruz v. Coach Stores, Inc.*, 196 FRD 228, 232 (SDNY 2000) (court is "doubtful that [privilege] should be recognized at all"); *Franzon M.D. v. Massena Memorial Hospital*, 189 FRD 220 (NDNY 1999).

If the Commission's staff is prepared to resassert a proposed examination privilege based on the logic asserted in the Putnam matter, it should recognize the broader implications of that rationale and be prepared to address the application of its reasoning in each of the situations described above as well.

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1. *In the Matter of Putnam Investment Management*, LLC, Investment Advisers Act of 1940, Release No. 2192; Investment Company Act of 1940, Release No. 26255 (Nov. 13, 2003).
2. *See In the Matter of Putnam Investment Management LLC*, Admin. Proceedings Rulings Release No. 613 (March 26, 2004) ("March 26 Order") at 1-2.
3. See *In the Matter of Putnam Investment Management, LLC*, Admin. Proceedings Rulings Release No. 614 (April 7, 2004) ("April 7 Order").
4. Memorandum in Support of Motion to Quash In Part Subpoena Served by Putnam on the Securities and Exchange Commission, Administrative Proceeding File No. 3-11317 (March 15, 2004) at 1, 4-5 ("Memorandum in Support").
5. Reply Memorandum In Support of Motion to Quash In Part Subpoena Served by Putnam on the Securities and Exchange Commission, Administrative Proceeding File No. 3-11317 (March 25, 2004) ("Reply Memorandum") at 4.
6. Declaration of John H. Walsh, March 31, 2004 at ¶6.
7. Reply Memorandum at 3; Memorandum in Support at 3-5.
8. March 25 Order at 4-5; April 7 Order at 2-3.
9. Reply Memorandum at 5.
10. April 7 Order at 3-4.
11. To date, this concept of limited waiver has been largely rejected by the courts. See In re Columbia/HCA Healthcare Corp. Billing Practices Lit., 293 F3d 289 (6th Cir. 2002).
12. Implementation of Standards of Professional Conduct for Attorney, Final Rule and Proposed Rule, 17 CFR §§ 205, 240 and 249 (2003).
13. See John F.X. Peloso, *The Privilege for Self-Critical Analysis: Protecting Confidentiality of Internal Investigation in the Securities Industry*, 18 SecRegLJ 229 (1990).