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 <u>not</u> 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," <u>first</u>, records or information it obtains pursuant to its examination authority under those statutes, and, <u>second</u>, 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 <u>not</u> 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.