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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.