MEMORANDUM

November 12, 1987

TO: David S. Ruder
Chairman

FROM: Daniel L. Goelzer
General Counsel

RE: Nonpublic Nature of Reports of Commission Examinations of Self-Regulatory Organizations

I. INTRODUCTION AND SUMMARY

This memorandum responds to a question raised by Edward J. Markey, Chairman of the Subcommittee on Telecommunications and Finance of the House Committee on Energy and Commerce, in his letter of August 6, 1987, requesting access to a report of a recent Commission examination of the New York Stock Exchange and to all similar reports concerning all self-regulatory organizations prepared during the last two years. In his letter, Chairman Markey requested that the Commission explain the basis for considering such reports to be nonpublic. On August 18, 1987, the Commission authorized the staff to provide access to the relevant documents to the staff of the Subcommittee and to brief the Subcommittee staff concerning them. At that time, the Commission indicated that a detailed explanation of the reasons that it considers examination reports to be exempt from public disclosure would be provided at a later date.

As discussed below, FOIA Exemption 8 protects SRO examination reports from disclosure under the Freedom of Information Act. 1/ In addition, portions of particular examination reports may be exempt under other provisions of the FOIA. Although, in some circumstances, the Commission can waive otherwise applicable FOIA exemptions, strong public policy considerations support the Commission's conclusion that these reports should generally remain nonpublic.

1/ 5 U.S.C. 552(b)(8).

II. DISCUSSION

A. The Statutory Scheme of Self-Regulation and the Commission's Inspection Program

The Securities Exchange Act of 1934 establishes a two-tiered system for regulating the securities markets. 2/ Under this system, much of the regulation of the markets is the responsibility of self-regulatory organizations (primarily national securities exchanges and the National Association of Securities Dealers, Inc.), subject to Commission oversight. Those self-regulatory organizations are required to register with the Commission and to obtain approval of their rules. 3/ The SROs are responsible for market surveillance and for rule enforcement with respect to members. 4/

In order to carry out its oversight responsibilities, the Commission has established within its Division of Market Regulation the Office of Inspections and Financial Responsibility, which is primarily responsible for examining SROs. The inspections are performed to ensure that each SRO possesses the financial and operational integrity to carry out its vital role in the functioning of the national economy; that all SRO rules have been submitted to and approved by the Commission and reflect the actual operations of the SRO; 5/ that the SRO is maintaining proper records; 6/ and that the SRO has the capacity and willing-

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2/ See generally Report of the Special Study of the Securities Markets of the Securities and Exchange Commission, H.R. Doc. No. 95, 88th Cong., 1st Sess., Pt. II 541 (1963).

3/ Simon and Colby, The National Market System for Over-the-Counter Stocks, 55 Geo. Wash. L. Rev. 17, 18 n.4 (1986). Exchanges are included in the definition of "self-regulatory organization" in Section 3(a)(26) of the Exchange Act, 15 U.S.C. 78c(a)(26).

4/ Generally, exchange members are either broker-dealers or persons associated with broker-dealers. Section 6(c)(1) of the Exchange Act, 15 U.S.C. 78f(c)(1).

5/ Section 19(b) of the Exchange Act, 15 U.S.C. 78s(b); Rule 19b-4, 17 C.F.R. 240.19b-4.

6/ Section 17 of the Exchange Act, 15 U.S.C. 78q; Rules 17a-1 and 17a-6, 17 C.F.R. 240.17a-1 and 240.17a-6.

ness to investigate violations of its own rules and the federal securities laws and to sanction members for these violations. 7/

Examination teams, composed of Commission staff attorneys, accountants, and financial analysts, regularly perform on-site reviews of an SRO's records and trading operations and supplement their review of documents with discussions with the responsible SRO staff. The team prepares for the Commission a memorandum of its findings and a proposed letter to the SRO (referred to collectively as an "examination report"). The examination report serves to inform the Commission of any deficiencies detected in the SRO's self-regulatory programs, and to assist it in supervising the SRO's efforts to improve these programs. After approval by the Commission, the letter, which summarizes the staff's conclusions, is sent to the SRO.

B. Exemption 8 of the Freedom of Information Act

FOIA Exemption 8 protects 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 financial institutions." 8/ Congress did not define the term "financial institution" in the FOIA, and neither the Senate nor the House reports on the legislation that became the FOIA give any examples of entities Congress intended to be included within that term. 9/ Subsequently, however, Congress identified those entities it considered "financial institutions" under the FOIA when it enacted the Government in the Sunshine Act. 10/ The FOIA and the Sunshine Act are statutes in pari materia as they were enacted as part of the same statutory scheme, and are to be construed together. Accordingly, courts have held that the legislative history of Sunshine Act provisions should be used to interpret corresponding FOIA provisions. 11/

7/ Section 6(b)(1) and (6) of the Exchange Act; Rules 19d-1, 19d-2, 19d-3, and 19g2-1, 17 C.F.R. 240.19d-1, 240.19d-2, 240.19d-3, and 240.19g2-1.

8/ 5 U.S.C. 552(b)(8).

9/ See S. Rep. No. 813, 89th Cong., 1st Sess. 10 (1965); H.R. Rep. No. 1497, 89th Cong., 2d Sess. 11 (1966).

10/ 5 U.S.C. 552b et seq.

11/ See, e.g., Jordan v. Department of Justice, 591 F.2d 753, 770 (D.C. Cir. 1978); cf. Duffin v. Carlson, 636 F.2d 709, 711 (D.C. Cir. 1980)(Privacy Act can be used to interpret FOIA exemption).

Congress used the term "financial institution" in both Sunshine Act Exemptions 8 and 9(A). 12/ In the legislative history of Exemption 9(A), Congress identified entities within the scope of the term "financial institution," and specifically named securities exchanges:

> [the term financial institution] is intended to include banks, savings and loan associations, credit unions, brokers and dealers in securities or commodities, exchanges dealing in securities or commodities, such as the New York Stock Exchange, investment companies, investment advisers, self-regulatory organizations subject to 15 U.S.C. § 78s, and institutional managers as defined in 15 U.S.C. § 78m(f). 13/

Congress presumably intended the term "financial institution" to have the same meaning in Sunshine Act Exemption 8 as it does in Sunshine Act Exemption 9(A). We believe, therefore, that SRO examination reports fall within Sunshine Act Exemption 8. Furthermore, since Congress has stated that it intended the FOIA and Sunshine Act exemptions to be interpreted in the same way, 14/ we believe that SRO examination reports are included within FOIA Exemption 8.

The conclusion that SRO examination reports are exempt from disclosure under the FOIA is supported by a recent federal court

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12/ Sunshine Act Exemption 9(A) permits agencies to close meetings which would:

> disclose information the premature disclosure of which would -- (A) in the case of an agency which regulates currencies, securities, commodities, or financial institutions, be likely to (i) lead to significant financial speculation in currencies, securities or commodities, or (ii) significantly endanger the stability of any financial institution.

5 U.S.C. 552b(c)(9)(A).

13/ S. Rep. No. 354, 94th Cong., 1st Sess. 24 (1975) (emphasis added). Congress also noted that this provision "would cover many of the regulatory activities of such agencies as the Federal Reserve Board and the Securities and Exchange Commission." Id. at 12.

14/ S. Rep. No. 354, 94th Cong., 1st Sess. 25 (1975).

decision. In Mermelstein v. SEC, 15/ the court held that the Boston Stock Exchange was a financial institution within the meaning of FOIA Exemption 8 and that the Commission properly denied the plaintiff's request for access to the staff's inspection report concerning the BSE. The court concluded that Congress had never acceded to a restrictive definition of "financial institution" for purposes of FOIA's Exemption 8, but, on the contrary, had given sufficient indication that it expected securities exchanges to be included among such institutions when it came to ordering public disclosure of matters relating to their regulation. 16/ Moreover, the court held that the portions of the inspection report that contained references to the exchange's disciplinary proceedings against the plaintiff's firm were an integral part of the Commission's evaluation of the sufficiency of the exchange's own self-policing efforts. The court concluded that, to the extent that the data might be of value to the Commission in its supervision of the exchange, information concerning specific disciplinary proceedings involving exchange members fit squarely within the spirit and purposes of FOIA Exemption 8. 17/

C. Other Applicable FOIA Exemptions

Under FOIA Exemption 8, an SRO examination report is exempt in its entirety from public disclosure and the Commission need make no further finding as to the applicability of other FOIA

15/ 629 F. Supp. 672 (D.D.C. 1986). See also House Committee on Government Operations, A Citizens Guide on How to Use the Freedom of Information Act and Privacy Act in Requesting Government Documents, H.R. Rep. No. 793, 95th Cong., 1st Sess. 13 (1977). This guide states that Exemption 8 protects, among other things, "* * * documents prepared by the Securities Exchange Commission [sic] regarding the New York Stock Exchange, and other similar information." The Committee's more recent guide does not include the Commission as an example. House Committee on Government Operations, A Citizens Guide on Using the Freedom of Information Act and the Privacy Act of 1974 to Request Government Records, H.R. Rep. No. 199, 100th Cong., 1st Sess. 14 (1987).

16/ The court declined to follow M.A. Shapiro & Co. v. SEC, 339 F. Supp. 467 (D.D.C. 1972), a previous case interpreting the meaning of "financial institution" under Exemption 8, on the grounds that the Shapiro court's source for the definition of a "financial institution" was a Commission rule, 17 C.F.R. 250.70(c)(5), promulgated in 1941 under the Public Utility Holding Company Act of 1935, 15 U.S.C. 79-797-6, for an altogether different purpose.

17/ 629 F. Supp. at 470.

exemptions. Other FOIA exemptions may, however, apply to portions of an SRO examination report. Depending on the content of the documents, the Commission may assert FOIA Exemptions 4, 5, and 7(A), (C), and (E) with respect to a particular report. 18/

Exemption 4 of the FOIA protects from disclosure "trade secrets and commercial or financial information obtained from a person and privileged or confidential." 19/ Among other things, the exemption protects the interest of commercial entities that submit proprietary information to the government. 20/ Reports of the inspection of an SRO often contain information on the financial condition of an exchange or one of its members. Release of this or similar information might compromise the competitive position of the SRO or a member.

Exemption 5 of the FOIA protects "inter-agency or intra-agency memorandums or letters which would not be available by law to a party other than an agency in litigation with the agency." 21/ Exemption 5 encompasses both statutory privileges and those commonly recognized by case law and is not limited to those privileges explicitly mentioned in the legislative history. 22/ The most frequently invoked privileges under Exemption 5 are the deliberative process privilege, the attorney work-product privilege and the attorney-client privilege. 23/

18/ Typically, the Commission asserts all applicable exemptions in responding to a FOIA request, even when one exemption would protect the entire document from disclosure.

19/ 5 U.S.C. 552(b)(4).

20/ See, e.g., Gulf & Western Industries, Inc. v. United States, 615 F.2d 527 (D.C. Cir. 1979). Courts have held that Exemption 4 is coextensive with the protections of the Trade Secrets Act, 18 U.S.C. 1905. See, e.g., General Electric Co. v. NRC, 750 F.2d 1394, 1401-02 (7th Cir. 1984). For this reason, an agency cannot generally choose to waive, in its discretion, this exemption, as its discretionary release of otherwise exempt material would constitute "a serious abuse of agency discretion" that could be attacked in a "reverse" FOIA suit. National Organization for Women v. Social Security Administration, 736 F.2d 727, 743 (D.C. Cir. 1984) (Robinson, J., concurring).

21/ 5 U.S.C. 552(b)(5).

22/ United States v. Weber Aircraft Corp., 465 U.S. 792, 799 (1984).

23/ NLRB v. Sears, Roebuck & Co., 421 U.S. 132, 149 (1975).

As described above, an exchange examination report includes a memorandum from the staff to the Commission in which the staff describes its findings and often makes recommendations for Commission action. These memoranda are antecedent to the Commission's decision whether to send a particular letter to the SRO containing the findings and deliberative to the extent they recommend the contents of those letters. Accordingly, these documents are entitled to protection under Exemption 5.

Exemption 7 of the FOIA protects from disclosure:

> records or information compiled for law enforcement purposes, but only to the extent that production of such law enforcement records or information could (A) reasonably be expected to interfere with enforcement proceedings, * * * (C) constitute an unwarranted invasion of personal privacy, * * * [or] (E) disclose investigative techniques or procedures. 24/

Thus, to be within Exemption 7, the records or information must be compiled for law enforcement purposes, and an agency must determine that production of the records or information could reasonably result in one of the enumerated harms. Because the Commission's inspections are performed primarily to ensure that the SROs are complying with their obligations under the federal securities laws, the reports satisfy the first element of the test.

The staff's examination reports often discuss particular investigations performed by an SRO or the Commission. The reports sometimes identify weaknesses in the SRO's investigation or suggest new lines of inquiry that the SRO should pursue. Were the Commission forced to disclose the contents of those inspection reports, it might hamper its own enforcement efforts, which sometimes parallel or grow out of SRO investigations; might damage an ongoing SRO investigation; or might even jeopardize a criminal investigation by another agency. Accordingly, reports containing such information are protected, at least in part, by Exemption 7(A). In those instances where an examination report discusses individuals who have been investigated by an SRO and describes their conduct, but those individuals are not ultimately sanctioned by the SRO and do not become the subject of Commission proceedings, disclosure of their identities could constitute an unwarranted

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24/ 5 U.S.C. 552(b)(7).

invasion of their privacy within the meaning of Exemption 7(C). 25/

In addition, the examination reports occasionally discuss deficiencies or suggest improvements in the SRO's surveillance systems or investigative techniques. Information concerning these matters could assist persons in evading detection or prosecution for violations of the law or SRO rules, a harm Exemption 7(E) is intended to prevent. 26/

D. Policy Considerations

The staff believes that substantial harm could result if information generated in the inspection process routinely became public. The effectiveness of the Commission's oversight of securities exchanges and the NASD depends on its ability to remain informed about the SROs' self-regulatory and market operations and the SROs' cooperation in correcting deficiences or implementing improvements in these operations. If inspection reports were automatically made public, the SRO staff would be considerably less candid in their discussions with Commission staff, and the examination process might well become more adversarial. Moreover, routine disclosure might cause staff reports to the Commission to become more general and less useful. For instance, the staff would be forced to avoid discussing surveillance parameters used by an exchange to determine when to initiate an inquiry into suspicious trading for fear of providing opportunities for abusive trading strategies.

Existing inspection protocol, which contemplates the reports regarding the SROs remaining confidential, has worked extremely well in correcting deficiences in SRO programs and in improving the effectiveness of the SRO surveillance, examination and enforcement programs. For example, the Commission's staff identified the absence of audit trails as a deficiency in the SROs' market surveillance programs. The staff then worked closely with the

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25/ See, e.g., Miller v. Bell, 661 F.2d 623, 631-32 (7th Cir. 1981) (there is a "real potential for harassment where an individual is merely mentioned in a law enforcement file"); Fund for Constitution Government v. National Archives & Records Service, 656 F.2d 856, 861-66 (D.C. Cir. 1981) (where individuals have been investigated but never charged, release of their names is likely to constitute an unwarranted invasion of privacy).

26/ Cf. Windels, Marx, Davies & Ives v. Department of Commerce, 576 F. Supp. 405, 413-14 (D.D.C. 1983) (computer program used to detect antidumping law violations exempt under Exemption 7(E)) (alternative holding).

SROs to monitor developments and to ensure that progress was being made at a satisfactory rate. As a result, the SROs implemented functional audit trails, and market surveillance across the various markets, including an enhanced ability to detect possible insider trading activity, was improved. The staff believes that achievement of this important market oversight tool was facilitated by its ability to communicate candidly, in a nonpublic manner, its inspection findings regarding the SROs' market surveillance efforts.

III. CONCLUSION

As discussed above, the legislative history of the FOIA and the Sunshine Act and the relevant case law authorize the Commission's policy of withholding Commission reports of SRO examinations from the public. The potential harms that could result from publicly releasing those reports also justify the retention of the Commission's current policy.

Prepared by: David C. Mahaffey 272-2428
Kerry F. Hemond 272-2437