

ALJ

ADMINISTRATIVE PROCEEDING  
FILE NO. 3-11317

UNITED STATES OF AMERICA  
Before the  
SECURITIES AND EXCHANGE COMMISSION  
March 26, 2004

SECURITIES & EXCHANGE COMMISSION  
MAILED FOR SERVICE

MAR 30 2004

FIRST CLASS

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In the Matter of :  
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PUTNAM INVESTMENT : ORDER  
MANAGEMENT, LLC :  
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The Office of Compliance Inspections and Examinations (OCIE) of the Securities and Exchange Commission (SEC or Commission) moves to quash, in part, a Subpoena Duces Tecum served upon it by Putnam Investment Management, LLC (Putnam). See Rule 232(e) of the Commission’s Rules of Practice. OCIE acknowledges that it has responsive documents, but asserts that they should be protected from disclosure under Section 31(c) of the Investment Company Act of 1940 (Investment Company Act) and a novel “SEC Examination Privilege.”<sup>1</sup>

Before me are: (1) OCIE’s Motion to Quash, dated March 15, 2004; (2) Putnam’s Memorandum of Law in Opposition to the Motion to Quash, dated March 22, 2004; (3) the Division of Enforcement’s Memorandum in Support of OCIE’s Motion to Quash, dated March 24, 2004; and (4) OCIE’s Reply to Putnam’s Opposition, dated March 25, 2004.

Background

The Commission initiated this administrative proceeding on October 28, 2003. It then issued a Partial Settlement Order on November 13, 2003, which imposed a censure, granted cease-and-desist relief, and directed Putnam to comply with certain undertakings. The Partial Settlement Order left the issues of a civil monetary penalty and disgorgement of ill-gotten gains to be resolved by settlement or decided after a hearing. There has been no settlement, and the hearing is scheduled to begin on April 19, 2004.

On March 2, 2004, Putnam requested the issuance of a subpoena seeking eleven categories of documents from several of the Commission’s Divisions and Offices. On March 3, 2004, I held a telephonic prehearing conference and heard argument regarding the requested

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<sup>1</sup> The Commission has delegated to its General Counsel the function of asserting governmental privileges on its behalf in litigation where the Commission appears as a party or in response to third party subpoenas. See 17 C.F.R. § 200.30-14(f). The Office of the General Counsel (OGC) represents OCIE in connection with the Motion to Quash.

subpoena. See Rule 232(b) of the Commission's Rules of Practice. Putnam, the Division of Enforcement, and the OGC participated in that conference. By order issued that same day, I denied Putnam's subpoena application, but advised the parties that I would grant a new subpoena application, if it was revised and narrowed. I signed Putnam's revised and narrowed subpoena application on March 4, 2004.

Putnam's subpoena seeks five categories of documents, two of which are at issue here:

2. All communications on and after January 1, 1999, between the SEC and any person concerning whether such person is obligated [to] make any disclosure in a public filing with the SEC concerning "market timing" trading or "excessive short term trading."
3. All communications on and after January 1, 1999, between the SEC and any person concerning any actions that such person might undertake in order to supervise persons in his employ or associated with him with respect to "market timing" trading or "excessive short term trading."

#### OCIE Has Not Yet Shown That It Has Conducted a Search of the Proper Scope

As an initial matter, a presiding Administrative Law Judge must have confidence that the recipient of a subpoena has carried out a search of the proper scope and has performed an appropriate review of the responsive documents. There is very little in the record to demonstrate that OCIE has done so.

OCIE represents that its Director recently testified before Congress that the examination staff did not detect abusive market timing and did not review trading in a fund's own shares before September 2003. OCIE states: "It appears that there are no responsive documents pre-dating September 2003" (Motion to Quash at 2) (emphasis added). I find the equivocation troubling. Either there are responsive documents prior to September 1, 2003, or there are not. OCIE should not attempt to preserve "wiggle room" for itself by using the phrase "it appears."

OCIE further states that the Commission's examination staff has been reviewing market timing issues since September 2003, and the staff has responsive documents from that month forward (Motion to Quash at 2-3). Once again, however, OCIE equivocates as to whether it has yet assembled all of the responsive documents and conducted a document-by-document review: "To the extent the examination staff had information about disclosure and supervisory obligations, it would be only in letters reporting on and discussing an examination" (Motion to Quash at 6) (emphasis added). I find OCIE's use of the subjunctive troubling. Either OCIE has conducted a comprehensive search of its files, assembled all the responsive documents, and reviewed every one of them, or it has not. Speculation by OGC about what such a search might show, if it were to be conducted, does not satisfy the requirements of the subpoena.

On or before March 31, 2004, a responsible management official within OCIE must submit an affidavit stating that OCIE has conducted a comprehensive search of its files and has gathered all the responsive documents for which privilege is claimed. The affidavit must also

clarify whether there are or are not any responsive documents pre-dating September 1, 2003. An affidavit from OGC will not suffice for these purposes.

### The Standards Governing Motions to Quash

Rule 232(e)(2) of the Commission's Rules of Practice provides that a hearing officer shall quash or modify a subpoena, if compliance with the subpoena would be unreasonable, oppressive, or unduly burdensome. Presumably, OCIE's Motion to Quash is based on the theory that it would be "unreasonable" to require production of documents that are privileged. Rule 232 does not contain a provision comparable to Federal Rule of Civil Procedure 26(b)(1), which insulates privileged materials from discovery. Notwithstanding the silence of Rule 232 on this subject,<sup>2</sup> the Commission and its Administrative Law Judges have entertained claims of privilege when ruling on motions to quash. That approach will be followed here.

It is well settled that the party asserting a privilege bears the burden of establishing all of its essential elements. See, e.g., United States v. BDO Seidman, 337 F.3d 802, 811 (7th Cir. 2003); In re Grand Jury Investigation, 723 F.2d 447, 450-51 (6th Cir. 1983) (collecting cases). A "blanket claim" as to the applicability of a privilege does not satisfy the government's burden of proof. See In re Grand Jury Subpoena, 831 F.2d 225, 226-27 (11th Cir. 1987); McCoo v. Denny's, Inc., 192 F.R.D. 675, 680 (D. Kan. 2000).

### FOIA Exemptions are not the Equivalent of Discovery Privileges

The Freedom of Information Act (FOIA), 5 U.S.C. § 552, imposes on federal agencies an affirmative obligation to disclose records, but it also exempts nine enumerated categories of information from the disclosure obligation.

OCIE first asserts that the documents it seeks to withhold from Putnam fall within the scope of Exemption 8 to FOIA, 5 U.S.C. § 552(b)(8) (Motion to Quash at 3-5). That exemption applies to 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 or supervision of financial institutions." OCIE recognizes that FOIA does not create evidentiary privileges, but nonetheless argues that Exemption 8 to FOIA supports its policy arguments for the claim of privilege here (Motion to Quash at 3 n.3; Reply at 3).

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<sup>2</sup> Various subparts of Rule 230 of the Commission's Rules of Practice discuss privilege. For example, Rule 230(b)(1)(i) permits the Division of Enforcement to withhold investigative documents from a respondent on the grounds of privilege and Rule 230(c) describes the preparation of a privilege log. In addition, Rule 230(a)(1)(vi) requires the Division of Enforcement to make available for inspection and copying any final examination or inspection reports prepared by OCIE, if such reports are part of its investigative file. The Commission has recently amended Rule 230(a)(1)(vi) and Rule 230(c) of its Rules of Practice, but those amendments will not take effect until April 19, 2004. However, the present controversy does not involve the Division of Enforcement's investigative file. Rule 230 is therefore inapposite.

The case law does not support OCIE's argument. See Bank of Am. Nat'l Trust & Sav. Ass'n v. Hotel Rittenhouse Assocs., 101 F.R.D. 10, 11 (E.D. Pa. 1983) ("In the civil litigation context, the need of a litigant for the material must be taken into account, and may require disclosure where the FOIA itself would not."); Jupiter Painting Contracting Co. v. United States, 87 F.R.D. 593, 597 (E.D. Pa. 1980) ("Clearly the [FOIA] exemptions do not create any evidentiary privilege of their own force. With regard to a qualified privilege, such as governmental privilege, [a] FOIA exemption cannot even indirectly delimit claims of privilege since it does not take into account the degree of need for the information exhibited by the claimant.") (citation omitted).

As recognized in Friedman v. Bache Halsey Stuart Shields, Inc., 738 F.2d 1336, 1344 (D.C. Cir. 1984) (citations omitted):

If information in government documents is exempt from disclosure to the general public under FOIA, it does not automatically follow the information is privileged within the meaning of [Federal Rule of Civil Procedure 26(b)(1)] and thus not discoverable in civil litigation. . . . Though information available under the FOIA is likely to be available through discovery, information unavailable under the FOIA is not necessarily unavailable through discovery. . . .

In the FOIA context, the requesting party's need for the information is irrelevant; the most urgent need will not overcome an applicable FOIA exemption. In the discovery context, when qualified privilege is properly raised, the litigant's need is a key factor. . . . It is unsound to equate the FOIA exemptions and similar discovery privileges.

Putnam is not a member of the general public seeking disclosure of documents under FOIA. Accordingly, OCIE's reference to FOIA Exemption 8 provides minimal "policy support" for its claim of privilege.<sup>3</sup>

OCIE Has Failed To Make the  
Showing Necessary To Invoke Section 31(c)  
of the Investment Company Act

OCIE next argues that Section 31(c) of the Investment Company Act should be interpreted expansively, so as to bar the release of responsive records to Putnam (Motion to Quash at 5-6). Section 31(c) provides in relevant part:

Notwithstanding any other provision of law, the Commission shall not be compelled to disclose any internal compliance or audit records, or information contained therein, provided to the Commission under this section. Nothing in this

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<sup>3</sup> I rejected a similar argument in another proceeding only two months ago. See Michael Batterman, A.P. No. 3-11259, Order of Jan. 12, 2004, at 3-4 (rejecting the Division of Enforcement's efforts to rely on FOIA exemptions to justify a claim of privilege) (unpublished).

subsection shall authorize the Commission to withhold information from the Congress or prevent the Commission from complying with a request for information from any other Federal department or agency requesting the information for purposes within the scope of the jurisdiction of that department or agency, or complying with an order of a court of the United States in an action brought by the United States or the Commission.

Section 31(d) of the Investment Company Act defines “internal compliance and audit record” to mean “any record prepared by a subject person in accordance with internal compliance policies and procedures.” It also defines “internal compliance policies and procedures” to mean “policies and procedures designed by subject persons to promote compliance with the Federal securities laws.”

Responses provided to the Commission within the context of its examination and oversight program are generally kept confidential. However, it is a long way from “confidential” to “privileged.” *Cf. Pearson v. Miller*, 211 F.3d 57, 67-68 (3d Cir. 2000). I find it impossible to evaluate the Section 31(c) argument advanced here, because OCIE has offered so little information in its Motion to Quash. It is far from obvious that all the responsive materials that OCIE proposes to withhold from Putnam were “provided to the Commission under this section” (that is, under Section 31 of the Investment Company Act). Without a list of the specific documents provided to OCIE under Section 31(c) of the Investment Company Act, I am unable to determine whether each withheld document was even designed and prepared by a “subject person.”

OCIE has cited no authority to support its sweeping claim that Section 31(c) “necessarily applies” to documents prepared by the Commission’s staff (Motion to Quash at 6). I assume from OCIE’s silence that there is no such authority and that the issue is one of first impression.

Finally, OCIE claims that the exception in Section 31(c) of the Investment Company Act should not apply to administrative proceedings (“Nothing in this subsection shall . . . prevent the Commission from complying with . . . an order of a court of the United States in an action brought by . . . the Commission.”) (Motion to Quash at 6).

To be sure, the Commission brought this proceeding in the administrative forum, and that is not the same as filing an action in district court before an Article III judge. However, it is somewhat facile for OCIE to treat this administrative proceeding as “litigation” when it wishes to assert privilege under 17 C.F.R. § 200.30-14(f), *see supra* note 1, while treating it as beyond the scope of the exception of Section 31(c) when that exception becomes problematic. OCIE’s effort to distinguish administrative proceedings from district court actions has been considered with this in mind.

If OCIE wishes to pursue its Section 31(c) argument, it must take the following steps. First, if it has not already done so, OCIE shall conduct a comprehensive review of its files and assemble all of the responsive documents that it believes are subject to Section 31 of the Investment Company Act. Second, OCIE shall provide a detailed index of the responsive documents that were “provided to the Commission” by a “subject person,” and that it wishes to

withhold. Third, if OCIE intends to argue that Section 31(c) “necessarily applies” to documents prepared by the Commission’s staff, it shall provide a separate detailed index of such responsive documents. Finally, OCIE shall provide an affidavit from a responsible management official in OCIE, stating that he or she has personally reviewed each of the responsive documents for which Section 31(c) protection is claimed. The affidavit and the indices shall be filed and served no later than March 31, 2004. An affidavit from OGC will not suffice for these purposes.

### The Analogous Bank Examination Privilege

The “crown jewel” of the Motion to Quash is a policy argument for the creation of a novel “SEC examination privilege” that would protect from disclosure to Putnam all documents related to OCIE’s examinations of investment companies, investment advisers, brokers, and dealers (Motion to Quash at 3, 6-7). OCIE believes that such a privilege should be absolute, not qualified (Motion to Quash at 7). It contends that such a privilege would be “analogous” to the bank examination privilege (Motion to Quash at 3 nn.2-3).

Although the United States Supreme Court has not explicitly recognized a bank examination privilege, two circuit courts of appeal have done so. See In re Bankers Trust Co., 61 F.3d 465, 471 (6th Cir. 1995); In re Subpoena Served Upon the Comptroller of the Currency and the Secretary of the Bd. of Governors of the Federal Reserve Sys., 967 F.2d 630, 633-34 (D.C. Cir. 1992) (In re Subpoena). The primary purpose of the privilege is to preserve candor in communications between bankers and examiners, which those parties consider essential to the effective supervision of banking institutions. In re Subpoena, 967 F.2d at 633.

The bank examination privilege is not an absolute privilege, but rather, a qualified privilege. Bankers Trust, 61 F.3d at 471; In re Subpoena, 967 F.2d at 633-34; In re Bank One Secs. Litig., 209 F.R.D. 418, 427 (N.D. Ill. 2002). It shields from discovery only agency opinions or recommendations. Any materials pertaining to purely factual matters fall outside the scope of the privilege and, if proven to be relevant, must be produced. Bankers Trust, 61 F.3d at 471; Schreiber v. Society for Savings Bancorp, Inc., 11 F.3d 217, 220 (D.C. Cir. 1993); In re Subpoena, 967 F.2d at 634; Bank One Secs. Litig., 209 F.R.D. at 426. Likewise, the privilege may be overridden as to its protection of deliberative material if good cause is shown. Bankers Trust, 61 F.3d at 471; In re Subpoena, 967 F.2d at 634.

Because the bank examination privilege is not absolute, a court must balance the competing interests of the party seeking the documents and those of the government. At a minimum, the court must consider: (1) the relevance of the evidence sought to be protected; (2) the availability of other evidence; (3) the seriousness of the litigation and the issues involved; (4) the role of the government in the litigation; and (5) the possibility of future timidity by government employees who will be forced to recognize that their secrets are violable. Bankers Trust, 61 F.3d at 472; Schreiber, 11 F.3d at 220; In re Subpoena, 967 F.2d at 634.

Based on this case law, an “SEC Examination Privilege”—if indeed it ought to be created—could not possibly be an absolute privilege. At most, it would be a limited and qualified privilege, and factual matters would be beyond its scope.<sup>4</sup>

OCIE Has Not Properly  
Asserted Its Claim of Privilege

OCIE and the Division of Enforcement have presented arguments on the five-prong balancing test. They are particularly anxious for me to address the first prong of the test (the relevance of the subpoenaed documents). However, this approach would put the cart before the horse. It is premature to address the balancing test until OCIE has properly presented its claim of privilege in a focused and deliberate manner.

At this juncture, the claim of privilege is little more than an abstraction. I have no idea if OCIE is claiming privilege for thousands of responsive documents, or only for a few responsive documents. OCIE has not provided a detailed index of the responsive documents for which it is claiming privilege. Cf. Fed. R. Civ. Pro. 26(b)(5). Nor has it demonstrated that a responsible management official within OCIE has personally reviewed all of the responsive documents and determined that each one falls within the scope of the claimed privilege. These are essential steps before any balancing test may be conducted. I therefore reject OCIE’s claim that a privilege log would serve no purpose (Reply at 1 n.1). As the United States Court of Appeals for the District of Columbia Circuit found in Schreiber, 11 F.3d at 220-21 (citations omitted):

The first task of the district court . . . is to determine whether the banking agency has shown that the requested documents are not primarily factual in nature. If the agency demonstrates that the documents are not primarily factual and thus fall within the scope of the bank examination privilege, the court must then determine whether the documents can be redacted so that the factual portions may be produced in compliance with the subpoena. If the factual and privileged material are inextricably intertwined, then the court must determine whether the privilege, which is qualified, should be overridden for good cause and the documents produced. . . .

We are not prepared to say that an in camera inspection is always necessary in order for the district court to satisfy itself about the factual nature of a bank regulatory document; a non-conclusory affidavit [from the governmental party asserting the privilege] might suffice in a particular case. We note, however, that courts commonly do examine such documents in camera before determining whether they fall within the claimed privilege.

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<sup>4</sup> OCIE nonetheless asserts that it would be “appropriate” for the newly minted “SEC Examination Privilege” to protect purely factual information (Reply at 5). This argument undercuts OCIE’s earlier claim that it seeks nothing more than what is available to the federal banking agencies under the bank examination privilege.

If the district court proceeds to an in camera inspection, it should not have to comb through a mountain of material in order to determine whether each particular document is primarily factual in nature or, if a mixture of facts and opinion, whether the facts are segregable. Rather, the court could require the agency [asserting the privilege] to submit to it an index correlating the agency's assertion of privilege to the evaluative portions of the documents, much as it does when an agency asserts that a document requested pursuant to [FOIA] is exempt from disclosure. . . . With a Vaughn-type index in hand, the court could review all or, if voluminous, a representative sampling of the disputed documents in order to determine respectively whether any particular document or type of document falls within the bank examination privilege. . . .

[W]e note that every court that has examined the nature of bank examination reports thus far has found them to be at least partly factual.

If there is going to be an "SEC Examination Privilege," it will require no less from OCIE than Schreiber requires from agencies asserting the analogous bank examination privilege. In the absence of a Vaughn-type index and an affidavit providing a document-by-document explanation for the assertion of privilege, OCIE's Motion to Quash is deficient.

I have considered denying OCIE's claim of privilege at this time and ordering OCIE to produce the responsive documents to Putnam. However, disclosure of the documents in question might arguably have an adverse impact on the public interest. Accordingly, I will afford OCIE a brief opportunity to present the necessary affidavits and indices, and I will hold in abeyance a ruling on the Motion to Quash. Cf. Grand Jury Subpoena, 831 F.2d at 227 (granting a second chance, but warning that "[f]uture litigants who make only blanket assertions of privilege at enforcement proceedings should not expect such grace"). If OCIE does not make the necessary filings within the time allowed, I will issue a subsequent order deeming its claim of privilege to be waived.<sup>5</sup>

#### ORDER

IT IS ORDERED THAT, not later than March 31, 2004, the Office of Compliance Inspections and Examinations of the Securities and Exchange Commission shall file and serve affidavits and indices in compliance with the terms of this Order.

  
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James T. Kelly  
Administrative Law Judge

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<sup>5</sup> If OCIE moves to enlarge the time for complying with this Order, its motion must state that it has consulted with Putnam about the proposed enlargement. The motion must also state Putnam's position on the proposed enlargement.