



U.S. Securities and Exchange Commission  
Office of Inspector General  
Office of Audits

# Assessment of Corporation Finance's Confidential Treatment Processes and Procedures



September 28, 2010  
Report No. 479



OFFICE OF  
INSPECTOR GENERAL

UNITED STATES  
SECURITIES AND EXCHANGE COMMISSION  
WASHINGTON, D.C. 20549

**MEMORANDUM**

September 28, 2010

**To:** Meredith Cross, Director, Division of Corporation Finance (CF)  
**From:** H. David Kotz, Inspector General, Office of Inspector General *YDK*  
**Subject:** *Assessment of Corporation Finance's Confidential Treatment Processes and Procedures, Report No. 479*

This memorandum transmits the U.S. Securities and Exchange Commission, Office of Inspector General's (OIG) final report detailing the results of our audit on the CF's confidential treatment processes and procedures. This audit was conducted as part of our continuous effort to assess the management of the Commission's programs and operations and as a part of our annual audit plan.

The final report contains eight recommendations that were developed to strengthen the Commission's confidential treatment processes and procedures. CF fully concurred with four recommendations, partially concurred with three recommendations, and did not concur with one recommendation. CF's written response to the draft report is included in its entirety in Appendix V.

Within the next 45 days, please provide the OIG with a written corrective action plan that is designed to address the agreed-upon recommendations. The corrective action plan should include information such as the responsible official/point of contact, time frames for completing the required actions, milestones identifying how you will address the recommendations cited in this report.

Should you have any questions regarding this report, please do not hesitate to contact me. We appreciate the courtesy and cooperation that you and your staff extended to our staff during this audit.

Attachment

cc: Kayla J. Gillan, Deputy Chief of Staff, Office of the Chairman  
Diego Ruiz, Executive Director, Office of the Executive Director  
Shelly Parratt, Deputy Director, Division of Corporation Finance,  
Disclosure Operations

# Assessment of Corporation Finance's Confidential Treatment Processes and Procedures

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## Executive Summary

**Background.** The Division of Corporation Finance's (CF) chief roles within the agency are to ensure that investors are provided with material information, offer interpretive assistance to companies on the Securities and Exchange Commission's (SEC or Commission) rules and forms, and make proposals to the Commission for new disclosure rules or revisions to existing disclosure rules. Material information is provided to investors to assist them in making an informed decision. This is not only done when a company originally offers its stock to the public. It is also provided on a consistent basis as the company discloses information to the marketplace. Companies are required to comply with the reporting requirements set forth by the Securities Act of 1933 (Securities Act) and the Securities Exchange Act (Exchange Act) of 1934.

CF has a number of statutory requirements and review priorities that it must meet in pursuing its core investor protection responsibilities. For example, in addition to processing requests for confidential treatment, CF reviews registrants' Exchange Act reports, including the review of the financial statements of every registrant at least once every three years, as mandated by the Sarbanes-Oxley Act of 2002. Consistent with its investor protection mandate and the spirit of the Sarbanes-Oxley Act, CF further reviews a substantial number of registrant's Exchange Act reports. CF also:

- Reviews and declares effective Securities Act registration statements;
- Reviews the filings of all companies registering with the Commission for the first time, regardless whether they are filing under the Securities Act or the Exchange Act;
- Responds to requests for no action relief;
- Assists the Commission with rule writing;
- Reviews tender offers and other transactions; and
- Provides interpretive guidance to registrants and would-be registrants.

The Securities Act is commonly referred to as the "truth in securities" law. This act has two main components: 1) the Act requires that investors receive financial and other significant information concerning securities being offered for public sale; and 2) the Act prohibits deceit, misrepresentations, and other fraud in the sale of securities. The basic means of accomplishing these goals are the disclosure of important financial information through the registration of securities.

With the Exchange Act, Congress created the Securities and Exchange Commission. The Exchange Act empowers the Commission with extensive authority over all aspects of the securities industry. This includes the power to register, regulate, and oversee brokerage firms, transfer agents, and clearing agencies, as well as the nation's securities self regulatory organizations (SROs).

The federal securities laws generally require any company that is publicly held or is registering its securities for public sale to disclose a broad range of financial and non-financial information in registration statements, annual reports, and other filings made with the Commission. The disclosure requirements for financial and non-financial information primarily are found in Regulation S-K. Regulation S-X sets forth the financial statement disclosure requirements.

Sometimes the public disclosure of information required by the disclosure rules (e.g., Regulation S-K) can adversely affect a company's business and financial condition because of the competitive harm that could result from the disclosure.<sup>1</sup> This issue frequently arises in connection with the requirement that a registrant file publicly all contracts material to its business other than those it enters into in the ordinary course of business.<sup>2</sup> Typical examples of the information that raises this concern include pricing terms, technical specifications and milestone payments.<sup>3</sup> To address the potential disclosure hardship, the Commission has adopted a system that allows companies to request confidential treatment of information filed under the Securities Act and the Exchange Act.<sup>4</sup>

Specifically, Commission Rules 406 and 24b-2 set forth the exclusive means for obtaining confidential treatment of information contained in documents filed under the Securities Act and the Exchange Act, respectively that would be exempt from disclosure under the Freedom of Information Act (FOIA). FOIA requires all federal agencies to make specified information available to the public, including information required to be filed publicly by Commission rules. FOIA, however, contains nine specific exemptions. Rules 406 and 24b-2 require that confidential treatment requests contain an analysis of the applicable FOIA exemptions. Most applicants rely on the exemption for "trade secrets and commercial or financial information obtained from a person privileged or confidential,"<sup>5</sup> which is commonly referred to as "the (b)(4) exemption."

**Congressional Report.** On January 25, 2010, the U.S. House of Representatives Committee on Oversight and Government Reform issued a special report focused on the disclosure surrounding payments made to

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<sup>1</sup> Division of Corporation Finance Staff Legal Bulletin No.1 (with Addendum), February 28, 1997 (Addendum included: July 11, 2001), page 2. See <http://www.sec.gov/interps/legal/slbcf1r.htm>.

<sup>2</sup> *Id.* Regulation S-K, Item 601, 17 C.F.R. § 229.601, requires all material contracts not made in the ordinary course of business to be filed with the SEC as an exhibit.

<sup>3</sup> Division of Corporation Finance Staff Legal Bulletin No.1 (with Addendum), February 28, 1997 (Addendum included: July 11, 2001), page 2. See <http://www.sec.gov/interps/legal/slbcf1r.htm>.

<sup>4</sup> *Id.*

<sup>5</sup> 5 U.S.C. § 552(b)(4).

counterparties of American International Group (AIG), as a result of the Federal Reserve Bank of New York (FRBNY) Maiden Lane III (ML 3) transaction.<sup>6</sup> The report stated that, as a result of the ML 3 transaction between AIG and the FRBNY, AIG was required to file an 8-K report with the SEC to disclose information as required under the securities laws.<sup>7</sup> The report further described AIG's 8-K regulatory filing submission process for the ML 3 transaction, which included a confidential treatment request to the SEC for information contained in an attachment to the ML 3 contract agreement identified as "Schedule A." The report stated that the "Schedule A" attachment contained details of payments certain companies received as a result of the ML 3 transaction that terminated certain derivative agreements, to which AIG was a counterparty.

In a statement issued by the FRBNY regarding public disclosure of the ML 3 transaction with AIG, the FRBNY stated that AIG's decision to initiate a confidential treatment request with the SEC for its 8-K filing associated with the ML 3 transaction was not an uncommon practice and within the confines of the SEC rules, as the SEC typically receives 1,500 confidential treatment requests each year and grants confidential treatment requests 95 percent of the time.<sup>8</sup>

Considering the Congressional efforts to provide the public with greater transparency surrounding the Federal assistance to AIG, along with the statements rendered by the FRBNY pertaining to the SEC's confidential treatment request process, the OIG decided to conduct an audit of CF's confidential treatment request processes and procedures. This audit aligns with our overall objective and audit plan to continuously assess management of the Commission's programs and operations.

The OIG did not assess the confidential treatment request submitted by American International Group (AIG) during its audit. Our audit objective was to evaluate the CF confidential treatment request process in its entirety and included testing a sample of confidential treatment requests, which did not include the AIG request. Moreover, the findings do not specifically relate to any single confidential treatment request including the AIG confidential treatment request, but rather reflect observations that pertained to the overall confidential treatment request processes and procedures.

**Objectives.** The audit's objectives were to assess the adequacy of CF's internal policies that govern the intake, processing, and decision-making associated with confidential treatment requests. In addition, our audit was planned to assess if registrants that were provided confidential treatment by CF adhered to the SEC rules that govern confidential treatment requests. Throughout our audit, the OIG

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<sup>6</sup> U.S. House of Representatives Committee on Oversight and Government Reform Special Report: *Public Disclosure as a Last Resort: How the Federal Reserve Fought to Cover Up the Details of the AIG Counterparties Bailout From the American People*, January 25, 2010.

<sup>7</sup> *Id.*, page 6.

<sup>8</sup> Federal Reserve Bank of New York: *Statement Regarding Public Disclosures of AIG Concerning Maiden Lane III LLC*, January 19, 2010. Available at <http://www.newyorkfed.org/markets/st100119.html>.

also tested whether CF followed its internal policies and procedures for processing confidential treatment requests. The OIG also determined where improvements and best practices could be implemented for the CF confidential treatment process. However, the OIG audit was not planned to render an opinion on the decisions made by CF with respect to grants or denials of confidential treatment requests.

**Prior OIG Audit Reports.** The OIG last audit of the CF confidential treatment process was conducted in 1994. All of the recommendations provided were followed up on and implemented by management. The OIG more recently performed audits/reviews of the Commission's Office of the Secretary<sup>9</sup> and FOIA Office,<sup>10</sup> which included examining the activities performed in these offices that pertain to confidential treatment requests. However, our audit focused on confidential treatment requests submitted in connection with SEC regulatory filings under the Securities Act of 1933 and Securities Exchange Act of 1934, and did not extend to confidential treatment granted for information related to the SEC comment letter process.

**Results.** The OIG found that CF is not performing a robust review and examination of many confidential treatment requests. Specifically, out of 3,381 confidential treatment requests submitted to CF between January 2008 through March 2010, 2,298, or approximately 68 percent, were processed without review, as a result of the initial screening process. A total of 789 out of 3,381, or approximately 23 percent requests, were monitored for one or more particular matters (e.g., duration, materiality, etc.), while 286 out of 3,381, or approximately 8.5 percent of the requests, were selected for full review. As a result, over 90 percent of confidential treatment requests submitted were not subject to a thorough review and examination for compliance with all aspects of the confidential treatment request rules. As a result, the OIG believes there is an increased risk that material information to investors may not be disclosed. Additionally, the OIG determined that the denial of a confidential treatment request is a rare occurrence, as we only found one confidential treatment request that CF did not grant during the scope of our review, January 2008 through April 2010.<sup>11</sup>

Additionally, the OIG found that the use of conclusory statements in some applicants' analyses of the applicable FOIA exemptions and in arguments regarding the potential competitive harm that could result if the subject matters for which confidential treatment was requested were disclosed. The OIG also identified instances where the scope of confidential treatment requests appeared

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<sup>9</sup> OIG Audit Report No. 402, "Office of the Secretary," September 20, 2005.

<sup>10</sup> OIG Audit Report No. 465, "Review of the SEC's Compliance with the Freedom of Information Act," September 25, 2009, and OIG Audit Report No. 422, "Backlog of FOIA Requests for Comment Letters" (March 30, 2007).

<sup>11</sup> Some confidential treatment requests are granted in situations where the applicant will revise their confidential treatment request applications and reduce the scope of the initial confidential treatment request based on comments from CF examiners or counsel.

to be overly broad. In addition, the OIG found that documentation explaining why the subject matter of the confidential treatment request was not necessary for the protection of investors did not always include a robust assessment of both qualitative and quantitative factors that should be considered in assessing materiality.

During our audit, the OIG also identified numerous cases where confidential treatment requests were assigned for review to CF staff in Assistant Director (AD) offices that do not normally review the SEC filings of the confidential treatment request applicants or companies in the confidential treatment request applicants' industry group. CF's Disclosure Operations function is structured into 11 AD offices that specialize in reviewing the disclosures of registrants for various industry clusters.<sup>12</sup> The industry experts in each AD group are knowledgeable of the accounting, disclosure, and technical issues associated with their respective assigned industry and perform the file reviews for those associated companies. However, only 247 out of 914, or 27 percent, of confidential treatment requests received from January 2008 through December 2009 from companies in the healthcare and insurance industries were assigned to AD office No. 1, which processes confidential treatment requests submitted by companies in the healthcare and insurance industries. The OIG notes that CF has established its Disclosure Operations component along AD offices segregated by industry groups with similar accounting and financial reporting matters. Staff who are not assigned to a confidential treatment request applicant's industry group may not be as knowledgeable of the subject matter of certain confidential treatment requests, thus increasing the risk that confidential treatment may be improperly granted for material information to investors.

Lastly, the OIG determined that CF needs to implement additional controls in its confidential treatment request tracking database to ensure data is captured correctly. The OIG identified some data discrepancies in the CF confidential treatment request database. The OIG also found that the confidential treatment request tracking database lacks certain functionality, such as the ability to track confidential treatment requests that are modified after the initial submission. The CF confidential treatment request tracking database is used by management as a medium to generate performance reports. As such, the OIG determined that the reliability, accuracy, and completeness of information contained in the confidential treatment request tracking database is necessary to assist those charged with oversight of and decision-making for the confidential treatment request process.

**Summary of Recommendations.** This report contains eight recommendations for CF that are designed to improve CF's policies and procedures for processing, screening, and examining confidential treatment requests.

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<sup>12</sup> CF recently announced the creation of a few additional offices to focus on capital market trends, structured finance products, and large financial services companies. See <http://www.sec.gov/news/press/2010/2010-124.htm>.

The OIG recommendations cover a facet of areas that can be implemented to improve CF's confidential treatment request program. The recommendations include CF recommend to the Commission that the substantive requirements for confidential treatment requests that are currently described in Staff Legal Bulletin No. 1, as well as any additional substantive requirements deemed appropriate, be codified as formal guidance for confidential treatment request applicants. Additionally, the OIG recommends that CF revise its internal procedures for processing confidential treatment requests to require additional documentation of the substantive review of the materiality and competitive harm application-specific requirements. Such additional documentation should detail the specific qualitative and/or quantitative factors considered in assessing the materiality and competitive harm of the confidential treatment subject matter. The OIG also recommends that CF perform periodic internal assessments of the confidential treatment program and verify on a periodic basis that the information that has been granted confidential treatment has not been publicly disclosed. If CF determines that information previously granted confidential treatment has been publicly disclosed, it should take steps, as appropriate, to revoke the confidential treatment grant. The OIG also recommends that CF should revise its internal procedures for handling the initial screening of confidential treatment requests to ensure that the materiality and competitive harm criteria are not met by simply making conclusory statements or including boilerplate language in the applications by requiring additional documentation of how the screening and review process identified specific and concrete representations to support each criteria. Within CF, the OIG believes an opportunity exists for increased information sharing, such as our recommendation for AD offices that receive the highest number of confidential treatment requests to provide training to CF staff in other AD offices that review confidential treatment requests submitted by applicants outside their assigned AD offices. The OIG also recommends that CF add controls to the confidential treatment tracking database to ensure the accuracy and completeness of data used by management to evaluate program performance, and enhance the functionality of the database to allow management to identify applicants that are consistently provided with comments by CF to refine their confidential treatment requests.

A detailed list of our recommendations can be found in Appendix IV.

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# Background and Objectives

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## Background

**Introduction.** Federal securities laws generally require any company that is publicly held or registering its securities for public sale to disclose a broad range of financial and non-financial information in registration statements, annual reports, and other filings made with the Securities and Exchange Commission (SEC or Commission).<sup>13</sup> Companies that are registered with the SEC are required to comply with the reporting requirements set forth by the Securities Act of 1933 (the Securities Act), 15 U.S.C. § 77a *et seq.*, and the Securities Exchange Act of 1934 (the Exchange Act), 15 U.S.C. § 78a *et seq.*<sup>14</sup> The specific disclosure requirements for financial and non-financial information are primarily found in Regulation S-K, 17 C.F.R. § 229.10. Regulation S-X, 17 C.F.R. § 210.1-01 *et seq.*, sets forth the financial statement disclosure requirements.<sup>15</sup>

The Division of Corporation Finance (CF) assists the Commission in executing its responsibility to oversee corporate disclosure of important information to the investing public and manages the confidential treatment request process. CF has a number of statutory requirements and review priorities that it must meet to pursue its core investor protection responsibilities. For example, in addition to processing requests for confidential treatment, CF reviews registrants' Exchange Act reports and reviews the financial statements of every registrant at least once every three years, as mandated by the Sarbanes-Oxley Act of 2002.<sup>16</sup> Consistent with its investor protection mandate and the spirit of the Sarbanes-Oxley Act, CF reviews a substantial number of registrants' Exchange Act reports much more frequently. CF further:

- Reviews and declares effective Securities Act registration statements;
- Reviews the filings of all companies registering with the Commission for the first time, regardless of whether they file under the Securities Act or the Exchange Act;
- Responds to requests for no action relief;
- Assists the Commission with rule writing;
- Reviews tender offers and other transactions; and
- Provides interpretive guidance to registrants and would-be registrants.

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<sup>13</sup> Division of Corporation Finance Staff Legal Bulletin No.1 (with Addendum), February 28, 1997 (Addendum included: July 11, 2001), page 2. See <http://www.sec.gov/interps/legal/slbcf1r.htm>.

<sup>14</sup> Division of Corporation Finance Overview: The Investor's Advocate. How the SEC Protects Investors, Maintains Market Integrity, and Facilitates Capital Formation. See <http://www.sec.gov/about/whatwedo.shtml#corpfin>.

<sup>15</sup> Division of Corporation Finance Staff Legal Bulletin No.1 (with Addendum), February 28, 1997 (Addendum included: July 11, 2001), page 2. See <http://www.sec.gov/interps/legal/slbcf1r.htm>.

<sup>16</sup> Section 408 of Public Law 107-204, July 30, 2002, 15 U.S.C. § 7266.

Sometimes disclosure of information required by the disclosure rules (e.g., Regulation S-K) can negatively affect a company's business and financial condition because of the competitive harm that could result from the disclosure.<sup>17</sup> This issue can arise in connection with the requirement that a registrant file publicly all contracts material to its business other than those it enters into in the ordinary course of business.<sup>18</sup> To address the potential disclosure hardship, the Commission has established a system that allows companies to request confidential treatment of information filed under the Securities Act and the Exchange Act.<sup>19</sup>

**Rules Governing CF's Confidential Treatment Request Process.** The rules promulgated at 17 C.F.R. § 230.406, "Confidential Treatment of Information Filed with the Commission," and 17 C.F.R. § 240.24b-2, "Non-Disclosure of Information Filed with the Commission and with Any Exchange" (Rules 406 and 24b-2), prescribe the requirements for obtaining confidential treatment of information contained in documents filed under the Securities Act and the Exchange Act, respectively, that would be exempt from disclosure under the Freedom of Information Act (FOIA).<sup>20</sup> FOIA requires all federal agencies to make specified information available to the public, including information required to be filed publicly by Commission rules.<sup>21</sup> FOIA, however, includes nine specific exemptions.<sup>22</sup> Rules 406 and 24b-2 require that confidential treatment requests contain an analysis of the applicable FOIA exemptions.<sup>23</sup>

Rule 24b-2, 17 C.F.R. § 24b-2(b)(2), requires an applicant to include the following items, among other things, in an application to the Commission for a confidential treatment request:

- 1) Identification of the confidential portion of the filing;
- 2) A statement of the grounds of objection to disclosure, including an analysis of how the confidential portion meets an applicable FOIA exemption(s); and
- 3) A justification of the time period for which confidential treatment is requested.

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<sup>17</sup> Division of Corporation Finance Staff Legal Bulletin No.1 (with Addendum), February 28, 1997 (Addendum included: July 11, 2001), page 2. See <http://www.sec.gov/interps/legal/slbcf1r.htm>.

<sup>18</sup> *Id.* Regulation S-K, Item 601, 17 C.F.R. § 229.601, requires all material contracts not made in the ordinary course of business to be filed with the SEC as an exhibit.

<sup>19</sup> Division of Corporation Finance Staff Legal Bulletin No.1 (with Addendum), February 28, 1997 (Addendum included: July 11, 2001), page 2. See <http://www.sec.gov/interps/legal/slbcf1r.htm>.

<sup>20</sup> *Id.*

<sup>21</sup> *Id.*

<sup>22</sup> See 5 U.S.C. § 552(b).

<sup>23</sup> 17 C.F.R. § 230.406(b)(2); 17 C.F.R. § 240.24b-2(b)(2)(ii).

Similarly, Rule 406, 17 C.F.R. § 230.406(b)(2), requires that an applicant include similar information in its request for confidential treatment.<sup>24</sup>

**CF's Confidential Treatment Process – Intake.** The confidential treatment request process is initiated upon an applicant's submission of a confidential treatment request application to the SEC's Office of the Secretary. Upon receipt of the applicant's confidential treatment request application, the Office of the Secretary will acknowledge receipt with a date stamp on the application and subsequently file it in CF's mail slot in the Office of the Secretary. Staff from CF's Office of Disclosure Support (ODS) pick up applicants' confidential treatment request applications in person from CF's mail slot in the Office of the Secretary on a daily basis.

During the course of the audit, the OIG observed that upon obtaining possession of the applicant's confidential treatment request application, staff from CF's ODS enter the application as a record in CF's confidential treatment tracking system (a Microsoft Access database). The system assigns a control number to each record entered into the confidential treatment tracking system. In addition, a staff member from ODS then creates a file folder for the application and places a confidential treatment tracking form on the cover of the file folder.

**CF's Confidential Treatment Process – Screening.** Research specialists in ODS perform a screening of the applicant's confidential treatment request application using CF's confidential treatment request screening form. Per CF's confidential treatment request screening form, the research specialist is responsible for populating the following information pertaining to the confidential treatment request:

- Applicant's Name.
- Assistant Director (AD) office number ("*AD office No.*" per the form).
- Control No. (Automatically generated by CF's Confidential Treatment Tracking system).
- Date Request Submitted.
- Indication if the application is for a new request or extension of a confidential treatment order previously granted ("*New Request or extension?*" per the form).
- Form Type.
- File No.
- Date Form Filed.<sup>25</sup>

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<sup>24</sup> CF has acknowledged that there is a difference in the language of Rules 406 and 24b-2, as Rule 24b-2 does not include a statement similar to the provision at 17 C.F.R. § 230.406(b)(2)(iii), which requires the applicant to include "[a] detailed explanation of why, based on the facts and circumstances of the particular case, disclosure of the information is unnecessary for the protection of investors. However, CF has indicated that in practice it views no difference in the requirements to which applicants must adhere to when requesting confidential treatment under Rule 406 or Rule 24b-2.

<sup>25</sup> Based on a screenshot of fields from CF's Confidential Treatment Request Tracking Database.

In addition, the research specialist is required to answer “Yes” or “No” to the following statements (both company-related and application-related) as they pertain to the applicant’s confidential treatment request application:

**Company-Related Items**<sup>26</sup>

Applicant is a [REDACTED]  
If the application was submitted by a reporting company, [REDACTED]

**Note:** [REDACTED]

**Application-Related Items**

- Applicant claims [REDACTED]
- Applicant includes [REDACTED]
- Applicant [REDACTED]
- Applicant [REDACTED]
- Applicant filed the document subject to the confidential treatment request on EDGAR [REDACTED]
- Applicant requests a [REDACTED]

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<sup>26</sup> In the audit, we identified one additional criterion that was included in the past as part of ODS screening.

[REDACTED]

CF Confidential Treatment Request Screening Form, April 2008.

<sup>28</sup> *Id.*

<sup>29</sup> *Id.*

<sup>30</sup> *Id.*

<sup>31</sup> *Id.*

<sup>32</sup> *Id.*

<sup>33</sup> *Id.*

<sup>34</sup> *Id.* Per CF’s confidential treatment operating procedures, CF usually does not grant confidential treatment for a duration beyond [REDACTED]

■ Applicant provides [REDACTED]  
■ [REDACTED]

Subsequent to answering “Yes” or “No” to the above mentioned statements, the research specialist in ODS proceeds to recommend the type of review the AD office will perform. The options available to the research specialist are:

- “None.”<sup>37</sup>
- “Full Review.”
- “Monitor.”<sup>38</sup>

During the audit, the OIG learned that in cases where ODS recommends a review level of “None,” to the AD office, ODS will prepare a draft “No Review” letter and draft “Grant Order” for confidential treatment and forward these documents and the confidential treatment file folder (which includes the application initially submitted to the Office of the Secretary and a confidential treatment request screening form) to the assigned AD office based upon the industry group of the applicant. The OIG also learned that in cases where the recommended level of review by ODS is “Monitor,” ODS will prepare a draft “monitor letter.” Similarly, the OIG learned that if the recommended level of review by ODS is “Full Review,” ODS prepares a draft “review letter.”

**CF’s Confidential Treatment Process – AD Office Examination.** On a periodic basis, staff members (e.g., special counsel/attorneys) from the AD offices assigned to examine the confidential treatment applications will pick up applicants’ confidential treatment request file folders for their assigned offices from ODS. Staff members are required to sign off acknowledging receipt of the confidential treatment request file folders containing the confidential treatment application, an unredacted copy of the filed materials, and the confidential treatment request screening form. After obtaining the confidential treatment request file folder, the AD office will make a determination whether to concur or disagree with the level of review recommended by ODS.

In cases where the ODS recommended level of review is “None” and the processing AD office concurs, the AD office will prepare the confidential treatment grant order. In cases where the AD office does not concur with the ODS recommended level of review of “None,” the AD office will perform some level of review of the confidential treatment application.

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<sup>35</sup> CF Confidential Treatment Request Screening Form, April 2008

<sup>36</sup> *Id.*

<sup>37</sup> This level of recommendation generally arises in instances where the research specialist answers “Yes” to all of the application-related items.

<sup>38</sup> The screener is asked to indicate the subject matter to be monitored.

For applications that were recommended for a level of review of “Monitor,” the assigned processing AD office may issue a “monitor letter” and concurrently issue comments (written or oral) to the applicant on certain matters pertaining to the confidential treatment application. The applicant can submit an amended confidential treatment application in order to satisfy the concern(s) raised by the AD office. The amended confidential treatment application will be reviewed by the AD office, and a determination will be made whether or not to grant confidential treatment. In cases where the AD office determines to grant the applicant’s amended confidential treatment request, the AD office will prepare the confidential treatment grant order.

In some cases, the AD office may perform a “Full Review” of an applicant’s confidential treatment request. The AD office staff member (e.g., special counsel/attorney) performing the full review/examination must complete a confidential treatment request examination report. In the confidential treatment request examination report, the AD office staff member will be required to answer “Yes” or “No” to the following statements as they pertain to the applicant’s confidential treatment request application:

[REDACTED]

**CF’s Confidential Treatment Process – Grants and Denials.** Upon completion of the examination, the AD office will make a decision to grant or deny the confidential treatment application. According to CF, the authority to grant a confidential treatment request is limited to specific members of its staff. In most AD offices, the staff members delegated the authority to grant requests include the Special Counsel, Legal Branch Chief or the Assistant Director. In cases where the AD office determines to grant the applicant’s confidential treatment request, the AD office will prepare the confidential treatment grant

<sup>39</sup> CF Confidential Treatment Request Examination Report, January 2009.

<sup>40</sup> *Id.*

<sup>41</sup> *Id.*

<sup>42</sup> *Id.*

<sup>43</sup> *Id.*

<sup>44</sup> *Id.*

<sup>45</sup> *Id.*

order. The OIG found during its audit that denial of a confidential treatment request is a very rare occurrence.

Subsequent to the processing of the AD office's determination to grant the confidential treatment request, the application file folder is returned to ODS. The Records Management group picks up completed confidential treatment request files weekly and carries them to the Records Management office. A signature is required by Records Management on the confidential treatment tracking form, indicating receipt of the applicant's confidential treatment request file folder at the time they pick up the folder.

**The Majority of Confidential Treatment Requests are for Material Contracts Filed as Exhibits.** The majority of confidential treatment requests received by CF seek redactions of provisions of material contracts that are included as exhibits in filings submitted to the Commission. Such contracts are required to be filed under the authoritative guidance of Item 601(b)(10) of Regulation S-K. This section requires material contracts not entered into in the ordinary course of business to be filed as exhibits in filings made with the Commission. 17 C.F.R. § 229.601(b)(10). Item 601(b)(10) of Regulation S-K also contains four exceptions whereby contracts even made in the ordinary course of business have to be filed unless they are immaterial in amount or significance. Generally, information in material contracts such as pricing terms, technical specifications and milestone payments are considered to potentially cause substantial harm to the competitive position of the applicant if publicly disclosed. While the majority of confidential treatment requests are associated with provisions in material contracts required to be filed under S-K Item 601 "Exhibits," it is CF's view that such items are eligible for confidential treatment, as CF interprets the word "required" in Staff Legal Bulletin (SLB) No. 1 as follows:

CF considers if the confidential portion in an exhibit (e.g., contract) is required to be disclosed based upon existing disclosure requirements (e.g., an S-K required disclosure such as the identity of a 10 percent customer per 17 C.F.R. § 229.101(c)(vii)).

CF's policy is to not grant confidential treatment to such items required by other existing disclosure requirements. Items in exhibits (e.g., contracts) that are the subject matter for confidential treatment requests are not considered "required" information if the subject matter is not required by other existing disclosure requirements and the subject matter is included in the filing solely as a result of it being a component of the exhibit.<sup>46</sup>

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<sup>46</sup> Testimonial evidence based on inquiry with an Associate Director in CF's Disclosure Operations.

While the contracts filed under Regulation S-K, Item 601, are assumed to be material, the granting of confidential treatment to portions of material contracts filed as exhibits requires a judgment by the CF counsel that the terms of a material contract that are the subject matter of a confidential treatment request are immaterial to an investor. In our sample, the OIG identified a few instances where both parties to a contract filed a confidential treatment request.

**Confidential Treatment Request Processing Time.** CF’s goal is to complete the initial review of confidential treatment requests filed pursuant to Rule 24b-2 within 28 days after the filing date. Upon completion of the review of the confidential treatment request, comments may be issued (either verbally or written) to the applicant. If the staff has no comments, an order will be issued granting the confidential treatment request. If the staff issues comments, applicants must respond to those comments within 21 days of the date of the comment letter. If the applicant does not respond within this period, the staff will consider, pursuant to its delegated authority from the Commission, what action is warranted based on the record before it, including whether to grant, or deny the confidential treatment application. The staff will base its decision on the initial application and all amendments and supplemental information received.

Over a span of ten years CF has made significant strides in reducing the average processing time for confidential treatment requests. As shown in Table 1 below, the average number of days it takes to render a confidential treatment request disposition (grant or denial) has improved dramatically in the past few years. CF informed the OIG that in 2008 it was able to reduce a substantial backlog of confidential treatment requests that had been submitted in previous years.

**Table 1: Average Confidential Treatment Request Processing Time<sup>47</sup>**

	2001	2002	2003	2004	2005	2006	2007	2008	2009	2010
<b>Average Number of Days to Render A Disposition</b>	198	178	204	207	293	279	160	77	61	37

Source: SEC’s Division of Corporation Finance

**CF’s Overall Disclosure Review Program is Selective.** According to CF, the Division’s selective review program allows it to balance the need to conduct a sufficient level of review of each confidential treatment request to make the necessary findings, with the need to allocate resources to meet all the requirements of its mission. The purpose of the selective review program is to provide a sufficient level of review for each request so that legal staff in the AD offices can determine whether a request demonstrates all the required elements

<sup>47</sup> The OIG did note a few instances where the processing time was significantly longer than the average processing time. One confidential treatment request was granted after the requested period for confidential treatment had expired. Within our sample, the OIG found instances where companies did not submit all of the required information for exhibits which sometimes led to amended confidential treatment requests resulting in lengthier processing times.

needed for a valid confidential treatment request under Rules 406 and 24b-2.<sup>48</sup> Further, the purpose is to permit staff to identify requests that either have demonstrated deficiencies or have other characteristics that might require further review.<sup>49</sup>

Based on CF's overall disclosure program, CF has set a target goal to perform a review of the filings of at least 33 percent of Exchange Act reporting companies.<sup>50</sup> This is consistent with the requirement under the Sarbanes-Oxley Act of 2002 that requires companies to undergo a filing review at least once every three years.<sup>51</sup> CF uses a risk assessment (risk-based approach) for determining which companies are selected for the overall filing review. Although CF does not have a formal policy in place for conducting a risk assessment for confidential treatment requests, CF informed the OIG that there are certain types of confidential treatment requests for which CF will more likely perform an in-depth review [REDACTED]

## Objectives

The audit's objectives were to assess the adequacy of CF's internal policies that governed the intake, processing, and decision-making associated with confidential treatment requests. In addition, our audit was planned to assess if registrants that were provided confidential treatment by CF adhered to the SEC rules that govern confidential treatment requests. Throughout our audit, the OIG tested whether CF followed its internal policies and procedures for processing confidential treatment requests. The audit was also intended to determine where improvements and best practices could be implemented for the CF confidential treatment process. However, the audit was not planned to render an opinion on the decisions made by CF with respect to grants or denials of confidential treatment requests.

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<sup>48</sup> Memorandum from CF (September 2, 2010) Re: Division's Response to Discussion Draft – Assessment of Corporation Finance's Confidential Treatment Processes and Procedures.

<sup>49</sup> Memorandum from CF (September 2, 2010) Re: Division's Response to Discussion Draft – Assessment of Corporation Finance's Confidential Treatment Processes and Procedures.

<sup>50</sup> CF's target percentage of reporting companies reviewed per the SEC 2009 Performance and Accountability Report.

<sup>51</sup> Section 408 of the Sarbanes-Oxley Act of 2002, 15 U.S.C. § 7266. "Enhanced Review of Periodic Disclosures by Issuers."

# Findings and Recommendations

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## **Finding 1: CF’s Policies Do Not Provide for In-Depth, Substantive Reviews of Most Confidential Treatment Requests**

CF’s internal policies and procedures do not require the majority of confidential treatment requests to be thoroughly examined and reviewed for compliance with the confidential treatment request rules. As a result, there is an increased risk that confidential treatment will be improperly granted for information that may be considered material information to investors.

**CF’s Confidential Treatment Request Policies and Procedures.** During our review of CF’s internal policies and procedures for the processing of confidential treatment requests, we found that confidential treatment requests typically go through an initial screening process by ODS.<sup>52</sup> In the initial screening process, research specialists in ODS screen confidential treatment request applications using a set of company-specific and application-specific criteria.<sup>53</sup>

The research specialists inspect the confidential treatment request application and indicate in the application where the applicant has made representations regarding the FOIA exemption applicable to the confidential treatment request subject matter, why the information that is the subject of the confidential treatment request is not necessary for the protection of investors, and how disclosure of the information would cause competitive harm. We found that the research specialists, however, do not perform any substantive evaluation of the aforementioned items identified in the confidential treatment request application.

At the conclusion of the screening process, the research specialist in ODS will make a recommendation of the type of review to be performed by the AD office. The following options are available for recommendation:

- “No Review.”<sup>54</sup>
- “Full Review.”
- “Monitor.”<sup>55</sup>

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<sup>52</sup> Division of Corporation Finance Operating Procedures Manual, Confidential Treatment Requests (December 2008).

<sup>53</sup> See pages 4 and 5 in the background section above for the company-specific and application-specific criteria.

<sup>54</sup> This level of recommendation generally arises in instances where the research specialist answers “Yes” to all of the application-related items.

<sup>55</sup> Where this option is recommended, the screener will indicate to the Assistant Director’s office the subject matter to be monitored.

In instances where the ODS recommended level of review was “No Review” and the processing AD office concurs, the AD office will prepare the confidential treatment grant order. According to CF, if the AD office staff member decides that an additional, substantive review is necessary because legal judgment is needed to determine whether a particular assertion is supportable, the staff member may recommend an additional review of that matter. However, we found rare instances when the AD office did not concur with ODS’ recommendation of “No Review,” or conducted any substantive evaluation of the application after such a recommendation was made. We also found no documentation of the factors considered by the AD office in determining whether or not to concur with the “No Review” recommendation.

For applications that were recommended with a level of review of “Monitor,” the assigned processing AD office may issue a “monitor letter,” and concurrently issue comments (written or oral) to the applicant on certain matters pertaining to the confidential treatment application.

When it has been determined that there is to be “full review” of a confidential treatment application, an examiner in the assigned AD office will perform a full review, which will include a review of the applicant’s confidential treatment request and the screening form completed by ODS, and completion of an examination report to document the results of the full review. Special Counsel in each AD office will perform a review of the examiner’s report and discuss the full review with the examiner. Key judgments and factors considered in evaluating the applicant’s confidential treatment request are discussed at length, and comments are prepared to be issued to the applicant (if applicable) to revise the confidential treatment requests.

If a confidential treatment request is filed by an applicant that concurrently has an open filing review being performed by CF, the confidential treatment request is generally reviewed by the AD office performing the open filing review.<sup>56</sup> In addition, if the AD office is performing a review of the filing referenced in the confidential treatment application, the AD office will review the application and filing to ensure that the material omitted in the filing reconciles with the material for which requested for confidential treatment is requested in the application. Generally, a full review is performed for a confidential treatment request submitted in connection with an initial registration statements [REDACTED] [REDACTED] the confidential treatment request. CF policies allow for an AD office to override the level of review recommended by ODS.

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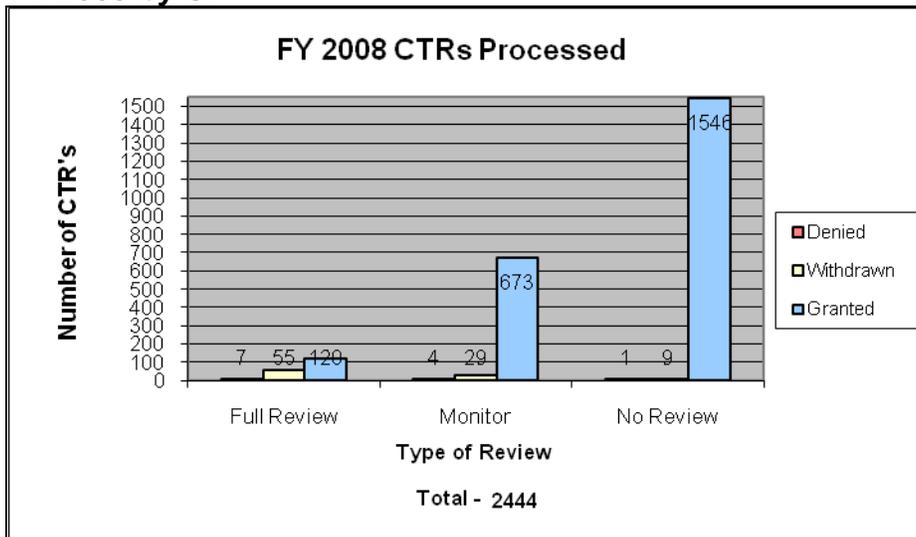
<sup>56</sup> CF is a required under the Sarbanes-Oxley Act of 2002 to perform some level of review of each reporting company at least once every three years. See Section 408 of the Sarbanes Oxley-Act of 2002, 15 U.S.C. § 7266, “Enhanced Review of Periodic Disclosures by Issuers.”

**The Majority of Confidential Treatment Requests are Screened with a Recommendation for No Review by the AD Offices.** During the audit, we reviewed all confidential treatment requests submitted to CF for the period from January 2008 to March 2010. Based on our scope, we found that CF granted approximately 87 percent (2,956 of 3,381) of the confidential treatment requests it received, and an additional 9.3 percent (316 of 3,381) of the confidential treatment requests were still pending. Further, approximately three percent (108 of 3,381) of the confidential treatment requests were withdrawn during this period. Of the 3,381 confidential treatment requests made from January 2008 to March 2010, CF only denied one confidential treatment request.

We also found that approximately 68 percent (2,298 of 3,381) of the confidential treatment requests submitted during this period were processed without review, as a result of the initial screening process. Approximately 23 percent (789 of 3,381) of requests were monitored for one or more particular matters (e.g., duration, materiality), while only approximately 8.5 percent (286 of 3,381) were selected for full review.

Overall, we found that more than 90 percent of the confidential treatment requests CF processed from October 2008 to March 2010 were granted. As shown in Figure 1, there were a total of 2,444 confidential treatment requests processed in FY 2008, of which 1,556 or approximately 64 percent were processed with no review beyond the screening process.<sup>57</sup>

**Figure 1: Confidential Treatment Requests Processed in FY 2008 by CF**

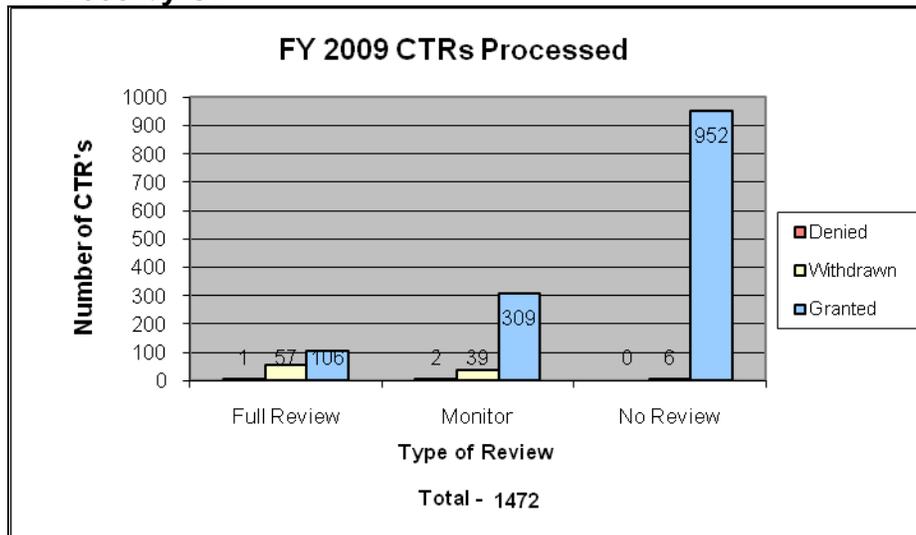


Source: SEC's Division of Corporation Finance

<sup>57</sup> The high number of confidential treatment requests processed in FY 2008 is related to CF's clearing of a backlog of confidential treatment requests submitted in previous fiscal years.

As Figure 2 demonstrates, the percentage of confidential treatment requests that were not reviewed in FY 2009 is comparable to the data for FY 2008. In FY 2009, 65 percent (958 of 1,472) of confidential treatment requests were not reviewed beyond the initial screening process.

**Figure 2: Confidential Treatment Requests Processed in FY 2009 by CF**



Source: SEC's Division of Corporation Finance

**Ease of Compliance with the Procedural Requirements of the Rules.** Upon review of Rules 406<sup>58</sup> and 24b-2,<sup>59</sup> which govern the confidential treatment process, OIG determined that these rules are procedural, rather than substantive, in nature, and focus exclusively on the requirements for what must be included in a confidential treatment application submitted to the Commission. Furthermore, Rules 406 and 24b-2 contain no specific provisions that restrict the scope of the confidential treatment that can be requested by an applicant. The rules also do not specify on what grounds a confidential treatment request should or should not be granted. The decision to grant or deny an applicant's request is solely at the discretion of CF examiners and legal counsel.<sup>60</sup>

An Associate Director for CF's Disclosure Operations stated that CF does not wish to have a narrow scope for the nature of items that could potentially be the subject matter of a confidential treatment request. Further, CF does not want to create a bright-line test or enumerate a specific set of items that are permitted to be submitted in a confidential treatment request.

<sup>58</sup> 17 C.F.R. § 230.406, "Confidential Treatment of Information Filed with the Commission."

<sup>59</sup> 17 C.F.R. § 240.24b-2, "Non-Disclosure of Information Filed with the Commission and with Any Exchange."

<sup>60</sup> The confidential treatment request rules provide an outlet for an applicant to appeal a denial of a confidential treatment request.

Our audit found that as a result of the procedural requirements, the screening process and the lack of substantive review, achieving compliance with the requirements of the rule may become a rote process, whereby applicants can mimic the language in the requirements and create an application that will likely result in a “No Review” finding by a CF research specialist.

We found that in many cases, applicants include sub-title headings in their applications to identify each requirement to be included per Rules 406 and 24b-2, so that research specialists can easily conclude that each requirement has been met. We found an extraordinary level of consistency in the form and presentation of a number of confidential treatment requests that we examined. Such consistency may be attributed to many applicants employing to assist in the preparation of confidential treatment applications legal counsel who are knowledgeable of the SEC’s requirements pertaining to confidential treatment requests and routinely prepare confidential treatment requests for various SEC registrants.

We also found during the audit that the majority of confidential treatment requests leave the screening process with a recommended level of “No Review,” as the screening process does not involve a substantive evaluation of the application-specific criteria. The research specialists in ODS only verify that representations or statements are made in the application regarding how the subject matter of the confidential treatment request meets a FOIA exemption and that this subject matter is not material to investors. CF’s policies currently do not provide for any in-depth analysis to verify the reasonableness of the assertions made by applicants regarding the application-specific criteria. Thus, it is not difficult for a company to comply with the procedural requirements of the confidential treatment request rules, as they are only required to affirmatively state that they comply with the criteria, and their applications are easily reviewed and verified by CF.

**A Deeper Review of Materiality and Competitive Harm Arguments Is Needed.** The OIG found that several components of a confidential treatment request require a substantive analysis, which is currently not being conducted. The issues related to why disclosure of the confidential portion would cause competitive harm, and why disclosure of the confidential portion is not necessary for the protection of investors, should be analyzed in more than a rote fashion. There are numerous cases in which courts have expressed opinions on what constitutes competitive harm, as well as the concept materiality. The Supreme Court has taken the position that a fact is material if there is “a substantial likelihood that the disclosure of the omitted fact would have been viewed by the reasonable investor as having significantly altered the ‘total mix’ of information made available.”<sup>61</sup>

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<sup>61</sup> *Basic, Inc. v. Levinson*, 485 U.S. 224, 231-32 (1988)

According to CF, confidential treatment request applicants must assess materiality from the perspective of their “business, financial condition, and financial results.”<sup>62</sup> In addition, SLB No.1 notes that the determination of materiality depends upon the facts and circumstances of each particular request for confidential treatment. The assessment of an applicant’s argument that the information is not material to investors is subjective by nature and should be based upon qualitative and quantitative factors. Given that CF takes a broad view of the term “investors,”<sup>63</sup> which includes existing holders with a financial interest (e.g., whether debt or equity and long or short positions), the analysis to determine if the subject matter of the confidential treatment request is material to investors is an analysis that requires significant judgment and can be difficult, as the investment objectives of individual investors are not all the same and a determination of what constitutes material information can differ from investor to investor.

Staff Accounting Bulletin No. 99 (SAB 99) describes the importance of the concept of materiality with respect to financial statements. SAB 99 requires that an assessment of materiality include both quantitative and qualitative factors. We found that in many cases, companies’ confidential treatment applications do not describe any qualitative or quantitative factors showing why the information is not material to investors or necessary for the protection of investors. We also found that CF does not have a specific policy regarding how an applicant’s submission regarding materiality should be documented or analyzed. We further found in numerous cases, the entirety of the materiality analysis performed by CF was in the screening process which only required that the screener respond with a “Yes” or “No” checked next to a question indicating whether the applicant



Similarly, the representations made on the behalf of confidential treatment applicants pertaining to the competitive harm that could arise from disclosure of the subject matter of the confidential treatment request is a component that involves significant judgment. According to the confidential treatment request requirements, an applicant must cite the FOIA exemption it believes is applicable to the confidential treatment request. We found that the majority of applicants stated that the subject matter of the confidential treatment request fell within the scope of Exemption four,<sup>64</sup> which covers “trade secrets and commercial or financial information obtained from a person [that is] privileged or confidential.”<sup>65</sup> Moreover, a significant number of these confidential treatment requests pertained

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<sup>62</sup> Division of Corporation Finance Staff Legal Bulletin No.1 (with Addendum), February 28, 1997 (Addendum included: July 11, 2001), page 4. See <http://www.sec.gov/interps/legal/slbcf1r.htm>

<sup>63</sup> CF believes that the term “investors” should be treated broadly. However, CF does not consider investors in the competitor of an applicant in its analysis of whether the confidential portion is material to investors (sometimes stated by applicants “unnecessary for the protection of investors”).

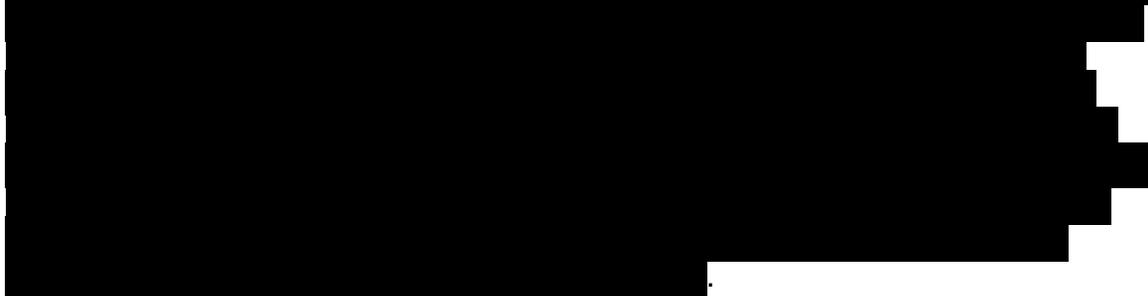
<sup>64</sup> 5 U.S.C. § 552(b)(4).

<sup>65</sup> See CF’s Staff Legal Bulletin No. 1 (with Addendum), February 28, 1997, page 2 (Addendum included: July 11, 2001).

to commercial or financial information that was purportedly privileged or confidential. In order for an applicant to establish that the subject matter of the confidential treatment was request qualifies as confidential commercial or financial information, the applicant is supposed to establish that the subject matter is commercial or financially related, obtained from a “person,” and privileged or confidential.<sup>66</sup>

A number of confidential treatment requests the OIG reviewed included statements that courts have taken broad views as to whether information is classified as commercially or financially related. The requests also contained statements to the effect that anything related to a company’s generation of profits can be considered commercial or financial information based on applicable court cases. Applicants also referenced particular legal decisions in attempting to establish that the redacted information is actually confidential or privileged, citing the fact that the information would “cause substantial harm to the competitive position of the [company.]”<sup>67</sup> Based on our review, we have determined that many confidential treatment requests included statements made on behalf of the applicant that would require significant judgments to be made by CF to determine if the application fell within the FOIA exemption relied on by the applicant.

For example, a large company submitted a confidential treatment request pertaining to an exhibit filed with a 10-Q quarterly report. The exhibit was a separation agreement with a former senior executive officer of the company. The agreement included a restrictive covenant provision that prohibited the departing senior executive from being employed by, providing advice to or acting as a consultant for a number of companies listed in the agreement as the company’s competitors.



Further, we found a number of confidential treatment requests that appeared to be difficult to assess for both materiality and competitive harm, as the facts and circumstances involved significant subjective judgments and analysis on the part of CF counsel. Yet, we found that in numerous cases, such confidential treatment requests were granted with limited evidence of a review of any qualitative or quantitative factors pertinent to the materiality and competitive harm

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<sup>66</sup> The Department of Justice Guide to the Freedom of Information Act, 2009 Edition, “Exemption 4”, page 263, [http://www.justice.gov/oip/foia\\_guide09/exemption4.pdf](http://www.justice.gov/oip/foia_guide09/exemption4.pdf).

<sup>67</sup> *Public Citizen Health Research Group v. Food and Drug Administration*, 704 F.2d 1280, 1290-1291 (D.C. Cir. 1983).

representations after the initial screening. This initial screening simply verified that the applicant claimed the subject matter of the confidential treatment request was not material to investors and met an applicable FOIA exemption and included some manner of legal analysis.

**Need for Continuous Monitoring.** The OIG learned that CF currently does not perform periodic internal audits to verify that its staff are screening and examining confidential treatment requests in accordance with CF policy. Based on a review of the sample files examined in our audit, we determined that a periodic review could help CF identify best practices and also identify instances where sufficient review is not conducted. An internal monitoring program could also help CF identify issues arising in the confidential treatment request program on a timelier basis and take corrective action sooner to improve its program.

Additionally, OIG found that CF currently does not perform any periodic assessments to determine if the subject matter of a confidential treatment request has been disclosed by an applicant after confidential treatment has been granted. Public disclosure of the subject matter of a confidential treatment request negates the effectiveness of the confidential treatment order and should prompt CF to terminate the confidential treatment that has been granted. The OIG also found that CF does not perform any checks to determine if subsequent filings have any effect on the subject matter of a previous confidential treatment request that was granted. For example, we found an instance where a company submitted a confidential treatment application associated with a stock purchase agreement that included a request to redact information concerning its ability to manage pending litigation strategies. Before the confidential treatment request was granted, the company publicly disclosed that the pending litigation had been settled and also filed an amended stock purchase agreement that included provisions that deleted clauses in the original stock purchase agreement. However, these deleted clauses remained a part of the subject matter of the confidential treatment request.

**Requirements Not Codified in Rules.** In reviewing management's policies for confidential treatment requests, the OIG further determined that the requirements to which an applicant must adhere when submitting a confidential treatment request are actually not codified in Rules 406 and 24b-2, but are contained in CF's SLB No. 1.<sup>68</sup> In a number of comment letters CF issued to confidential treatment applicants, CF directed the applicant to seek guidance concerning the requirements for the confidential treatment request in SLB No.1 and not Rules 406 and 24b-2.<sup>69</sup> CF's SLB No. 1 specifies what an applicant must provide in order to have a request for confidential treatment granted. SLB No. 1 also contains the requirements that applicants should follow when requesting confidential treatment of material contained in filings. For example, SLB No. 1

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<sup>68</sup> Staff Legal Bulletin No. 1 is not an official SEC rule and does not have the same level of authority as Rules 406 and 24b-2.

<sup>69</sup> Based on the OIG's inspection of a sample of confidential treatment request files obtained from CF.

states that confidential treatment cannot be granted if the information has been publicly disclosed and notes that confidential treatment should not be requested for required and/or material information.<sup>70</sup> It also includes the following requirements for an applicant to follow when submitting a request:

1. The application should not be overly broad.
2. Applicants must include an analysis of why the confidential portion meets a FOIA exemption.
3. Applicants must specify a particular duration for which it requests the SEC to keep the information confidential.
4. Applicants must clearly identify the confidential portion of the application.
5. Applicants must consent to the release of the information for official purposes.<sup>71</sup>

These requirements, as contained in CF's internal SLB No.1, govern the process for approving confidential treatment requests. Thus, OIG determined that the Commission could achieve greater transparency by codifying these requirements in its formal rules, which are subject to notice and comment from the public.

**Conclusion.** As a result of CF granting an applicant's confidential treatment request, portions of materials filed with the Commission are not publicly disclosed. Given the high number of confidential treatment requests that are not subject to full review, there is a risk that information that is material to investors is not being fully disclosed. The high degree of subjectivity particularly with regard to competitive harm and materiality analyses necessitates a more substantive review. Yet, most applications are being approved after an initial screening process that is not substantive in nature and verifies only that the applicant indicated that it met the requirements.

#### **Recommendation 1:**

The Division of Corporation Finance should recommend to the Commission that the substantive requirements for confidential treatment requests that are currently described in Staff Legal Bulletin No. 1, as well as any additional substantive requirements deemed appropriate, be codified as formal guidance for confidential treatment applicants.

**Management Comments.** CF does not concur with this recommendation. See Appendix V for management's full comments.

**OIG Analysis.** During the audit, the OIG found that CF's Staff Legal Bulletin No. 1 sets forth the views of CF regarding the requirements a registrant must satisfy when requesting confidential treatment of

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<sup>70</sup> Division of Corporation Finance Staff Legal Bulletin No.1 (with Addendum), February 28, 1997 (Addendum included: July 11, 2001), pages 2-4. See <http://www.sec.gov/interps/legal/slbcf1r.htm>.

<sup>71</sup> *Id.* pages 5-6.

information that otherwise is required to be disclosed in registration statements, periodic reports and other documents filed with the SEC. Although CF claims in its Management Comments that Staff Legal Bulletin No. 1 does not represent the substantive requirements that a company must meet in order to request confidential treatment, the audit found that the requirements to which an applicant must adhere when submitting a confidential treatment request are contained in CF's Staff Legal Bulletin No. 1 and that in a number of comment letters CF issued to confidential treatment applicants, CF directed the applicant to seek guidance concerning the requirements for the confidential treatment request in Staff Legal Bulletin No. 1 and not Rules 406 and 24b-2.

Thus, our position remains that CF should recommend that the Commission codify the substantive requirements currently described in Staff Legal Bulletin No. 1, as well as any additional substantive requirements deemed appropriate for confidential treatment request applicants.

#### **Recommendation 2:**

The Division of Corporation Finance should revise its internal procedures for processing confidential treatment requests to require additional documentation of the substantive review of the materiality and competitive harm application-specific requirements. Such additional documentation should detail the specific qualitative and/or quantitative factors considered in assessing the materiality and competitive harm pertinent to the subject matter of the confidential treatment request.

**Management Comments.** CF has partially concurred with this recommendation. See Appendix V for management's full comments.

**OIG Analysis.** While the OIG acknowledges and appreciates CF's concerns with the commitment of staff resources that are needed to fully implement this recommendation, our audit found that a number of requests that were granted did not contain sufficient documentation of the factors CF considered to determine why the information was not material to investors. Without sufficient documentation providing the quantitative and/or qualitative factors considered in the materiality analysis of a confidential treatment request, CF lacks critical support or evidence to demonstrate that a full and appropriate level of review was conducted. Therefore, we believe CF should reconsider its decision and fully implement this recommendation.

### **Recommendation 3:**

The Division of Corporation Finance should revise its internal procedures to require additional documentation of the Assistant Director Office's review of the Office of Disclosure Support's recommendations of "No Review" to document the factors considered in making the determination that no review is required.

**Management Comments.** CF has concurred with this recommendation. See Appendix V for management's full comments.

**OIG Analysis.** We are pleased that CF has concurred with this recommendation.

### **Recommendation 4:**

The Division of Corporation Finance (CF) should perform periodic internal audits of the confidential treatment process to provide for continuous monitoring of the confidential treatment program. As part of these periodic internal audits, the CF should verify on a periodic basis that the information for which confidential treatment was granted has not been publicly disclosed. If CF determines that information previously granted confidential treatment has been publicly disclosed, it should take steps, as appropriate, to revoke the confidential treatment grant.

**Management Comments.** CF has partially concurred with this recommendation. See Appendix V for management's full comments.

**OIG Analysis.** We are pleased that CF agrees with the essence of this recommendation. While the OIG acknowledges and appreciates CF's concerns with the commitment of staff resources, our audit found that CF currently does not perform any procedures to monitor whether confidentiality has been maintained after a grant order is issued. The OIG believes that the failure to maintain the confidentiality of the subject matter contained in the confidential treatment request negates the effect of the confidential treatment order. Therefore, OIG requests that CF reconsider its position and fully implement this recommendation.

## Finding 2: The OIG Identified Significant Use of Conclusory Statements, Boilerplate Language and Overly Broad Scopes in Confidential Treatment Requests

Numerous confidential treatment requests appeared to be overly broad and included conclusory statements and boilerplate language in the applicants' analysis of competitive harm and materiality.

**Companies' Confidential Treatment Requests Failed to Contain Specific Statements.** As noted above, SLB No. 1 contains the following content requirements for an applicant to follow when submitting a confidential treatment request:

1. The application should not be overly broad.
2. Applicants must include an analysis of the why the confidential portion meets a FOIA exemption.

In the sample of confidential treatment requests the OIG tested, we found numerous confidential treatment requests that appeared to be overly broad. Many of these requests included boilerplate language and conclusory statements in the applicant's analysis of the applicable FOIA exemption(s) and in arguments regarding the potential competitive harm that would result if the subject matter of the confidential treatment request were disclosed. In addition, we found that confidential treatment request applications did not always include documentation explaining why disclosure of the subject matter of the confidential treatment request was not necessary for the protection of investors and did not always include a robust assessment of the qualitative and quantitative factors that should be considered in assessing materiality. For example, in a confidential treatment request submitted by one company, the application included simply the following conclusory phrase supporting the argument for why disclosure of the subject matter of the confidential treatment request was not necessary for the protection of investors:

*The applicant does not believe the redacted details are material to an investor's decision to invest. Instead, disclosure would be material to the applicant's competitor and would harm the applicant's investors.*

In the above instance, CF did not select this confidential treatment request for a full review and did not perform a substantive evaluation of whether the information was necessary for the protection of investors even though the language in the application was overly broad and did not provide any substantive

basis for the request for confidential treatment. In instances when CF does not perform a significant review, conclusory statements and boilerplate language are unlikely to be identified and applicants are unlikely to revise their confidential treatment requests to provide a better analysis of how the subject matter of the confidential treatment request meets an applicable FOIA exemption or why the information is not necessary for the protection of investors.

**The ODC Screening Lends Itself to Conclusory, Boilerplate Statements in the Applications.** The “Confidential Treatment Request Screening Form” utilized by the research specialists in the ODS screening process, identifies the questions for which a “Yes” or “No” answer is to be given, as follows:



Thus, for example, with respect to the issue of “materiality,” the application passes the initial screening if the applicant [redacted]. There is no requirement that the applicant provide more than conclusory, boilerplate language that the information is not material.

The OIG determined that having a screening process by which conclusory and boilerplate language that criteria are met simply passes through an initial approval stage does not constitute a useful manner of review of confidential

<sup>72</sup> CF Confidential Treatment Request Screening Form, April 2008.

<sup>73</sup> *Id.*

<sup>74</sup> *Id.*

<sup>75</sup> *Id.*

<sup>76</sup> *Id.*

<sup>77</sup> *Id.* Per CF’s confidential treatment operating procedures, CF usually does not grant confidential treatment for a duration beyond [redacted].

<sup>78</sup> CF Confidential Treatment Request Screening Form, April 2008.

<sup>79</sup> *Id.*

treatment requests, particularly when, in most of the cases, this initial screening review is the only review conducted of an application.

#### **Recommendation 5:**

The Division of Corporation Finance should revise its internal procedures for handling the initial screening of confidential treatment requests to ensure that the materiality and competitive harm criteria are not met by simply making conclusory statements or including boilerplate language in the applications by requiring additional documentation of how the screening and review process identified specific and concrete representations to support these criteria.

**Management Comments.** CF has partially concurred with this recommendation. See Appendix V for management's full comments.

**OIG Analysis.** While the OIG acknowledges that the identification of specific representations may require the commitment of additional resources we found, and it is not disputed, that numerous applicants' requests contained boilerplate language and conclusory statements. The audit found that these requests were not always reviewed beyond the screening process, which is not intended to focus on the quality of the responsive portions of the requests. Without a more in-depth review of the quality of representations for the materiality analysis and a competitive harm argument associated with a confidential treatment request, the OIG notes that information material to investors that may be needed for them to make informed decisions, may not always be disclosed. As such, the OIG would like CF to reconsider implementing this recommendation in full.

### **Finding 3: Many Confidential Treatment Requests are Not Reviewed by Staff Experts in the Confidential Treatment Request Applicant's Industry**

The OIG identified a significant number of confidential treatment requests that were not assigned to the appropriate industry group of the applicant for processing.

**Some AD Offices Receive a Disproportionate Number of Confidential Treatment Requests.** CF's Disclosure Operations function is structured into various AD offices that specialize in reviewing the disclosures of registrants for different industry clusters. The industry experts in each AD group are knowledgeable of the accounting, disclosure and technical issues associated

with their respective assigned industry and perform the filing reviews for companies within that industry.

A significant number of confidential treatment requests are not assigned for processing to the industry group of the applicant. For example, a total of 914 of 2,970 confidential treatment requests received from January 2008 through December 2009 were from companies in the healthcare and insurance industries. Based on CF's internal structure, healthcare and insurance companies' filings and confidential treatment requests should have been assigned to AD office No. 1, which has expertise in the healthcare and insurance industries. However, the OIG found that only 27 percent (247 of 914) of the confidential treatment requests submitted by healthcare and insurance companies were actually processed and reviewed by AD office No. 1.

We found that the high concentration of confidential treatment requests from a few industry groups is likely a significant factor resulting in the assignment of confidential treatment requests to AD offices that are not experts in the industry groups of the applicants. Of the 11 AD offices in CF's Disclosure Operations,<sup>80</sup> about a third of all confidential treatment requests came from companies in the industry group assigned to AD office No. 1 (Healthcare/Insurance), and close to half (approximately 47 percent) came companies in the industry group assigned to either AD office No. 1 and AD office No. 10. We understand that large numbers of companies in the healthcare industry have biotech and pharmaceutical contracts that contain sensitive information about patents and trade secrets and, therefore, prompt a higher number of confidential treatment requests compared to other industry groups. Our audit found that, there is an increased risk that a CF official in an AD office outside of the confidential treatment applicant's industry group may not evaluate an application with the same level of expertise as an individual assigned to the applicant's industry group due to a lack of familiarity of the subject matter of the confidential treatment request. This may cause certain confidential treatment requests to be granted where confidential treatment is, in fact, not warranted.

#### **Recommendation 6:**

The Assistant Director offices with the highest percentage of confidential treatment requests (i.e., Assistant Director office No. 1 and Assistant Director office No. 10) should provide training to staff in the other Assistant Director offices in order to share knowledge about specific industry matters with those who will be performing reviews of confidential treatment requests for companies in industries outside of their assigned industry group.

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<sup>80</sup> CF recently announced the creation of a few additional offices to focus on capital market trends, structured finance products, and large financial services companies. See <http://www.sec.gov/news/press/2010/2010-124.htm>.

**Management Comments.** CF has concurred with this recommendation. See Appendix V for management's full comments.

**OIG Analysis.** We are pleased that CF has concurred with this recommendation.

## **Finding 4: CF Needs to Enhance the Application Controls in the Confidential Treatment Request Database**

The OIG identified data errors in the confidential treatment request population that CF uses to evaluate the confidential treatment request program's performance measurements. These errors resulted from the lack of certain controls over data residing in the confidential treatment request tracking database.

**Confidential Treatment Request Tracking Database.** We identified in our review of the population of confidential treatment requests some data anomalies that resulted from the lack of controls in the confidential treatment request tracking database. We found instances where certain dates were incorrectly entered by end users; however, the system did not detect such errors. For example, in several instances, the disposition date of the confidential treatment request was before the date the confidential treatment request was received by CF. In addition, some data fields, such as the date of receipt of the request by CF, were not populated at all.

Additionally, we found that management does not currently have the capability in the confidential treatment request tracking database to identify requests that were modified from their initial state. Thus, some data analysis by management may contain inaccurate information, and certain items that should be prioritized may not be given the appropriate priority (e.g., confidential treatment requests that have been pending for a lengthy period of time and need to have processing completed). The OIG learned that CF management monitors the performance of the confidential treatment request program through various reports generated from data maintained in the confidential treatment tracking system. During the audit, the OIG found that CF management pays close attention to confidential treatment requests that have been in a pending status for a lengthy period of time. If data is not accurately captured in the confidential treatment request tracking database, there is a potential that management will not track confidential treatment requests that have been in a pending state for a significant period of time. Additionally, the data that management uses to evaluate its performance such as average processing time may be skewed due to errors in the data.

**The Tracking Database Lacks the Ability to Track Modified Confidential Treatment Requests.** During the audit, the OIG also found that CF does not currently have the ability to track confidential treatment requests that are modified in scope after the initial submission to CF but before confidential treatment is granted. For CF's purposes, all requests for which any aspect of the application has been modified from its initial state are categorized as "granted," with no separate distinction for applications where the scope of the request was revised during the course of processing the application.

However, we found in our review of confidential treatment requests situations where the scope of the confidential treatment request was significantly altered during the comment and review period. In fact, we identified instances where numerous comments were provided to applicants to make substantial changes to their confidential treatment requests.

As indicated above, we learned that most confidential treatment requests were submitted in connection with portions of material contracts and agreements filed as exhibits to various filings (e.g., 8-K, 10-LK, 10-Q, and S-1.) Within our sample, we found instances when companies did not provide all the required information for the exhibits. In those instances, CF staff requested that the applicants submit amended filings that included the additional required information (e.g., schedules and addendums to contracts.)

In another example, a company included a large number of items in its initial confidential treatment request related to its 10-Q quarterly filing; however, upon the final granting of the confidential treatment request, only one redacted item remained from the company's initial request. CF staff provided numerous comments on the various items for which the company initially requested confidential treatment. In most instances when CF asked the company to provide better justifications of why those items merited confidential treatment, the company simply withdrew these requests. However, upon review of the confidential treatment request database, one would assume that the initial request had been granted without modification.

In a number of instances when confidential treatment requests were modified during the course of a review during which comments were issued to the applicant, the time period between the initial submission of the confidential treatment request and the granting of the modified request was, on average, considerably longer than the normal processing time for confidential treatment requests. As such, having the ability to track modified confidential treatment requests could permit CF to better allocate staff and perform a larger number of full reviews by focusing its staff's efforts on applicants that have historically provided CF with initial confidential treatment requests that did not require significant modifications prior to granting the request.

**Recommendation 7:**

The Division of Corporation Finance should implement controls in the confidential treatment request database to perform validity checks for fields and to ensure that all information for each record has been completely populated.

**Management Comments.** CF has concurred with this recommendation. See Appendix V for management’s full comments.

**OIG Analysis.** We are pleased that CF has concurred with this recommendation.

**Recommendation 8:**

The Division of Corporation Finance should add functionality to the confidential treatment request tracking database to identify confidential treatment requests that were modified from their initial state.

**Management Comments.** CF has concurred with this recommendation. See Appendix V for management’s full comments.

**OIG Analysis.** We are pleased that CF has concurred with this recommendation.

## Acronyms

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AD	Assistant Director
AIG	American International Group
CF	Division of Corporation Finance
FOIA	Freedom of Information Act
FRBNY	Federal Reserve Bank of New York
ML 3	Maiden Lane III
ODS	Office of Disclosure Support
OIG	Office of Inspector General
SAB	Staff Accounting Bulletin
SEC or Commission	U.S. Securities and Exchange Commission
SLB	Staff Legal Bulletin
SROs	Self Regulatory Organizations

## Scope and Methodology

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We conducted this performance audit in accordance with generally accepted government auditing standards. Those standards require that we plan and perform the audit to obtain sufficient, appropriate evidence to provide a reasonable basis for our findings and conclusions based on our audit objectives. We determined that the evidence obtained provides a reasonable basis for our findings and conclusions based on our audit objectives.

**Scope.** We obtained CF's policies and procedures for processing confidential treatment requests submitted under Rules 406 and 24b-2, as of December 2008. We conducted our fieldwork from April 2010 to August 2010. We reviewed documentation pertaining to the CF confidential treatment request program covering the calendar years 2008 and 2009 and January through March 2010. The OIG reviewed the confidential treatment request rules and authoritative guidance and assessed CF's internal policies and procedures to determine if internal policies ensure that applicants met all confidential treatment request rule requirements. Additionally, our audit tested whether applicant's confidential treatment requests were submitted in accordance with the confidential treatment request rules and if CF followed its internal policies and procedures in processing confidential treatment requests.

**Methodology.** In order to accomplish our objectives to assess the adequacy of CF's internal policies that govern the intake, processing, and decision-making associated with confidential treatment requests, we reviewed CF's policies and procedures for the intake, processing, screening, and examination of confidential treatment requests. The OIG also reviewed the confidential treatment request rules and authoritative guidance and assessed the adequacy of CF's policies and procedures to determine if they ensured applicants met all confidential treatment request rule requirements. We conducted inquiries of CF management charged with overseeing the confidential treatment request program to understand CF's policies and procedures and to obtain interpretation of the confidential treatment request rules. The OIG also physically observed the intake, screening, processing and examination of a confidential treatment request in a walkthrough with staff members from CF. Further, the OIG performed testing of a sample of confidential treatment requests for the period within our audit scope by examining the confidential treatment application, the screening and examination reports completed by CF, and other supporting documentation in confidential treatment request files. We conducted inquiries of members of CF AD groups to understand some of the key judgments involved with certain confidential treatment requests in our sample selection.

**Judgmental Sampling.** Our population of confidential treatment requests consisted of those received by CF for the period from January 2008 through

March 2010 under Rules 406 and 24b-2 of the Securities Act and Exchange Act, respectively. The population consisted of confidential treatment requests from companies in various industries, including financial services, healthcare, insurance, telecommunications and travel, and requests that pertained different types of filings, including 10-Qs, 10-Ks, 8-Ks and S-1s. Based on data received from CF's Disclosure Operations, the total number of confidential treatment requests during the period from January 2008 through March 2010 was 3,381. From the population universe, we judgmentally selected a sample of 30 confidential treatment requests covering our scope. In addition, our sample was judgmentally selected to include companies that represented a span of industry groups (e.g., banking, healthcare and manufacturing) from the various AD offices. Our sample was also chosen to ensure coverage over the various forms filed under the Securities Act and the and Exchange Act (e.g., 10-Ks, 10-Qs and S-1s).

**Internal or Management Controls.** During our audit, the OIG reviewed internal and management controls that related to our audit objectives. A walkthrough was performed to verify management controls were in operation.

**Use of Computer-Processed Data.** We relied on data from the SEC's EDGAR system and from CF's confidential treatment request tracking database. The OIG performed testing of the accuracy of the CF database by comparing information for a sample of confidential treatment requests from the database against orders granting confidential treatment from the SEC's EDGAR database.

**Prior Audit Coverage.** The OIG last conducted an audit of the CF confidential treatment process in 1994. All of the prior report's recommendations were followed up on and implemented by management. More, recently, the OIG conducted audits/reviews of the Office of the Secretary<sup>81</sup> and the SEC's FOIA Office<sup>82</sup> which included examining the activities performed in each office that pertained to confidential treatment requests. However, our audit was focused on confidential treatment requests submitted in connection with SEC regulatory filings under the Securities Act of 1933 and Securities Exchange Act of 1934 and did not extend to confidential treatment granted for information related to the SEC comment letter process.

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<sup>81</sup> OIG Audit Report No. 402, "Office of the Secretary," September 20, 2005.

<sup>82</sup> OIG Audit Report No. 465, "Review of the SEC's compliance with the Freedom of Information Act," September 25, 2009, and OIG Audit Report No. 422, "Backlog of FOIA Requests for Comment Letters," March 30, 2007.

## Criteria

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**Rule 406 under the Securities Act of 1933 (17 C.F.R. § 230.406).** Governs the submission of confidential treatment requests for filings submitted under the Securities Act of 1933.

**Rule 24b-2 under the Securities Exchange Act of 1934 (17 C.F.R. § 240.24b-2).** Governs the submission of confidential treatment requests for filings submitted under the Exchange Act of 1934.

**Division of Corporation Finance Staff Legal Bulletin No. 1 (with Addendum), “Confidential Treatment Requests”, February 28, 1997 (Addendum included July 11, 2001).** This staff legal bulletin sets forth the Division of Corporation Finance’s requirements that a registrant must satisfy when requesting confidential treatment of information that otherwise is required to be disclosed in registration statements, periodic reports and other documents filed with the Commission.

**Division of Corporation Finance Operating Procedures Manual – Confidential Treatment Requests policies and procedures (December 2008).** CF’s formal policies and procedures for processing confidential treatment requests submitted under Rules 406 and 24b-2.

**Regulation S-K, Item 601 “Exhibits, 17 C.F.R. § 229.601”** Authoritative guidance for disclosures associated with exhibits to forms filed with the SEC. Item 601(b)(10) contains the provision that requires material contracts to be filed with the SEC. The majority of confidential treatment requests submitted under Rules 406 and 24b-2 are related to filing of exhibits (such as material contracts).

**SEC Staff Accounting Bulletin No. 99 – Materiality, August 12, 1999.** This staff accounting bulletin expresses the views of the staff that exclusive reliance on certain quantitative benchmarks to assess materiality in preparing financial statements and performing audits of those financial statements is not appropriate.

## List of Recommendations

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### **Recommendation 1:**

The Division of Corporation Finance should recommend to the Commission that the substantive requirements for confidential treatment requests that are currently described in Staff Legal Bulletin No. 1, as well as any additional substantive requirements deemed appropriate, be codified as formal guidance for confidential treatment request applicants.

### **Recommendation 2:**

The Division of Corporation Finance should revise its internal procedures for processing confidential treatment requests to require additional documentation of the substantive review of the materiality and competitive harm application-specific requirements. Such additional documentation should detail the specific qualitative and/or quantitative factors considered in assessing the materiality and competitive harm pertinent to the subject matter of the confidential treatment request.

### **Recommendation 3:**

The Division of Corporation Finance should revise its internal procedures to require additional documentation of the Assistant Director Office's review of the Office of Disclosure Support's recommendations of "No Review" to document factors considered in making the determination that no review is required.

### **Recommendation 4:**

The Division of Corporation Finance (CF) should perform periodic internal audits of the confidential treatment process to provide for continuous monitoring of the confidential treatment program. As part of these periodic internal audits, the CF should verify on a periodic basis that the information for which confidential treatment was granted has not been publicly disclosed. If CF determines that information previously granted confidential treatment has been publicly disclosed, it should take steps, as appropriate, to revoke the confidential treatment grant.

**Recommendation 5:**

The Division of Corporation Finance should revise its internal procedures for handling the initial screening of confidential treatment requests to ensure that the materiality and competitive harm criteria are not met by simply making conclusory statements or including boilerplate language in the applications by requiring additional documentation of how the screening and review process identified specific and concrete representations to support each criteria.

**Recommendation 6:**

The Assistant Director offices with the highest percentage of confidential treatment requests (i.e., Assistant Director office No. 1 and Assistant Director office No. 10) should provide training to staff in the other Assistant Director offices in order to share knowledge about specific industry matters with those who will be performing reviews of confidential treatment requests for companies in industries outside of their assigned industry group.

**Recommendation 7:**

The Division of Corporation Finance should implement controls into the confidential treatment request database to perform validity checks for fields and to ensure that all information for each record has been completely populated.

**Recommendation 8:**

The Division of Corporation Finance should add functionality to the confidential treatment request tracking database to identify confidential treatment requests that were modified from their initial state.

# Management Comments

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## MEMORANDUM

September 24, 2010

To: H. David Kotz, Inspector General  
Office of Inspector General

From: Meredith B. Cross, Director   
Division of Corporation Finance

Re: Division's Response to the Office of Inspector General's Report, *Assessment of Corporation Finance's Confidential Treatment Processes and Procedures*, Report No. 479

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Thank you for the opportunity to review and respond to the Office of Inspector General's Draft Report No. 479 entitled *Assessment of Corporation Finance's Confidential Treatment Processes and Procedures*. The review your office conducted is helpful to us in improving the Division of Corporation Finance's program to better fulfill the Commission's investor protection mission. In addition, I want to thank you for the courtesy your staff extended to us during the course of your audit and for the opportunity you have given us to present the Division's views on your findings. As described below, the Division will implement procedural changes in response to your recommendations.

### General Observations

While we respond to your individual recommendations on how we can improve our processes and procedures below, we would first like to provide some general observations about your assessment of our confidential treatment program, which I believe are important to place your report and our response in context.

The report suggests that the Division's processes and procedures under which only a portion of confidential treatment requests receive some substantive staff review increases the risk that a company requesting confidential treatment will not disclose material information to investors. However, we note that, without regard to whether we review a confidential treatment request, a company is subject to the provisions in the federal securities laws and well-established case law precedent that specify what information a company must disclose in its filings. I disagree with the *Assessment's* conclusion that we must, in determining whether to grant confidential treatment for a material contract, judge whether the terms of that contract are immaterial to an investor. Rather, the Division must evaluate whether it can object to the company's assertion that the information is not necessary for the protection of investors in the context of the company's overall disclosures, including whether that information is necessary to make the information the company has already disclosed, in light of the circumstances under which it was disclosed, not misleading. Thus, for example, while the detailed, commercially-sensitive terms of an agreement may appear important in

isolation, disclosure may not be necessary in light of the information a company otherwise provides.

Given our resources and our program responsibilities, we are not able to undertake a detailed review of every confidential treatment request. Therefore, I believe a process through which we evaluate whether a request, on its face, conflicts with Commission rules and warrants further review is consistent with the full disclosure mandate. While the *Assessment* describes, in great detail, the role of the Research Specialists in the Division's Office of Disclosure Support, it does not equally describe the role of the Division's legal staff in this evaluative process. I believe this is because, in this process, we currently place greater documentation requirements on our Research Specialists than we do on our legal staff. I want to make clear that the review recommendations of the Office of Disclosure Support are only one element our legal staff considers in making review determinations and processing confidential treatment requests. You recommend that we improve the documentation associated with this legal review role in the screening process evaluation of materiality and competitive harm, and, as noted below, we concur with your recommendations and will do so.

In stating that you found only one instance where we denied a confidential treatment request, I believe that the *Assessment* provides an erroneous impression that we granted all other requests as submitted. While it is true that we rarely deny a confidential treatment request, it is important to understand that we conduct a robust evaluation and comment process on a substantial number of requests, and that this review frequently results in a narrowing of the information subject to the request or, in some cases, in the withdrawal of the request. Absent the opportunity to engage in this evaluation and comment process, we would certainly expect to deny more requests. We note that you recommend in Recommendation 8 that we improve our tracking of this "narrowing" activity, and, as noted below, we concur with this recommendation and will do so.

Finally, I am concerned about the conclusion a reader of your report might reach regarding our processing of a confidential treatment request relating to an exhibit filed by American International Group, Inc. with a Form 8-K in December 2008. In your most recent draft of the report, you state that you elected to commence your audit of the Division's confidential treatment processes and procedures "[c]onsidering the Congressional efforts to provide the public with greater transparency surrounding the Federal assistance to AIG along with statements rendered by the FRBNY pertaining to the SEC's confidential treatment process." As you note in your report, you did not provide any conclusions regarding our processing of the AIG confidential treatment request. While I appreciate your explanation that you did not reach any conclusion with regard to the AIG request, I remain concerned that a reader of your report might conclude that the concerns you express about our confidential treatment program in general were present in our review of the AIG request. Therefore, I want to emphasize my understanding that your report does not reflect any concern about our review and processing of this particular confidential treatment request.

**Division Responses to your Recommendations****Recommendation 1:**

The Division of Corporation Finance should recommend to the Commission that the substantive requirements for confidential treatment requests that are currently described in Staff Legal Bulletin No. 1 as well as any additional substantive requirements deemed appropriate, be codified as formal guidance for confidential treatment request applicants.

**Division Response to Recommendation 1:**

The Division does not concur with your recommendation that we should recommend to the Commission that it should codify the substantive requirements for confidential treatment requests described in Staff Legal Bulletin No. 1. We note that Staff Legal Bulletin No. 1 does not represent the substantive requirements that a company must meet in order to request confidential treatment under Rules 406 and 24b-2. Instead, the Staff Legal Bulletin is a method by which the staff can provide public guidance (contrary to the report, it is not an “internal” document) to assist the public in understanding how the staff interprets the Freedom of Information Act and Commission rules that apply to a request for confidential treatment. We believe that providing this type of guidance through Staff Legal Bulletins posted on the Commission’s website is helpful to the public and promotes better compliance with the federal securities laws, without burdening the Commission with additional rulemaking initiatives.

**Recommendation 2:**

The Division of Corporation Finance should revise its internal procedures for processing confidential treatment requests to require additional documentation of the substantive review of the materiality and competitive harm application-specific requirements. Such additional documentation should detail the specific qualitative and/or quantitative factors considered in assessing the materiality and competitive harm of the confidential treatment subject matter.

**Division Response to Recommendation 2:**

As we noted above, we evaluate whether a request, on its face, conflicts with Commission rules and warrants further review and we agree that we can enhance our documentation of that consideration. We therefore concur with your recommendation that we revise our internal procedures to require additional documentation of the review our legal staff undertakes of the materiality and competitive harm application-specific requirements in the screening process.

We do not concur with your recommendation that this documentation should detail the specific qualitative and/or quantitative factors considered in assessing the materiality and

competitive harm of the confidential treatment subject matter. We believe that to do so would require a full evaluation of materiality and competitive harm as it relates to each company's specific facts and circumstances which would, in turn, require a full evaluation of that information in the context of the company's overall disclosure. Given limited staff resources and our program responsibilities, we are not able to undertake this level of review on each confidential treatment request. We believe that our revised screening process documentation, as we describe in our response to Recommendation 3, should identify those requests that warrant a more robust review and appropriately balance our resources and responsibilities.

**Recommendation 3:**

The Division of Corporation Finance should revise its internal procedures to require additional documentation of the Assistant Director Office's review of the Office of Disclosure Support's recommendations of "No Review" to document factors considered in making the determination that no review is required.

**Division Response to Recommendation 3:**

We concur and plan to implement this recommendation by revising our screening process documentation to make clear that all review decisions are made by the Assistant Director Office, to document whether the company materiality and competitive harm discussions appear to warrant further evaluation by the Assistant Director Office legal staff, and to require an affirmation of the Office of Disclosure Support's review recommendation by the Assistant Director Office.

**Recommendation 4:**

The Division of Corporation Finance should perform periodic internal audits of the confidential treatment process for continuous monitoring. As part of these periodic internal audits, the Division of Corporation Finance should verify on a periodic basis that the information that has been granted confidential treatment has not been publicly disclosed. If the Division of Corporation Finance determines that information previously granted confidential treatment has been publicly disclosed, it should take steps, as appropriate, to revoke the confidential treatment grant.

**Division Response to Recommendation 4:**

With regard to the recommendation that we periodically audit the confidential treatment process, we concur and will develop a procedure through which the Division will periodically audit the confidential treatment process to confirm that we are following our documented procedures.

With regard to the recommendation that the Division should implement a program to periodically evaluate whether information subject to a grant of confidential treatment has remained confidential, we do not concur. The Division believes that such a program represents a significant commitment of resources without a corresponding benefit to investors. The amount of work necessary to implement a meaningful program to monitor whether information has been publicly disclosed would be very significant. Presumably, this would entail comprehensive searches of publicly available information (not limited to the EDGAR database) to attempt to locate specific information relevant to a specific grant of confidential treatment (e.g., the pricing terms in a purchase agreement). For such a program to be meaningful, presumably some significant number of these searches would need to be undertaken each year. In light of the large number of documents subject to confidential treatment orders at any given time, this would be extremely time intensive, and we do not believe it would be a cost-effective use of staff resources. As noted in the "General Observations" section above, receiving a grant of confidential treatment does not excuse a company from complying with its disclosure obligations under the federal securities laws. Thus, on balance, we do not believe that the incremental benefit that might arise from such an undertaking supports the use of staff resources for that effort.

**Recommendation 5:**

The Division of Corporation Finance should revise its internal procedures for handling the initial screening of confidential treatment requests to ensure that the materiality and competitive harm criteria are not met by simply making conclusory statements or including boilerplate language in the requests by requiring additional documentation of how the screening and review process identified specific and concrete representations to support each criteria.

**Division Response to Recommendation 5:**

We concur with your recommendation in that where a confidential treatment request presents conclusory or boilerplate materiality and competitive harm statements, the request warrants consideration for further review. Therefore, we will revise our processes and procedures to identify these requests for further consideration by the Assistant Director Office.

We do not concur with your recommendation that we should further document how our processes and procedures identified specific and concrete representations to support each criterion and do not require further evaluation in the review and comment process. To do so would require a full evaluation of the materiality and competitive harm as it relates to each company's specific facts and circumstances. Given limited staff resources and our program responsibilities, we are not able to undertake this level of review on each confidential treatment request. We believe that the revisions we will make to our screening process in response to Recommendation 3 should be helpful in addressing your concerns.

**Recommendation 6:**

The Assistant Director offices with the highest percentage of confidential treatment requests (i.e., Assistant Director office No. 1 and Assistant Director office No. 10) should provide training to the other Assistant Directors' offices' staff in order to share knowledge about specific industry matters with those that will be performing reviews of confidential treatment requests for companies in industries outside of their assigned industry.

**Division Response to Recommendation 6:**

We concur and will implement this recommendation.

**Recommendation 7:**

The Division of Corporation Finance should implement controls into the confidential treatment request database to perform validity checks for fields and to ensure that all information for each record has been completely populated.

**Division Response to Recommendation 7:**

We concur and will implement this recommendation.

**Recommendation 8:**

The Division of Corporation Finance should add functionality to the confidential treatment request tracking database to be able to identify confidential treatment requests that were modified from their initial state.

**Division Response to Recommendation 8:**

We concur and will implement this recommendation.

## OIG Response to Management's Comments

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CF concurred with four of our eight recommendations, partially concurred with three recommendations, and did not concur with one recommendation. We feel these recommendations if fully implemented will strengthen CF's ability to improve its internal policies and procedures for the confidential treatment request program and further improve CF's review of companies' confidential treatment requests. Therefore, we implore CF to reconsider fully implementing Recommendation Nos. 2, 4, and 5 because doing so will enhance the transparency around the decision making to grant confidential treatment requests. Further, the OIG believes CF should reconsider fully implementing Recommendation No. 1 due to the fact that Staff Legal Bulletin No.1 expresses the requirements that CF expects companies to adhere to when submitting confidential treatment request and is intricately woven into its internal policies and procedures. Codification of these requirements would benefit companies as well as CF.

Once all of the recommendations are fully implemented, we believe that the improvements will greatly assist CF to better monitor its performance of the confidential treatment program.

# Audit Requests and Ideas

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The Office of Inspector General welcomes your input. If you would like to request an audit in the future or have an audit idea, please contact us at:

U.S. Securities and Exchange Commission  
Office of Inspector General  
Attn: Assistant Inspector General, Audits (Audit Request/Idea)  
100 F Street, N.E.  
Washington D.C. 20549-2736

Tel. #: 202-551-6061  
Fax #: 202-772-9265  
Email: [oig@sec.gov](mailto:oig@sec.gov)

## Hotline

To report fraud, waste, abuse, and mismanagement at SEC,  
contact the Office of Inspector General at:

Phone: 877.442.0854

Web-Based Hotline Complaint Form:  
[www.reportlineweb.com/sec\\_oig](http://www.reportlineweb.com/sec_oig)