

ALJ

ADMINISTRATIVE PROCEEDING
FILE NO. 3-11317

UNITED STATES OF AMERICA
Before the
SECURITIES AND EXCHANGE COMMISSION
April 7, 2004

SECURITIES & EXCHANGE COMMISSION
MAILED FOR SERVICE
APR 07 2004
FIRST CLASS

In the Matter of :
: ORDER
PUTNAM INVESTMENT :
MANAGEMENT, LLC :
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The Office of Compliance Inspections and Examinations (OCIE) of the Securities and Exchange Commission (SEC or Commission) moves to quash, in part, a Subpoena Duces Tecum served upon it by Putnam Investment Management, LLC (Putnam). OCIE acknowledges that there are responsive documents, but asserts that they should be protected from disclosure under Section 31(c) of the Investment Company Act of 1940 (Investment Company Act) and a novel "SEC Examination Privilege." Putnam opposes OCIE's Motion to Quash.

I previously found that: (1) OCIE had not shown that it had conducted a search of the proper scope; (2) because exemptions under the Freedom of Information Act (FOIA), 5 U.S.C. § 552, are not the equivalent of discovery privileges, OCIE's invocation of FOIA Exemption 8 provided minimal support for its claim of privilege; (3) OCIE had failed to make the showing necessary to invoke Section 31(c) of the Investment Company Act; and (4) because OCIE failed to submit the affidavit of a responsible management official who had personally reviewed the documents in question, it had not properly asserted its claim of privilege. I withheld a final ruling on the Motion to Quash, and gave OCIE an opportunity to cure the deficiencies in its presentation. Putnam Inv. Mgmt., LLC, Admin. Proceedings Rulings Release No. 613, ___ SEC Docket ___ (Mar. 26, 2004) (March 26 Order).

I have now received: (1) the sworn Declaration of John H. Walsh, Associate Director and Chief Counsel of OCIE, and a Privilege Log, dated March 31, 2004 (Walsh Declaration and Privilege Log, respectively); (2) Putnam's Response to the Walsh Declaration and Privilege Log, dated April 1, 2004; and (3) OCIE's Statement Regarding Redaction and in camera Inspection, dated April 2, 2004. OCIE produced the disputed documents for in camera review on April 5, 2004.

At issue are fourteen documents, consisting of seventy-three pages of material. The documents are deficiency letters, written by members of the Commission's staff to registered

brokers, investment advisers, and investment companies after the Commission's staff had completed field examinations. Although the documents were written fairly recently (between February 2003 and March 2004), some of them discuss the registrants' activities dating back as far as 2000. The format of the letters is identical: each letter brings deficiencies and/or violations to the attention of the registered entity for immediate corrective action, and requires a written reply within thirty days, detailing the steps taken to eliminate the deficiencies. Some of the identified deficiencies (approximately 15% of the total) are the "market timing" and "excessive short-term trading" issues at the heart of the present proceeding. Most of the identified deficiencies (approximately 85% of the total) involve other regulatory provisions that are not germane to the present dispute.

The Standards Governing Motions to Quash

Rule 232(e)(2) of the Commission's Rules of Practice provides that a hearing officer shall quash or modify a subpoena if compliance with the subpoena would be unreasonable, oppressive, or unduly burdensome. Presumably, OCIE's Motion to Quash is based on the theory that it would be "unreasonable" to require production of documents that are privileged. Because the present dispute involves only fourteen documents, and a total of seventy-three pages, there can be no serious claim that Putnam's request is oppressive or unduly burdensome.

The Federal Rules of Civil Procedure do not govern administrative proceedings before the Commission, but they often provide helpful guidance in resolving issues not directly addressed by the Commission's Rules of Practice. See Clarke T. Blizzard, 77 SEC Docket 1505, 1510-11 nn.17, 19 (Apr. 23, 2002). Under Fed. R. Civ. P. 26(b)(1), parties may obtain discovery regarding any matter, not privileged, that is relevant to the claim or defense of any party. "Relevance" does not hinge on admissibility at trial. Under Fed. R. Civ. P. 26(b)(1), a court need only determine if the information sought "appears reasonably calculated to lead to the discovery of admissible evidence."

It is well settled that the party asserting a privilege bears the burden of establishing all of its essential elements. See, e.g., United States v. BDO Seidman, 337 F.3d 802, 811 (7th Cir. 2003); In re Grand Jury Investigation, 723 F.2d 447, 450-51 (6th Cir. 1983) (collecting cases). If OCIE meets its burden of demonstrating that an absolute privilege exists, then the motion to quash must be granted. If OCIE is able to demonstrate that a qualified privilege exists, then the hearing officer must balance the competing interests of the party seeking the documents against those of the government. If no privilege exists, and if Putnam shows that the documents are relevant, then OCIE must produce the documents.

It Is Too Late for OCIE to Argue That the Documents on its Privilege Log "May Be" Beyond the Scope of Putnam's Subpoena

On page 3 of its Motion to Quash, OCIE stated unambiguously: "[T]he staff has responsive documents." However, after I required OCIE to identify and describe each of the withheld documents for which it is claiming privilege, OCIE started to backtrack. The Walsh Declaration states: "Items 2 and 3 in [the Putnam] subpoena could be read to seek, among other

documents, communications between the examination staff and entities registered with the Commission” (§ 2) (emphasis added).

If this language is designed to lay the foundation for an eventual claim that the fourteen items identified in the Privilege Log might not even be “responsive documents” for purposes of Putnam’s subpoena, I find that OCIE has waived its opportunity to make that argument.¹ Cf. Ray v. U.S. Dept. of Justice, 908 F.2d 1549, 1557 (11th Cir. 1990), rev’d on other grounds, 502 U.S. 164 (1991); Ryan v. Dept. of Justice, 617 F.2d 781, 792 (D.C. Cir. 1980); Jordan v. U.S. Dept. of Justice, 591 F.2d 753, 779-80 (D.C. Cir. 1978) (en banc). It is in the interest of judicial economy that all arguments for quashing a subpoena be presented at one time. In this case, there is an additional consideration. The hearing is scheduled to begin on April 19, 2004. Any delay caused by the piecemeal invocation of reasons to quash could easily render Putnam’s request for the documents futile.

Section 31(c) of the Investment Company Act

OCIE argues that Section 31(c) of the Investment Company Act should be interpreted expansively, so as to bar the release of responsive documents to Putnam (March 26 Order at 4-6). OCIE acknowledges that there are no documents “provided to the Commission” by a “subject person” that are responsive to Putnam’s subpoena. OCIE nonetheless claims Section 31(c) protection for two documents written by the Commission’s staff to registered investment companies (Privilege Log Items ## 10, 13).

The Walsh Declaration provides little assistance in analyzing the Section 31(c) claim. Paragraph 8 states only: “Certain of the letters, as identified on the log, contain information from internal compliance or audit records, protected by Section 31(c) of the Investment Company Act.” The argument could be dismissed on that ground alone.

Notwithstanding the lack of a proper declaration on the Section 31(c) issue, I have reviewed the two documents in camera. I conclude that Section 31(c) does not protect either one. Item #10 involves a registrant’s failure to have a written policy or a review process for monitoring potential market timing issues in certain accounts. Item #13 describes a similar situation. The registrant had no policies or procedures for detecting market timing in its employees’ retirement accounts. The examination staff insisted that the registrant make the appropriate inquiry during the examination.

¹ The Commission has stated that deficiency reports from OCIE’s inspections and examinations do not constitute “informal guidance” for small entities, at least for purposes of the Small Business Regulatory Enforcement Fairness Act of 1996, Pub. L. No. 104-121, 110 Stat. 857 (1996). See Policy Statement: Informal Guidance Program for Small Entities, 64 SEC Docket 443, 445-46 (Mar. 27, 1997). However, OCIE has not relied on that theory here, and the time for doing so has passed.

The Claimed “SEC Examination Privilege” Does Not Exist

OCIE also argues that an “SEC Examination Privilege” should protect all fourteen documents from disclosure to Putnam. OCIE concedes that the existence of the claimed privilege “is a matter of first impression before the Commission” (Motion to Quash at 3 n.3). Putnam agrees: “A more direct way of describing the situation would be to say that there is no precedent supporting the existence of the privilege asserted here” (Putnam Opposition, dated Mar. 22, 2004, at 4).

Federal Rule of Evidence 501 authorizes the federal courts to recognize new common law evidentiary privileges. However, the courts have exercised that authority sparingly. See Jaffee v. Redmond, 518 U.S. 1, 7-18 (1996).

Evidentiary privileges “are not lightly created nor expansively construed.” United States v. Nixon, 418 U.S. 683, 710 (1974). Thus, with very limited exceptions, the federal courts have generally declined to grant requests for new privileges. See, e.g., Univ. of Pa. v. EEOC, 493 U.S. 182, 189 (1990) (declining to adopt academic peer-review privilege); Virmani v. Novant Health, Inc., 259 F.3d 284 (4th Cir. 2001) (refusing to recognize a medical peer-review privilege); Pearson v. Miller, 211 F.3d 57, 65-72 (3d Cir. 2000) (rejecting a claim that state confidentiality statutes ought to be recognized under the federal law of evidentiary privilege); In re Sealed Case, 148 F.3d 1073, 1078-79 (D.C. Cir. 1998) (declining to adopt “protective function” privilege requested by the Secret Service); Carman v. McDonnell Douglas Corp., 114 F.3d 790, 794 (8th Cir. 1997) (rejecting a corporate ombudsman privilege and stating that “[t]he creation of a wholly new evidentiary privilege is a big step”); In re Grand Jury, 103 F.3d 1140 (3d Cir. 1997) (refusing to recognize a parent-child privilege); Linde Thomson Langworthy Kohn & Van Dyke, P.C., v. Resolution Trust Corp., 5 F.3d 1508, 1514 (D.C. Cir. 1993) (“Federal courts have never recognized an insured-insurer privilege as such.”); EEOC v. Ill. Dept. of Employment Sec., 995 F.2d 106 (7th Cir. 1993) (rejecting privilege under Fed. R. Evid. 501 for transcripts of unemployment hearings); United States v. Holmes, 594 F.2d 1167 (8th Cir. 1979) (declining to recognize a probation officer privilege).

OCIE relies upon the bank examination privilege by analogy. The case law demonstrates that the bank examination privilege is a limited and qualified privilege, and that purely factual matters are beyond its protection (March 26 Order at 6-7). I previously found that an “SEC Examination Privilege,” if indeed one ought to be created, could not possibly be an absolute privilege. At most, it would be a limited and qualified privilege, and factual matters would be beyond its scope (id. at 7).

I do not question the sincerity of OCIE’s belief that the new privilege would serve a worthy public purpose. However, the boundaries of the proposed privilege are poorly defined. OCIE does not even pay lip service to the Supreme Court’s admonition that privileges are not to be lightly created or expansively construed. Accordingly, I decline to recognize even a qualified “SEC Examination Privilege” here. If OCIE wants to assert such a privilege, it must persuade the Commission to announce that the privilege exists and define its limits.

If There Is To Be an “SEC Examination
Privilege,” a Motion to Quash Is Not
the Appropriate Forum To Create It

It has been more than eleven years since the United States Court of Appeals for the District of Columbia Circuit discussed the scope and limitations of the bank examination privilege. See Schreiber v. Soc’y for Savings Bancorp, Inc., 11 F.3d 217, 220 (D.C. Cir. 1993); In re Subpoena Served Upon the Comptroller of the Currency and the Secretary of the Bd. of Governors of the Federal Reserve Sys., 967 F.2d 630, 633-34 (D.C. Cir. 1992) (In re Subpoena). Subsequently, the federal banking agencies have asked Congress to codify and strengthen the bank examination privilege. See, e.g., 145 Cong. Rec. E43 (Jan. 7, 1999) (remarks of Congressman McCollum, discussing the Bank Examination Report Protection Act (BERPA) of 1999).

If the Commission believed that the bank examination privilege ought to be extended to OCIE, it might have supported BERPA or drafted parallel legislation that applied the protections of Schreiber and In re Subpoena to OCIE’s examinations. Cf. Univ. of Pa., 493 U.S. at 189 (“We are especially reluctant to recognize a privilege in an area where it appears that Congress has considered the relevant competing concerns but has not provided the privilege itself.”).

A motion to quash a subpoena is not the ideal forum for crafting a new privilege. Only two months ago, a district court created a new federal privilege for abortion records. See Nat’l Abortion Fed. v. Ashcroft, 2004 U.S. Dist. LEXIS 1701, at *17-20 (N.D. Ill. Feb. 6, 2004). The Court of Appeals reversed, stating: “It is not for us—especially in so summary a proceeding as this litigation to quash the government’s subpoena—to create [such a privilege].” Northwestern Mem’l Hosp. v. Ashcroft, 2004 U.S. App. LEXIS 5724, at *7-9 (7th Cir. Mar. 26, 2004). At least at the Administrative Law Judge level, the same sort of restraint should apply to the creation of an “SEC Examination Privilege” here.

The Responsive Documents,
As Redacted, Are Relevant

When it comes to admitting evidence at an SEC administrative hearing, the standard of “relevance” is very broad. City of Anaheim, 71 SEC Docket 191, 193 & nn.5-7 (Nov. 16, 1999) (“The notion of ‘relevance’ in [Rule 320 of the Commission’s Rules of Practice] is much broader than that concept under the Federal Rules of Evidence. . . . Our law judges should be inclusive in making evidentiary determinations. . . . ‘If in doubt, let it in.’”); Alessandrini & Co., 45 S.E.C. 399, 408 (1973); Charles P. Lawrence, 43 S.E.C. 607, 612-13 (1967) (“[A]ll evidence which ‘can conceivably throw any light upon the controversy’ should normally be admitted.”). As discussed above, the standard of relevance is even broader when it comes to document subpoenas. See Fed. R. Civ. P. 26(b)(1).

Putnam argues that the fourteen documents are essential to its ability to present its case on sanctions. What the Commission’s staff has been telling industry participants about “market timing” and “excessive short-term trading” is directly relevant for several reasons, including the fact that Section 203(i) of the Investment Advisers Act of 1940 requires consideration of whether

there was “reckless disregard of a regulatory requirement.” According to Putnam, the documents on the Privilege Log may shed light on what “regulatory requirement” the Commission’s staff understood to have existed (if any). Similarly, Putnam intends to demonstrate that the Commission’s failure to supervise finding in the Partial Settlement Order of November 13, 2003, must be viewed in the context of the regulatory guidance.

OCIE contends that the documents are irrelevant because they do not concern Putnam or the industry in general; because many of them involve brokers, who have distinct obligations from investment companies and investment advisers; because one of them, written to an investment company, involves prospectus disclosure, which is not an issue here; because they were not prepared until after the period of Putnam’s misconduct; and because they are communications from the Commission’s staff, as opposed to the Commission itself.

After reviewing the documents in camera, I agree with Putnam. OCIE has not even attempted to reconcile its narrow understanding of “relevance” with the Commission’s rulings in City of Anaheim, Alessandrini, Lawrence, and similar cases, or with Fed. R. Civ. P. 26(b)(1). The parties have made it clear that the definition of “market timing” and “excessive short term trading” will be an issue in this proceeding; certain of the responsive documents provide definitions of these terms. Wholly apart from the dates the Commission’s staff prepared the documents in question, the documents address matters that occurred during the time period at issue as to Putnam (2000-2003). The fact that the documents originated with the staff, as opposed to the Commission itself, is not a reason for deeming them irrelevant. See WHX Corp., 80 SEC Docket 1318, 1338 (June 4, 2003), appeal pending, D.C. Cir. No. 03-1196 (considering a respondent’s state of mind for sanctioning purposes and concluding that the respondent “acted at its peril” when it ignored the staff’s warnings). Finally, the Division of Enforcement has made clear its intent to seek an enhanced civil penalty because Putnam’s violations are, in the Division’s view, egregious (Division’s Prehearing Brief, dated Mar. 15, 2004, at 32-33). While “egregiousness” is not specifically mentioned in Section 203(i) of the Investment Advisers Act of 1940, it could be considered under the “catch all” provision of Section 203(i)(3)(F) (“such other matters as justice may require”). Documents that may place Putnam’s violations in the appropriate context are “relevant.”

Putnam is not concerned with the identity of the registrants that received the deficiency letters. Accordingly, I have redacted the documents to eliminate those identifying details. I have also redacted all references to regulatory issues other than market timing and excessive short-term trading. These redactions satisfy OCIE’s legitimate concerns. Finally, I will impose a protective order, permitting Putnam to use these materials in the present proceeding, but barring Putnam from making any other use of the materials.

Order

I will return to OCIE the documents that it submitted for in camera review on April 5, 2004. I will also provide OCIE with redacted copies of the same documents. OCIE must produce the redacted documents to Putnam. Putnam must limit its use of the documents to this proceeding.


In its Statement Regarding Redaction and in camera Inspection, OCIE asked me to certify my ruling for interlocutory review and stay the effective date of my ruling, pending the completion of interlocutory review. See Rules 400(c)(1) and 400(d) of the Commission's Rules of Practice. That request is defective for several reasons. First, it is premature, to say the very least, for OCIE to seek certification and a stay before it has even read this Order or reviewed the redacted documents. Second, it is inappropriate for OCIE to ask for affirmative relief in a reply pleading. OCIE's Statement Regarding Redaction and in camera Inspection replied to Putnam's Response of April 1, 2004. The pleading should have been confined to that. Third, OCIE has not even attempted to meet the criteria for a stay.² Finally, OCIE has not specified the materials that it believes would be relevant in the event of certification.

I will set the time for compliance with this Order at April 13, 2004. If OCIE still wishes to seek certification and a stay, that deadline should afford enough time for the parties to file the necessary pleadings with me. Under Rule 400(d) of the Rules of Practice, "the Commission will not consider the motion for a stay unless the motion shall have first been made to the hearing officer." I will rule promptly on any motion that is filed in a proper form.

IT IS ORDERED THAT the Motion to Quash is denied for the reasons stated in this Order and in the Order of March 26, 2004; and

IT IS FURTHER ORDERED THAT the Office of Compliance Inspections and Examinations shall produce redacted copies of the fourteen documents on its Privilege Log to Putnam Investment Management, LLC, on or before April 13, 2004; and

IT IS FURTHER ORDERED THAT Putnam shall use the documents only in the present proceeding.



James T. Kelly
Administrative Law Judge

² Cf. Wisc. Gas Co. v. FERC, 758 F.2d 669, 673-74 (D.C. Cir. 1985); Wash. Metro. Area Transit Comm. v. Holiday Tours, Inc., 559 F.2d 841, 843-45 (D.C. Cir. 1977). OCIE has not addressed the likelihood of success on the merits. Nor has it attempted to reconcile its narrow understanding of "relevance" with the Commission's case law. Finally, OCIE has yet to explain why, if the need for an "SEC Examination Privilege" is so urgent, it has not encouraged the Commission to seek a legislative remedy from the Congress at any time in the past decade.