



U.S. SMALL BUSINESS ADMINISTRATION
WASHINGTON, D.C. 20416

OFFICE OF THE ADMINISTRATOR

November 6, 2007

The Honorable John Kerry
Chairman
Committee on Small Business and Entrepreneurship
United States Senate
Washington, D.C. 20510

Dear Mr. Chairman:

Thank you for your letter of October 23, 2007. I appreciate the opportunity to clarify the issues related to the U.S. Small Business Administration's (SBA) redactions to the Inspector General's (IG) Report Number: 7-28 on SBA's Oversight of Business Loan Center, LLC (BLX). As requested, enclosed are the following items referenced in your letter:

- (1) SBA Standard Operating Procedure 40 03 3 "Disclosure of Information";
- (2) U.S. Department of Justice, Office of Information and Privacy, "2007 Freedom of Information Act Guide and Privacy Act Overview" (DOJ FOIA Guide); and
- (3) A chart outlining the legal bases for every redaction to the IG's Report Number: 7-28 (Enclosure).

I hope these items are helpful, and I am happy to provide any additional information you may require. I would also like to take the opportunity to explain to you and to the Committee the specific reasons for the redactions undertaken by SBA with respect to Report Number: 7-28.

Disclosing the redacted information, which is exempt from public release pursuant to the deliberative process privilege, the bank examination privilege, and the Freedom of Information Act (FOIA), could harm SBA's ongoing oversight of BLX, as well as other Small Business Lending Companies (SBLCs). Based on the delicate balance SBA must strike between full public disclosure and protecting the integrity of the Agency's required oversight duties, SBA determined the public was best served by redacting certain portions of the IG report. These redactions cover information which both Congress and the courts have clearly determined should not generally be released because such release would damage equally important, but different, public objectives and values.

Specifically, SBA redacted portions of Report Number: 7-28 to accomplish the following three important objectives. First, SBA invoked the deliberative process privilege to redact information that: (1) threatened open, frank discussions on matters of policy; (2) risked the premature disclosure of proposed SBA policies or determinations; and (3) engendered potential public confusion. Second, in its capacity as SBLC regulator¹, SBA relied on the bank examination privilege and FOIA Exemption 8 to ensure the financial security of SBLCs and to protect SBA's regulatory effectiveness. Third, SBA utilized FOIA exemption 4 to protect trade secrets and privileged and confidential commercial and financial information.

SBA's redactions are consistent with the standard practices of other Federal agencies. For example, SBA consulted with the Federal Deposit Insurance Corporation to ensure the redactions were consistent with policies of other agencies that regulate financial institutions.² SBA also reviewed the regulations of other financial regulatory agencies and determined they typically do not release the type of information SBA redacted. This review included the regulations of the Farm Credit Administration (FCA), the agency SBA uses to examine the safety and soundness of SBLCs. With limited exceptions not at issue here, FCA regulations prohibit the public dissemination of FCA reports and examinations.³ Several of SBA's bank examination privilege and FOIA Exemption 8 redactions related to FCA reports and examinations. We also analyzed redacted IG reports from other agencies, such as the Office of the Comptroller of the Currency and the Federal Aviation Administration, to make certain that our redactions fell well within the scope of the deliberative process privilege, the bank examination privilege, and FOIA Exemptions 4 and 8.

Please note that SBA's redactions bear no reflection on our ongoing oversight of BLX. As you may know, on October 1, 2007, a former BLX executive-vice president pleaded guilty to conspiracy to defraud and commit offenses against the United States and making false declarations to a grand jury. After this former employee was indicted, SBA increased its oversight of BLX and took steps to prevent any losses due to fraud. For example, we have expanded and increased the frequency of our safety and soundness examinations of BLX. In addition, SBA currently requires BLX to buy back certain loans that default after being sold into the secondary market. These loans are submitted to an independent contractor for review, and only loans determined to be free of fraud and other deficiencies have their guarantees honored. At present, all Preferred Lender Program loans originated by BLX are undergoing an independent review at BLX's expense before any secondary market sales can occur. Similar reviews of loans at other stages of the lending process are also required. Finally, BLX paid SBA

¹ See 13 C.F.R. § 120.470 ("SBA supervises, examines, and regulates SBLCs.").

² See also 12 C.F.R. § 309.5(g)(8) (exempting from disclosure FDIC "[r]ecords that are contained in or related to examination, operating, or condition reports prepared by, on behalf of, or for the use of the FDIC or any agency responsible for the regulation or supervision of financial institutions.").

³ See 12 C.F.R. § 602.2(a) ("Reports of examination are FCA property. We prepare them for our confidential use and the use of the institution examined. We do not give reports of examination to the public.").

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over \$9 million to cover potential losses incurred from the former executive vice-president's criminal acts, and set aside additional money to cover future losses.⁴

Over the last few months, SBA has taken several steps to further improve its overall lender oversight program. This includes the implementation of additional oversight measures that cover all SBA lenders. For example, SBA just published in the Federal Register, a comprehensive lender oversight proposed regulation. We have also enhanced our data processing systems to allow the collection of loan broker information on individual loan applications submitted via SBA's E-TRAN system. Further, we have enhanced our on-site lender review and examination process by incorporating a review of loan brokers, in order to encourage lenders to develop internal controls that would alert them to possible fraud. Looking forward, the Agency will continue its efforts to ensure the effectiveness of SBA's lender oversight program.

As you requested, enclosed with this letter is a detailed list of the redactions SBA made to Report Number: 7-28. SBA believes that each of these redactions are appropriate in light of the relevant privileges and FOIA exemptions. However, I also want to address in greater detail, the specific redactions you noted in your October 23, 2007 letter.

First, you asked SBA to explain why it redacted the first three recommendations in the report, as well as the Agency's response to those recommendations and the IG's reply. SBA believes these recommendations by the IG to the Associate Administrator for Capital Access, the SBA official charged with making the necessary decisions as to whether to accept and implement such recommendations, present a text-book example of deliberative process material.

The deliberative process privilege, which is incorporated within Exemption 5 of FOIA, protects from disclosure of inter-agency and intra-agency deliberations and advice. As noted by the D.C. Circuit, the deliberative process privilege is an "ancient privilege [] predicated on the recognition 'that the quality of administrative decision-making would be seriously undermined if agencies were forced to operate in a fishbowl.'"⁵ And as set forth in the DOJ FOIA Guide, the following three policy purposes have consistently been held to constitute the bases for this privilege:

- (1) To encourage open, frank discussions on matters of policy between subordinates and superiors;
- (2) To protect against premature disclosure of proposed policies before they are finally adopted; and

⁴ See Press Release, U.S. Small Business Admin., SBA Protects Taxpayers in Loan Fraud Case, available at http://www.sba.gov/idc/groups/public/documents/sba_homepage/serv_news_030607.pdf (last visited Oct. 23, 2007).

⁵ *Dow Jones & Co. v. United States Department of Justice*, 917 F.2d 571, 573 (D.C. Cir. 1990).

- (3) To protect against public confusion that might result from disclosure of reasons and rationales that were not in fact ultimately the grounds for an agency's action.⁶

The DOJ FOIA Guide also notes the following:

[I]n a major en banc decision, the Court of Appeals for the District of Columbia Circuit emphasized that even the mere status of an agency decision with an agency decisionmaking process may be protectible if the release of that information would have the effect of prematurely disclosing 'the recommended outcome of the consultative process ... as well as the source of any decision.'⁷

The recommendations set forth by the IG are directly related to an open matter pending before SBA. It is SBA's view that it would be entirely inappropriate to release into the public sphere recommendations by the IG as to how it believes an SBA program office ought to resolve this open matter. The publication of IG recommendations, regarding pending matters, could stifle frank discussion within the Agency, as program personnel might feel reticent to contradict a publicly-stated position of the IG; it could result in unforeseen consequences if the IG recommendations prematurely revealed to the public a decision not yet ready for release; and it could confuse the public and harm SBA and its participants if the relevant program office chose not to adopt the IG's recommendations. The negative consequences of the publication of IG recommendations are particularly apparent where, as here, the IG is recommending action in the second of its recommendations which SBA's Office of General Counsel has determined to be impermissible under the law. Moreover, if the IG, at its discretion, could unilaterally release the above described privileged pre-decisional recommendations, this would cripple the decision-making process to a degree that is both unnecessary and not in the interests of sound government. Although SBA is actively considering the IG's recommendations, the above-described reasons make clear that SBA properly redacted those recommendations before the report was published.

You also inquired as to why significant portions of the section entitled "Results in Brief" were redacted. These redactions were made for two reasons: (1) the intended release by the IG of deliberative process material (i.e., revelation by the IG of the substance of particular non-final recommendations by subordinate field offices) and (2) the unauthorized unilateral revelation by the IG of information protected by the bank examination privilege and FOIA Exemption 8.

The bank examination privilege protects from disclosure the opinions, evaluations, and recommendations of a bank regulator with respect to a regulated entity. In this instance, SBA functions as a regulator of BLX. According to the United States Court of Appeals for the District of Columbia:

⁶ U.S. Department of Justice, Office of Information and Privacy, *Freedom of Information Act Guide and Privacy Act Overview*, 478 (2007), available at http://www.usdoj.gov/oip/foia_guide07.htm [hereinafter *DOJ FOIA Guide*].

⁷ *Id.* at 479-80 (citing to *Wolfe v. HHS*, 839 F.2d 768, 775 (D.C. Cir. 1988) (en banc)).

[t]he bank examination privilege is firmly rooted in practical necessity. Bank safety and soundness supervision is an iterative process of comment by the regulators and response by the bank. The success of the supervision therefore depends vitally upon the quality of communication between the regulated banking firm and the bank regulatory agency

Because bank supervision is relatively informal and more or less continuous, so too must be the flow of communication between the bank and the regulatory agency. Bank management must be open and forthcoming in response to the inquiries of bank examiners, and the examiners must in turn be frank in expressing their concerns about the bank. These conditions simply could not be met as well if communications between the bank and its regulators were not privileged.⁸

Moreover, FOIA Exemption 8 specifically protects from disclosure information “contained in or related to examination, operating, or condition reports prepared by, on behalf of, or for the use of an agency responsible for the regulation or supervision of financial institutions.”⁹ According to the DOJ FOIA Guide, “courts interpreting Exemption 8 have largely declined to restrict the ‘particularly broad, all-inclusive’ scope of the exemption.”¹⁰ Indeed, the FOIA Guide notes, “the D.C. Circuit has gone so far as to state that in Exemption 8, Congress has provided ‘absolute protection regardless of the circumstances underlying the regulatory agency’s receipt or preparation of examination, operating or condition reports.’”¹¹ And that same guidebook points out that “Courts have consistently discerned two purposes underlying Exemption 8, a primary purpose of ‘ensur[ing] the security of financial institutions,’ which could be undermined by frank evaluations of such institutions, and a secondary purpose of safeguarding ‘the relationship between the banks and their supervising agencies.’”¹² As the DOJ FOIA guide observes, in general all records concerning “a bank’s financial condition and operations [that are] in the possession of a federal agency ‘responsible for the regulation or supervision of financial institutions,’ are exempt.”¹³ Several of SBA’s redactions fall within this category.

Under 13 C.F.R. §120.470, SBA is responsible for supervising, examining, and regulating SBLC financial institutions such as BLX. The unredacted report would have improperly placed into the public realm a multitude of findings by SBA, directly resulting from the Agency’s oversight responsibilities of financial institutions. SBA determined that releasing such data might have an unintended effect upon BLX’s financial condition, and could undermine the overall relationship between SBA and the financial institutions it supervises. As noted

⁸ *In re Subpoena Served Upon the Comptroller of the Currency*, 967 F.2d 630, 633-34 (D.C. Cir. 1992).

⁹ 5 U.S.C. § 552(b)(8).

¹⁰ U.S. DOJ FOIA Guide, at 841.

¹¹ *Id.* at 842 (citing *Gregory v. FDIC*, 631 F.2d 896, 898 (D.C. Cir. 1980)).

¹² *Id.* at 843.

¹³ *Id.* at 845.

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above, the courts have specifically identified the avoidance of such potential consequences as among the underlying purposes of Exemption 8 (and, presumably, by extension, of the bank examination privilege). Accordingly, SBA grounded most of its redactions in the "Results in Brief" section upon the bank examination privilege and Exemption 8.

You next inquired as to the justification for SBA's redaction of certain section titles in the "Results" portion of Report Number: 7-28. SBA redacted the titles, because their public release would serve to waive the bank examination privilege and FOIA Exemption 8, and could possibly result in the negative consequences such privileges were intended by the courts and Congress to prevent. Additionally, another title was redacted because its text would serve to waive the deliberative process privilege.

Finally, SBA redacted the "Chronology of Events" set forth in Appendix III, because the chronology's text is interspersed with multiple statements revealing information protected from disclosure either by the deliberative process privilege or the bank examination privilege and FOIA Exemption 8.

In summary, the redactions SBA made to Report Number: 7-28 are not extraordinary. As previously mentioned, it is standard practice for other regulators of financial institutions to make similar redactions to publicly available IG reports. Just as other agencies dealing with issues similar to those presented here have done in the past, SBA determined that, in the case of Report Number: 7-28, unlimited disclosure was not in the public's best interest. Accordingly, in order to avoid the harm that could have resulted from the release of the IG report as drafted, SBA redacted the report on the basis of the accepted privileges provided under law that are identified and described above.

Sincerely yours,

A handwritten signature in black ink, appearing to read "Steven C. Preston". The signature is stylized and cursive.

Steven C. Preston

Enclosure

SBA Redactions to July 11, 2007, OIG Report No. 7-28 "SBA Oversight of Business Loan Center, LLC"

<u>Page/ Paragraph/ Line</u>	<u>Basis for Redaction</u>
Page 4, paragraph 4 – Page 5, paragraph 2.	Bank examination privilege, deliberative process privilege, FOIA Exemption 8.
Page 5, paragraph 3, lines 4-5.	Deliberative process privilege.
Page 5, paragraph 4, lines 1-3.	Deliberative process privilege.
Page 5, paragraph 4, lines 3-9 and 11-13.	Bank examination privilege and FOIA exemption 8.
Page 5, paragraph 5, line 3.	Bank examination privilege and FOIA exemption 8.
Page 6, paragraph 1, lines 1-2.	Bank examination privilege and FOIA exemption 8.
Page 6, paragraph 3, lines 5-8.	Bank examination privilege and FOIA exemption 8.
Page 6, paragraph 4, line 7 - Page 7, paragraph 1, lines 1-3.	Bank examination privilege and FOIA exemption 8.
Page 7, paragraph 2, heading title.	Bank examination privilege and FOIA exemption 8.
Page 7, paragraph 3, lines 1-6.	Bank examination privilege and FOIA exemption 8.
Page 8, paragraph 1, Table.	Bank examination privilege and FOIA exemption 8.
Page 8, paragraph 2, lines 5-8.	Deliberative process privilege.
Page 8, paragraph 3, heading title.	Deliberative process privilege.
Page 8, paragraph 3, lines 8-12.	Deliberative process privilege.
Page 9, paragraph 1.	Deliberative process privilege.
Page 9, paragraph 2.	Bank examination privilege and FOIA exemption 8.
Page 10, paragraphs 1-4, including table.	Bank examination privilege and FOIA exemption 8.
Page 10, paragraph 5, heading title.	Bank examination privilege and FOIA exemption 8.
Page 11, paragraph 3, lines 3-6.	Deliberative process privilege.
Page 11, paragraphs 4-6.	Bank examination privilege and FOIA exemption 8.
Page 11, footnote 4.	Deliberative process privilege.
Page 11, paragraphs 7, heading title and line 1.	Bank examination privilege and FOIA exemption 8.

Page 12, paragraph 1, line 1 – paragraph 3.	Bank examination privilege and FOIA exemption 8.
Page 13, paragraphs 1-5, including table.	Bank examination privilege and FOIA exemption 8.
Page 14, paragraph 4, lines 3-11.	Deliberative process privilege.
Page 15, paragraph 4, lines 1-2.	Deliberative process privilege.
Page 16, paragraph 1, lines 5-12.	Bank examination privilege and FOIA exemption 8.
Page 16, paragraph 3, Recommendation 1.	Deliberative process privilege, bank examination privilege and FOIA exemption 8.
Page 16, paragraph 3, Recommendation 2.	Deliberative process privilege.
Page 16, paragraph 3, Recommendation 3.	Deliberative process privilege.
Page 17 paragraph 1, lines 1-7.	Deliberative process privilege.
Page 17, Recommendation 1, paragraphs 1-2.	Deliberative process privilege, bank examination privilege and FOIA exemption 8.
Page 18, Recommendation 2, paragraphs 1-3.	Deliberative process privilege, bank examination privilege and FOIA exemption 8.
Pages 18-19, Recommendation 3, paragraphs 1-6.	Deliberative process privilege, bank examination privilege and FOIA exemption 8.
Page 19, Recommendation 4, paragraph 1.	Deliberative process privilege.
Page 20, Recommendation 4, paragraphs 1-3.	Deliberative process privilege.
Pages 20-21, Recommendation 5, paragraphs 1-5.	Deliberative process privilege.
Pages 21-23, Additional Comments, paragraphs 1-9.	Deliberative process privilege, bank examination privilege and FOIA exemption 8.
Page 25, Appendix I, BLX Portfolio Statistics.	Bank examination privilege and FOIA exemptions 4 and 8.
Page 27, Appendix II, BLX Performance Statistics.	Bank examination privilege and FOIA exemptions 4 and 8.
Pages 28-29, Appendix III, Chronology of Events.	Deliberative process privilege, bank examination privilege and FOIA exemption 8.
Pages 30-36, Appendix IV, Agency Response.	Deliberative process privilege, bank examination privilege and FOIA exemption 8.