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MEMORANDUM

June 7, 2004

Validity of Proposed Section 1710.13(b)

This memorandum addresses the validity of 12 C.F.R. § 1710.13(b), a proposed amendment to the corporate governance regulations promulgated by the Office of Federal Housing Enterprise Oversight ("OFHEO"). The proposed amendment provides as follows:

> (b) *Disgorgement.* If an Enterprise is required to prepare an accounting restatement due to the material noncompliance of the Enterprise, as a result of misconduct, with any financial reporting requirement under law or regulation, the chief executive officer and chief financial officer of the Enterprise shall reimburse the Enterprise as provided under section 304 of the [Sarbanes-Oxley Act, 15 U.S.C. § 7243].

We believe that this proposed amendment is invalid on both substantive and procedural grounds.

1. Substantive Grounds

As an initial matter, a disgorgement remedy is one in which the violator of a law is forced to pay back (or "disgorge") "profits causally connected to the violation." *SEC v. First City Fin. Corp., Ltd.*, 890 F.2d 1215, 1231 (D.C. Cir. 1989); *see also id.* ("[D]isgorgement primarily serves to prevent unjust enrichment."); *SEC v. Tome*, 833 F.2d 1086-96 (2d Cir. 1987) ("The paramount purpose of ... ordering disgorgement is to make sure that wrongdoers will not profit from their wrongdoing."). The proposed amendment, however, does not provide for the "disgorgement" of unjust enrichment. Rather, through its cross-reference to section 304 of the Sarbanes-Oxley Act, the proposed amendment requires a CEO or CFO to forfeit a bonus or certain profits on the sale of securities *regardless* of whether there is any connection to the financial reporting violation. Such forfeiture is not "disgorgement," because no attempt is being made at a "reasonable approximation of profits causally connected to the violation." *First City*, 890 F.2d at 1231. Rather, it is a pure fine or penalty.

OFHEO's authority to impose civil fines or penalties against officers and directors of an enterprise, however, is strictly limited by statute. In particular, OFHEO cannot assess a fine or penalty against an executive officer or director for violating a "regulation" without showing, at a minimum, either (1) a "pattern of misconduct," or (2) a violation involving "recklessness" and "a material loss to the enterprise." 12 U.S.C. § 4636(b)(2). And even upon such a showing, OFHEO cannot impose a fine or penalty in excess of $10,000 for each day the violation continues. Because proposed subsection 1710.13(b) does not incorporate these limitations, it is inconsistent with the statutory limits on OFHEO's authority to impose fines or penalties.

2. Procedural Grounds

In addition, OFHEO has not offered any legal or policy justification for proposed section 1710.13(b) consistent with OFHEO's organic act and facts gathered by the agency. Like any other administrative agency, OFHEO "must examine the relevant data and articulate a satisfactory explanation for its action including a 'rational connection between the facts found and the choice made.'" *Motor Vehicle Mfrs. Ass'n of U.S., Inc. v. State Farm Mut. Auto. Ins. Co.*, 463 U.S. 29, 43 (1983) (quoting *Burlington Truck Lines v. United States*, 371 U.S. 156, 168 (1962)). OFHEO is not free to adopt various provisions of Sarbanes-Oxley as its own without justifying such regulations by reference to OFHEO's statutory authority and facts in the record. The fact that Congress adopted a forfeiture provision enforceable by the SEC in the Sarbanes-Oxley Act does not, *ipso facto*, justify OFHEO in implementing its own forfeiture provision. OFHEO has a higher burden of justification than Congress. *See id.* at 43 n.9 ("We do not view as equivalent the presumption of constitutionality afforded legislation drafted by Congress and the presumption of regularity afforded an agency in fulfilling its statutory mandate."). Thus, OFHEO must explain not only its statutory authorization but the policy necessity of its proposal, and that task should be more difficult—not easier—given the existence of Sarbanes-Oxley. In the absence of any independent legal or factual justification, the regulation is unsustainable. *See, e.g., PG&E Gas Transmission Northwest, Corp. v. FERC*, 315 F.3d 383, 390 (D.C. Cir. 2003) (quoting *Greater Boston Television Corp. v. FCC*, 444 F.2d 841, 852 (D.C. Cir. 1970)).

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