

**THE FALL OF ENRON: HOW COULD IT HAVE
HAPPENED?**

HEARING

BEFORE THE

COMMITTEE ON
GOVERNMENTAL AFFAIRS
UNITED STATES SENATE
ONE HUNDRED SEVENTH CONGRESS
SECOND SESSION

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JANUARY 24, 2002
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THE FALL OF ENRON: HOW COULD IT HAVE HAPPENED?

THURSDAY, JANUARY 24, 2002

U.S. SENATE,
COMMITTEE ON GOVERNMENTAL AFFAIRS,
Washington, DC.

The Committee met, pursuant to notice, at 10:07 a.m., in room SH-216, Hart Senate Office Building, Hon. Joseph I. Lieberman, Chairman of the Committee, presiding.

Present: Senators Lieberman, Thompson, Levin, Collins, Durbin, Cochran, Torricelli, Cleland, Carper, Carnahan, Dayton, Voinovich, Bennett, and Bunning.

OPENING STATEMENT OF CHAIRMAN LIEBERMAN

Chairman LIEBERMAN. This hearing will come to order.

Good morning. With this hearing, the Senate Governmental Affairs Committee begins its investigation of the Enron scandal, the spectacular rise and fall of an American corporation and the devastating effects its collapse has had on its employees and retirees, on its shareholders and customers, and on the confidence many Americans have in the markets and in their government.

The basic facts of this story are now well known. Less than a year and a half ago, Enron was ranked as the seventh largest corporation in America. The energy trading company was a bright star on Wall Street, a juggernaut trading at \$90 a share at its height, with revenue over \$100 billion. Stock analysts could not recommend it fast enough, and the company made millionaires of many loyal employees who invested their life savings in its stock.

Then last month Enron's bright star collapsed into a black hole, when it abruptly declared bankruptcy and was exposed as a house of cards built on greed and deceit. To add insult to injury, average workers and investors were cheated out of their life savings, while a small group of executives and insiders made off with hundreds of millions of dollars from well-timed stock sell-offs.

Today, the company's stock is worth pennies, and it is no longer traded on the New York Stock Exchange. Five thousand of its employees are out of a job, and thousands more are reeling in the ruin of their retirement dreams. One of the Nation's top accounting firms, Arthur Andersen, is accused of helping to conceal Enron's liabilities instead of reporting them. Public and private employee pension funds from Florida to California have lost billions of dollars, and at a time when over 60 percent of Americans own stock, in one way or another, the confidence of the investing public in the stock market has been shaken.

So this is not just a tempest in a teapot. It is an unprecedented corporate storm that has already hurt thousands of people and now leaves dark clouds over America's economy and American's confidence in their future personal economic security. This scandal cries out for thorough congressional investigation to make sure that nothing like this ever happens again.

Yet, because Enron has made substantial political contributions to Members of Congress and the Executive Branch, some have questioned the capacity of any congressional committee to conduct an independent, thorough investigation of Enron.

Now I think there are two things we in Congress can do to overcome that skepticism and rebuild public trust. One is simply to do a completely independent and demanding investigation, and that is the intention of this Committee. The second is to pass campaign finance reform.

As for this Committee, we have a clear duty, under the rules of the Senate, to investigate, and we will carry out that duty by conducting an investigation that is independent, comprehensive, aggressive, fair and nonpartisan. We should neither jump to conclusions before the facts justify them, nor hesitate to ask tough questions of those in the public and private sectors who can produce the facts that we need in order to get answers, and we will follow the facts wherever they lead us.

This is a big and complicated investigation. So our Committee has divided it between the full Committee and our lead investigative committee. The Permanent Subcommittee on Investigations, chaired by Senator Levin, with Senator Collins as Ranking Republican, will investigate the internal malfeasance of Enron and its auditors, the role of the board of directors, conflicts of interests, offshore tax havens and insider trading.

Here at the full Committee level, we are going to focus on the external controls and protectors, the Federal agencies and laws, and ask why, in this case, they could not better protect the thousands of employees and investors who have suffered from Enron's untimely and unnatural demise.

As the Senate's chief oversight committee, it is our responsibility, again, under the Senate rules, to make sure the Federal Government is as effective as it can be in protecting the public interest. Because in this case so many have lost so much, this Committee must ask if the relevant Federal agencies, the Securities and Exchange Commission, the Labor Department, the Commodity Futures Trading Commission, and the Federal Energy Regulatory Commission did everything they could have done to protect the public and, if not, why not.

At least one of those agencies was formed way back in the most serious crisis American capitalism has ever faced, the Great Depression. It and those other watchdog agencies that have followed it, have been established, I think, to require the fullest disclosure and fairest play that are necessary to make our market economy work for the benefit of the many, the broad middle class and not just the privileged insider few.

Now, in the context of the Enron scandal, people are asking, and we will ask, whether these agencies need to be strengthened to per-

form this critically important function. Here are some of the questions we are going to ask:

How was Enron allowed to hide its debt and losses in shady accounting from SEC oversight?

Could the Labor Department have intervened when Enron barred its employees from selling company stock in their 401(k) plans and blocked them from salvaging what was left of their retirement nest eggs?

Could FERC and the CFTC have exercised more oversight to rein in abuses that might have contributed to Enron's collapse?

We have got to ask, also, if the regulatory agencies need additional powers to prevent this kind of massive investor rip-off from occurring again.

We have got to ask, and we will, and Senator Levin's Subcommittee will, why the private sector checks and balances that we rely on to keep the markets honest and open, the auditors, analysts, and independent corporate directors, did not do their part to make sure that the Enron investors and employees were getting the true story.

Are the auditors, with their enormous consulting fees, too beholden to management to protect the shareholders' interests?

Are stock analysts too concerned about protecting the lucrative business relationships of their firms to be objective in their assessments of companies?

Are independent directors, with their stock options, and consulting contracts and corporate perks, truly independent?

Is the system, in sum, so rife with conflicts of interest that the average American, trusting his or her future to the stock market, is inadequately informed and, therefore, poorly protected?

We are going to begin our oversight and investigation during a series of hearings during the next several weeks on the most important public policy questions that have emerged from the Enron scandal. At the same time, we will also issue written interrogatories to the agencies of the Federal Government that have had jurisdiction over Enron and to the White House to determine what they knew and did regarding Enron's regulation by the four agencies I mentioned earlier over the last several years.

We also plan to request, by subpoena, that Enron and Arthur Andersen turn over documents related to their context with the same Federal agencies and offices. After we have collected that information and conducted additional interviews, we will report our findings to the public in hearings to be conducted later this year.

In the end, I hope that this Committee will have specific recommendations to make to change the law and regulation, recommendations that will strengthen the watchdogs, both in and out of the Federal Government, so, I repeat, nothing like the Enron scandal ever happens again.

In today's hearing, we are going to set the stage for what will follow and try to put the Enron story into context by defining a set of the most important policy issues that have come into question as a result of Enron's collapse. The sudden, wholly unanticipated failure of the Nation's seventh largest corporation, under infuriatingly suspicious circumstances, with grave consequences for thousands of people, is a clarion call for all of us in government to make

sure we are doing all we can to protect the integrity of our markets, that in their way have allowed the growth of the great American middle class, and the savings and investments of the American people. That is what our Committee intends to do.

I would like to say just a few words, briefly, to my fellow Members of the Committee. We are beginning a journey today, one that will be long, and complicated and often controversial, but it is a very important journey. It is not a journey that was on our Committee agenda for this year, but then Enron happened, and now this Committee, which is uniquely charged with oversight and investigation by the Senate Rules, has a duty to act.

Along the way, there will be people outside the Committee who will try to distract us and divide us. For my part, I pledge to you that I will do everything possible to make sure they do not succeed. I want to end this journey together, as we begin it together today, having found the truth, as best we could, and proposing reforms that are the best we can.

I am very privileged to have Senator Fred Thompson as the Ranking Republican on this Committee. We have worked closely together over the years. I have great respect for Senator Thompson. I might even say I like him. [Laughter.]

I even, occasionally, enjoy his company.

I would say, in specific regard to this matter, I have consulted with him, as we have shaped our investigative plan, and I look forward to working closely with him as the investigation proceeds.

I am also pleased that Senator Levin, Senator Collins, and their staffs are working closely together on the work of the Permanent Subcommittee on Investigations.

Senator Thompson.

OPENING STATEMENT OF SENATOR THOMPSON

Senator THOMPSON. Thank you, Mr. Chairman.

I believe it is correct to say that this marks the first day of the first full Senate Committee hearing on the Enron matter, and it clearly is an appropriate matter for the Governmental Affairs Committee. How our government agencies and institutions perform is a vital part of the inquiry that needs to be made, as Congress works its way to the bottom of this.

Mr. Chairman, I think you have set exactly the right tone, and I would like to say that I am pleased that you are chairing these hearings. Having worked closely with you in the past, I know of no one who has a more proven record of fairness and objectivity, and I look forward to working with you on this matter.

I think we really have an opportunity to do some good here, to examine what went wrong and to consider constructive changes to the governance of our public capital markets, which appear to be inadequate to the demands of the 21st Century and the complex financial transactions that now take place on a daily basis.

It is true that not every aspect of the Enron matter is either unusual or especially a cause of great concern. For instance, to what extent is this simply a case of individual misconduct or illegal conduct? No system known to man can prevent unscrupulous and clever individuals from manipulating the system and even getting away with it for a period of time.

Also, how much of this financial disaster was simply the results of bad business judgment and legitimate risk taking that simply did not pan out? This is not the first big company to go belly up with losses to stockholders and employees, and when it happens it is not always because of illegal or unethical conduct.

But while it may be that part of what we are seeing here is individual misconduct or simple bad business judgment, both of which our system is very capable of dealing with, and we are in the process of dealing with it right now, there also seems to be some systematic failures that are much more troubling.

Our free markets and our public financial system—much as our government—are dependent upon certain checks and balances. Some of the unfortunate tendencies of human nature that were of concern to our Founding Fathers, are just as prevalent in the corporate world, as they are in the political world. People entrusted with power need watchdogs and must be required to operate under public scrutiny. We must ask ourselves where were the watchdogs here? Where were the auditors, the law firms, the board of directors, the analysts, and the government agencies?

As an economist recently pointed out, we must especially look at the role played by auditors. As they said, “The capital markets and, indeed, capitalism itself can function efficiently only if the highest standards of accounting, disclosure and transparency are observed. In America, well-policed stock markets, fearsome regulations at the SEC, stern accounting standards in the form of generally accepted accounting principles, and the perceived audit skills of the Big 5 accounting firms have long been seen as crucial to the biggest, most liquid and most admired capital markets in the world.”

The most troubling feature of this issue to me is not so much how these entities or gatekeepers, watchdogs failed in the Enron matter, as the fact that this may be indicative of problems with auditors, boards, and gatekeepers in general. For one thing, we have learned that most of them are up to their necks in conflicts of interest. One way or another, all of these people, especially the private entities, have tremendous financial incentive for the company to make the numbers and to keep the stock price high.

This, of course, plays right into the hands of the unscrupulous corporate executive, who is willing to cover up the financial realities of the corporation through nondisclosure, taking corporate debt off the books and any number of things that would raise a question in the mind of an average high school bookkeeping student.

As is often the case, the real scandal here may be in the form of not what is illegal, but what is totally permissible. If the generally accepted accounting principles allow the bookkeeping shenanigans that have been reported in the press, then we should all go into the derivative business.

It seems that all too often the name of the corporate game is to conceal the true financials, while doing the minimum amount of disclosure to avoid legal exposure. The system is clearly not designed with the primary interests of the general public or the investor in mind.

Also, what about the role of the government agencies? What should they have caught? Do they have an adequate staff? We have 17,000 public companies in this country. Is the SEC supposed to

keep up with all of them? Is it necessarily just an after-the-fact proposition? Perhaps it is. Can we put a government official in every board room in the Nation?

Also, what about those rare instances where the government catches wrongdoing? Are penalties sufficient to deter this kind of behavior?

So, while issues such as individual wrongdoing and who made contacts with the administration are interesting and titillating, the issue of most long-term importance to our country has to do with the integrity of our systems.

It is also the area in which we have the most responsibility as legislators. We must address our legal and regulatory framework, not as what we thought it was, but as we now know it to be, and work together toward reforming it.

As I said, I believe we have an opportunity here, Mr. Chairman, to do some real good on a bipartisan basis, and who knows, in the process, we may even finally decide that allowing huge amounts of soft-money contributions to public officials is not really such a good idea. We may even come to the conclusion that this practice is always just a scandal waiting to happen, and we do ourselves and the institution we serve a disservice by tolerating it.

So, Mr. Chairman, I look forward to working with you and other Members of this Committee toward a really constructive set of hearings. Thank you very much.

Chairman LIEBERMAN. Thank you, Senator Thompson. Thanks very much.

I am now going to give each of the Members of the Committee an opportunity for an opening statement, which I ask them, as best as they are able, to keep it close to 5 minutes.

Senator Levin.

OPENING STATEMENT OF SENATOR LEVIN

Senator LEVIN. Thank you very much, Mr. Chairman and Senator Thompson, for your statements, which I thought were really on target.

The Enron debacle has stirred the passions of Americans nationwide. The deceptions and the accounting gimmicks, the shredding of documents that have occurred shake the very foundation of our confidence in corporate America. What a travesty. Enron's management made out like bandits, while tens of thousands of average people saw their savings, retirement funds or jobs go down the drain. People are now concerned that the marketing of the stock of other U.S. corporations may be no more than "pump and dump" schemes writ large.

Enron's abrupt collapse from corporate star to disgraced bankrupt is crucial for all of us to understand, because each and every American's future is tied to the success or failure of corporate America. Publicly traded companies employ millions of Americans. They are the key to U.S. international competitiveness. Over half of all U.S. households are now investing in American capital markets, placing their hopes for a college education for their children, quality care for their parents, and adequate money for their retirement, in the hands of our publicly traded companies.

I was, frankly, surprised when Treasury Secretary O'Neill said, "Companies come and go. Part of the genius of capitalism is people get to make good decisions or bad decisions, and they get to pay the consequences or enjoy the fruits of their decisions."

Well, Ken Lay and his colleagues at Enron got the fruits. The employees and stockholders are the ones who suffered the consequences.

We have laws and regulations designed to ensure that our publicly traded corporations are managed for the benefit of stockholders and employees. We require boards of directors to serve as a check on overreaching and bad judgment by corporate offices. We require outside auditors to make sure company accounting practices are accurate and trustworthy. We require transparent financial reporting so that investors can track their investments and decide when to buy or sell stock.

Yet, in the case of Enron, we have misleading financial statements, corporate conflicts of interest, insider profits at the same time employees were losing their shirts, off-shore shenanigans, hidden debt, and what I call tax laundering—that is, taking earnings that are taxable in the United States and somehow creating off-shore paper entities in the Caribbean or elsewhere through which to route them and, presto, convert them to nontaxable earnings.

Enron also avoided hundreds of millions of dollars in taxes by its use of stock options. Some years ago some of us fought to require corporations to treat stock options on their financial statements the same way they treat them on their tax returns. Corporate executives receive large quantities of stock options from their companies. When they exercise those options, the companies can claim a compensation expense on their tax return, while accounting rules let them omit that same expense from the corporate earnings statement.

The company can tell Uncle Sam one thing, but its shareholders or future stock buyers the opposite. That is one of the means by which Enron avoided paying taxes for 4 out of the last 5 years, while bragging to investors about skyrocketing revenues.

Enron is far from unique in that regard, since other corporations use the same technique. The stock-option loophole that Enron used makes no sense to me. But when the Financial Accounting Standards Board or FASB, the entity that decides the accounting standards, tried to change the rules, audit firms and major corporations fought the board tooth and nail.

It may be that Enron and Andersen broke laws or it may be that the principal scandal is what passes for legal conduct in today's marketplace. Some of our witnesses will be telling us today that it is not just Enron, that our entire system of corporate management, auditing, stock analysis, investment banking needs a top-to-bottom shake-up and major repairs.

Many have been raising flags, shouting warnings for years, including the witnesses before us today. Arthur Levitt, former SEC Chairman, for one, carried on an intense and often lonely battle to curtail the conflicts of interest that are inherent in the practice of permitting our largest auditors to serve as both outside auditor and management consultant to the same company.

Mr. Chairman, I am very fortunate that Senator Collins is the Ranking Republican on our Permanent Subcommittee on Investigations. The legislative effort that is needed to turn this travesty into a positive force, to clean up some long-festering problems in U.S. corporate governance and accounting practice will require a sustained effort from all of us.

I know that she, with her history and experience of chairing hearings in such a distinguished, fair, and thoughtful way when she was Chair of the Permanent Subcommittee on Investigations, will help us a great deal to make the best contribution that we can to that sustained effort which must be made if we are going to clean up the mess that we, indeed, all face. Thank you.

[The prepared statement of Senator Levin follows:]

PREPARED STATEMENT OF SENATOR LEVIN

The Enron debacle has stirred the passions of Americans nationwide. The deceptions and accounting gimmicks and shredding of documents that occurred shake the very foundation of our confidence in corporate America. What a travesty. Enron's management made out like bandits while tens of thousands of average people saw their savings, retirement funds or jobs go down the drain. People are now concerned that the marketing of the stock of other U.S. corporations may be no more than "pump and dump" schemes writ large.

Enron's abrupt collapse from corporate star to a disgraced bankrupt is crucial for all of us to understand, because—like it or not—each and every American's future is tied to the success or failure of corporate America. Publicly traded companies employ tens of millions of Americans; they are the key to U.S. international competitiveness. Over half of all U.S. households are now investing in American capital markets—placing their hopes for a college education for their children, quality care for their elderly parents, and adequate money for their retirement in the hands of our publicly traded companies.

I was surprised when Treasury Secretary Paul O'Neill said, "Companies come and go. Part of the genius of capitalism is people get to make good decisions or bad decisions and they get to pay the consequences or enjoy the fruits of their decisions." Well, Ken Lay and his colleagues got the fruits and haven't yet suffered the consequences; the employees and stockholders have done that.

We have laws and regulations designed to ensure that our publicly traded corporations are managed for the benefit of stockholders and employees. We require Boards of Directors to serve as a check on overreaching and bad judgment by corporate officers. We require outside auditors to make sure their accounting practices are accurate and trustworthy. We require transparent financial reporting so that investors can track their investments and decide when to buy or sell stock. We require of our public accountants and corporate directors a fiduciary responsibility to act in the best interest of the investing public and the corporation's stockholders, and not in their own financial interest.

Yet in the case of Enron we have misleading financial statements; corporate conflicts of interest; insider profits at the same time employees were losing their shirts; offshore shenanigans; hidden debt, and what I call tax laundering—that is, taking earnings that are taxable in the United States and somehow creating offshore paper entities in the Caribbean through which to route them and voila—convert them to nontaxable earnings.

Enron also avoided hundreds of millions of dollars in taxes by its use of stock options. Some years ago some of us fought to require corporations to treat stock options on their financial statements the same way they treat them on their tax returns. Corporate executives receive large quantities of stock options from their companies. When they exercise those options, the company can claim a compensation expense on their tax returns, while accounting rules let them omit that same expense from the corporate earnings statement. The company can tell Uncle Sam one thing and its shareholders the opposite. That's one of the means by which Enron avoided paying taxes for four out of the last five years, while bragging to investors about skyrocketing revenues. The stock option loophole Enron used makes no sense, but when the Financial Accounting Standards Board or FASB—the entity that decides the accounting standards—tried to change the rules, audit firms and major corporations fought the Board tooth and nail. In the end, the best FASB could get was a footnote noting the earnings charge on a company's books. But that stock op-

tion footnote—like so many Enron footnotes—doesn't tell the true financial story of a company.

It may be that Enron and Andersen broke laws or it may be that the principal scandal is what passes for legal conduct in today's marketplace. Some of our witnesses will be telling us today that it's not just Enron—that our entire system of corporate management—auditing, stock analysis, investment banking—needs a top-to-bottom shake-up and major repairs. The Big 5 accounting firms admitted in a recent petition to the SEC that when it comes to financial disclosure many “public companies provide boilerplate or very high-level disclosures that provide little or no meaningful information.” And that's from the accountants themselves—the very group charged with ensuring that companies issue fair financial statements. What an indictment that is of our financial disclosure system.

Many in the industry have been raising red flags and shouting warnings for years. Arthur Levitt, the former SEC Chairman for one, carried on an intense and often lonely battle to curtail the conflicts of interest inherent in the practice of permitting our largest auditors to serve as both outside auditor and management consultant to the same company. Mr. Levitt knew what he was talking about, but not many wanted to listen. The question now is whether we've learned the lesson Mr. Levitt is still trying to teach.

Just about all the various failures in our corporate governance systems have coalesced in the Enron saga. Hopefully Enron's implosion, while damaging to so many lives, may serve as the engine for reforms long overdue. We already have some sense of what needs to be done: Insisting on greater auditor independence; a stronger Financial Accounting Standards Board; fairer accounting, including consistent treatment of stock options; ending the use of offshore tax havens; more accountable corporate governance; and employee pension protections.

A large number of investigations are ongoing in the Congress and the Executive Branch, because we have a lot of ground to cover and different responsibilities to fulfill. The Permanent Subcommittee on Investigations, which I chair, and on which Senator Susan Collins serves as the Ranking Member, will be paying particular attention in the months ahead to the role of the Enron Board of Directors and officers, the role of Arthur Andersen, particularly with regard to Enron's Special Purpose Entities, and Enron's use of offshore entities and tax havens.

Our hearings in the Permanent Subcommittee on Investigations will come later in the year, after our analysis of the thousands of documents that we receive as a result of the 51 subpoenas issued two weeks ago. I look forward to the hearings in our full committee, which will examine what federal agencies could have and should have done to detect or prevent the Enron debacle. The legislative effort needed to turn this travesty into a positive force to clean up some long-festered problems in U.S. corporate governance and accounting practice will require a sustained effort from all of us.

Chairman LIEBERMAN. Thank you, Senator Levin. Senator Collins.

OPENING STATEMENT OF SENATOR COLLINS

Senator COLLINS. Thank you, Mr. Chairman.

Mr. Chairman, I want to thank you and Senator Levin for convening this important investigation into some of the key issues involved in the Enron bankruptcy, the largest corporate failure in our Nation's history.

It is my hope that, with the help of our witnesses today, we can begin to gain a better understanding of how the financial and regulatory systems utterly failed to protect the company's shareholders, employees and customers, while top executives apparently walked away with handsome profits on the sale of their Enron stock.

A common theme in many of the issues we will examine is conflicts of interest. Corporate officers, outside accountants, board members, and security analysts all have duties, both legal and ethical, to investors, to clients, to employees, to regulators and to the public. To be more specific, we impose on corporate managers and financial professionals a fiduciary obligation to act in the best interest of those who provide the capital.

A brief review shows just how pervasive the role of the non-governmental protector of investor interests is in our capitalist system. We impose, for example, on auditor, the obligation to ensure that investors have access to financial statements that accurately and fairly describe the finances of the companies in which they invest. We impose on corporate managers the obligation to act in a fashion that will maximize the benefits received by the firm's stockholders. We impose on corporate directors the obligation to safeguard investor interests by monitoring the conduct of those managers, and we impose on retail brokerage firms the obligation to give their clients competent and objective advice about the companies they follow.

For a system that places such heavy reliance on the obligation of some private citizens to safeguard the interests of other private citizens, we are remarkably lenient, perhaps even lax, in allowing conflicts of interest. The potential for such conflicts to cause trouble in the accounting arena, in particular, has attracted considerable attention not just in the Enron case, but over the past few years, as the number of companies restating their earnings has increased significantly.

Indeed, Enron is only the latest in a string of well-known large corporations whose books were blessed by auditors, despite questionable accounting. Financial data, compiled in accordance with generally accepted accounting principles, certified as such by an independent auditor, and fully disclosed under securities laws, are fundamental to the integrity of our financial markets.

If a company's financial statements do not accurately represent its financial health, investors cannot make prudent decisions on whether or not to purchase its stock. Without the confidence engendered by fully disclosed financial data, our vibrant capital markets, which help businesses finance new plants and create new jobs, and which many Americans rely on for their children's college tuition and their own retirement, will be ultimately undermined. The very health of our economy hinges on the integrity of our financial markets.

A champion of small investors and strong capital markets, former SEC Chairman Arthur Levitt will be testifying before the Committee today. Chairman Levitt was very helpful to me when I held hearings with Senator Levin on penny stock fraud and day trading. He has long pressed for a prohibition on accounting firms providing both consulting and auditing services for the same client, to prevent the kinds of conflict of interest that contributed to the collapse of Enron.

Although the Enron bankruptcy raises many important issues, perhaps the most important to the individual investor may be what it has to teach us about the 401(k) plans relied upon by so many Americans as a future source of retirement income.

Private pensions governed by ERISA are intended to help Americans reach the goal of retirement security. Because of the rapid decline in Enron's stock price, however, thousands of its employees find themselves in dire straits, having lost nearly all of their savings from a lifetime of hard work.

Like Enron's employees, many American workers have a disproportionate share of their employer's stock in the 401(k) plan. In

fact, at some companies, workers have as much as 90 percent of their retirement assets in their employer's stock. One issue that I am very interested in is whether employees have access to impartial financial advice, and Senator Jeff Bingaman and I have introduced legislation to try to achieve that goal.

Although it is not perfect, it is important to remember that our systems of accounting and financial regulation are the best in the world. That makes the Enron case all that much more troubling because it simply should not have happened. It represents a colossal failure of virtually every mechanism that is supposed to provide the checks and balances on which the integrity of our capital markets depend.

I look forward to working with the Chairman, as well as the Chairman of the Subcommittee, my distinguished colleague, Senator Levin, as we proceed with these issues.

Chairman LIEBERMAN. Thank you very much, Senator Collins. Senator Durbin.

OPENING STATEMENT OF SENATOR DURBIN

Senator DURBIN. Thank you very much, Mr. Chairman.

With Biblical certainty, the United States preaches the gospel of free markets and capitalism to the unconverted around the world. Third-world nations, former command and control economies, and socialist governments alike are all exhorted to let the laws of supply and demand run their course.

As proof of the truth of our message, we can point to our own experience—a frontier nation which joined democratic government to a market economy and created the freest, most stable and prosperous nation in history.

But the American story also includes a chapter where we came to realize that the rule of law and the guiding hand of government were critical to a just result in the world of business.

Theodore Roosevelt was the first President to acknowledge that the genius of capitalism could also be a triumph of greed without rule and regulation to save us from our baser instincts.

Today this Committee joins a chorus of Congressional critics pecking at the carrion of Enron. When the mightiest fall, the politically curious scramble over the ruins. What we know is this: A flawed and fraudulent business concept failed. But there are other things we also know:

When the corporate insiders at Enron realized the ship was sinking, they grabbed the lifeboats and left the women and children, their workers and investors, to drown. When the accountants and auditors responsible for policing Enron were on the beat, they were also on the take—a badge in one hand, an open palm in the other.

When workers and investors were captivated by too-good-to-be-true profits and fraudulent claims by the corporate bigwigs in Houston, they made decisions they could not escape. And when the high-flying corporate executives became political high rollers, they left a lot of embarrassed people in their wake.

After all of the sound and fury of these investigations, the bottom-line questions are: Is Congress willing to amend the law to rein in the greed of the next Enron? Are we willing to concede that the genius of capitalism can result in ruthless behavior without our

oversight and the protection of law? Can we save pensioners and investors—who were outsiders believing in the fairness of the market—from the corporate insiders who walk away from these colossal business train wrecks with their pockets full and without a scratch?

Over 100 million Americans who own stock and 42 million who own 401(k)'s will be watching to see if these hearings and many others on Capitol Hill are about more than just face time on the nightly news.

To me, this national debate is about more than a failed corporate giant. It is about the values of our Nation. Enron is a big story not just because of its bankruptcy. Sadly, bankruptcies occur every day. Enron is a big story because it reminds us of our vulnerability. It reminds us that without the enforcement of fair and just laws, the average American doesn't have a fighting chance.

Mr. Chairman, I welcome the opportunity in the coming weeks and months to transform what we learn into legislation that will guard against a repeat of this shameful chapter in American business history. Thank you.

Senator LIEBERMAN. Thank you very much, Senator Durbin. Senator Cochran.

OPENING STATEMENT OF SENATOR COCHRAN

Senator COCHRAN. Mr. Chairman, I commend you for having this hearing to learn the facts surrounding the collapse of the Enron Corporation. While business failures are common, it is not at all common to see a company of Enron's size driven to bankruptcy and virtually unheard of to see it happen as quickly as it did, that a company like Enron could fail so precipitously and with such devastating consequences is both puzzling and troubling.

Particularly devastated are Enron's employees, many of whom have lost their jobs and nearly all of whom have seen their pensions and 401(k)'s disappear. While business ventures and investments in them always entail risk, the government has a role in assuring that there are safeguards in place to keep employees and investors from being victimized by inappropriate practices.

With Enron's failure, we must ask whether such safeguards were adequate and, if they were adequate, were they improperly circumvented? We should also find out if any Federal agencies failed to carry out their responsibilities.

This is a very complex case, and I hope we use these hearings to learn the facts and understand the complexities so we can determine what we need to do to help avoid this kind of unfortunate event in the future.

Senator LIEBERMAN. Thank you, Senator Cochran. Senator Torricelli.

OPENING STATEMENT OF SENATOR TORRICELLI

Senator TORRICELLI. I thank you, Mr. Chairman, Mr. Levitt, and Mr. Turner.

The matter of Enron is going to be addressed in a variety of forums. Some of these are going to be criminal proceedings because laws have obviously been violated. Creditors will be in bankruptcy

court for many years seeking redress, and there will be civil suits in courtrooms across the country involving thousands of people.

The responsibility of this Committee and this Congress is somewhat different. Allow the criminal and the civil proceedings to run their course, but our responsibility is to set what happened with Enron in some perspective. My hope is the testimony this morning begins that process. The collapse of Enron has been an individual tragedy for 5,000 employees and thousands of investors, people have lost their jobs, many will lose their homes, their families are in peril, and thousands of other Americans have lost their retirement savings.

This Committee and this Congress needs to recognize the impact on an even larger scale. Many of my colleagues have commented about the uniqueness of the American capital market. Those comments are well stated today. It is no exercise in hyperbole to note that we have become the world's largest economy in large measure because we created confidence in the world's most transparent equity markets.

The uniqueness of our system is that the individual worker, the retiree, the family planning their finances, feels that they stand in an equal position with members of the board, large firms, and management. All have access to equal information. They can make individual judgments—good or bad, we stand together. If that confidence is shaken, it is at enormous perils, to the financial future of the country.

Senator Lieberman noted that our duty is to ensure that what happened with Enron must never happen again. Perhaps, but the simple truth is it is happening all of the time. Enron has brought a dirty little lie into the light of day. The system of confidence and transparency in our markets has been steadily eroding.

Mr. Levitt, the purpose of these opening comments by Members of the Senate, if they serve any purpose at all, is to tend to direct testimony, to set a stage where you might respond. Here is the stage I would like to set. I have three charts I would like you to see.

Market losses to investors after corporate restatements.¹ Now every American knows about Enron, their restatements, their false accounting. What was a \$17-billion issue in 1998 has risen to a \$31-billion question in what has become a habit, a routine of corporate restatements. Some are undoubtedly required, some are necessitated by changing events, but the changing culture of corporate reporting to investors is at least suspicious.

The second chart² will give you an idea as well of what this means in terms of the number of corporations. It may have been proper in 1998 that 116 corporations needed to do restatements. Markets change, situations are altered. But it is at least suspicious that by the year 2000, 233 needed to do the same. Is Enron unique?

¹Chart entitled "Market Losses to Investors After Corporate Restatements" appears in the Appendix on page 135.

²Chart entitled "Corporate Restatements Have Increased Dramatically in the Last Three Years" appears in the Appendix on page 136.

Well, the third chart,¹ I think, illustrates Enron is not even the largest of what have become a series of outrageous corporate overstatements to the tunes of billions of dollars in recent decades.

Enron is now in bankruptcy, so is Sunbeam, largely, unrecognized outside of the investor community, Waste Management being even larger. These companies are not alone.

Mr. Levitt, I hope you will address these questions in your testimony. We would all prefer that the markets are able to regulate themselves. We all believe it would be better if professions could engage in self-management. We are being reminded that there is a reason for government regulation. Mark Twain once said that before he takes down a fence, he likes to ask why somebody put it up.

It is not so long ago you reminded the country and the Congress the reason for some additional regulations in the accounting industry. The country may not have listened, the Congress did not respond. We were wrong. You were right. Now we need to discover what else it is that we should be doing. Thank you, Mr. Chairman.

Senator LIEBERMAN. Thank you, Senator Torricelli. Senator Voinovich.

OPENING STATEMENT OF SENATOR VOINOVICH

Senator VOINOVICH. Thank you, Mr. Chairman, for holding this hearing today.

The story of Enron's collapse into bankruptcy has dominated the headlines nationwide this month and has replaced the war on terrorism as the most common news story. It was just last month that we were having hearings on terrorism. Enron is the most covered news event so far this year.

As such, this Committee, along with at least nine other congressional committees, the Department of Justice, the Securities and Exchange Commission, and the Department of Labor are looking into the causes of the corporation's collapse and any wrongdoing that may have taken place.

Our Nation's financial market is composed of a multi-layered system of checks and balances. Within a public company, the executives are obligated to report honest earnings in their books. Internal auditors are responsible for publishing fair and independent reports on the company's financial situation. Audit committees are responsible for ensuring that the auditors produce fair and accurate statements.

Outside of a public company, the external auditors are hired to make sure the company's finances present an accurate picture of what is going on. Financial analysts scrutinize the company's financial situation to recommend to investors whether or not the company is a smart investment. Credit lenders analyze a company's financial reports to determine the level of risk associated with lending to the company, and the Securities and Exchange Commission and other Federal regulators are responsible for monitoring the financial markets and the public companies that compose this market.

¹ Chart entitled "Corporate Overstatements In the Past Decade" appears in the Appendix on page 137.

This system usually works pretty well. Mr. Chairman, in the case of Enron, the multi-layered system of checks and balances failed. It calls out for Congress to consider overhauling the whole system to guarantee that we are not going to have any more situations like Enron.

The aspect of Enron's collapse that bothers me most, however, is the dishonesty and disloyalty that appears to have existed at the top of the corporation, conduct which has dealt a lethal economic blow to thousands of shareholders and employees and cast a dark shadow on corporate America. It will take a long time for people's faith in investing to be restored.

Our country has the best system of civil and criminal laws in the world, and if there was any wrongdoing—and I suspect there was—at Enron, we must utilize that system to the fullest extent to make an example of executives and warn other public companies and their executives not to gamble with the life savings of thousands of American families and the investing public.

In Ohio alone, the Public Employees Retirement System, of which I am a member, and the State Teachers Retirement System estimate their losses as a result of investments in Enron at approximately \$127 million. The State has filed a class action lawsuit against Enron in coordination with a number of other States that invest in Enron as a result of the company's misleading financial statements.

I am equally concerned about the allegations I read in the paper about Arthur Andersen's failure to do its job. I know a little bit about this company from my experience with them as Governor, and it was not very good. I think we should take a careful look at our accounting system and evaluate it if we can, under the current system, provide the unbiased assessment which the public expects and is entitled to. Is a new independent oversight of the profession needed? At the very minimum, we must prevent the inherent conflict of interest that arises when a company hires the same firm to audit its books and then provide consulting services.

In the midst of headlines about the Enron scandal, there is some good news, and that is, the condition of our Nation's energy markets. The biggest corporation in the world collapsed within a few weeks, and I did not hear about a single blackout that resulted from that crash, nor have I seen a tremendous fluctuation in gas prices, as some would have predicted. I think it says a lot about the country's efforts to deregulate our energy markets, and I think we need to continue with deregulation in the smartest way possible.

In closing, I look forward to hearing from our witnesses today and from our witnesses in the future on what steps the Federal Government must take to guarantee that there are not going to be any more Enrons and how should we restore the public's faith in our financial markets. Thank you, Mr. Chairman.

Chairman LIEBERMAN. Thank you, Senator Voinovich. Senator Cleland.

OPENING STATEMENT OF SENATOR CLELAND

Senator CLELAND. Thank you very much, Mr. Chairman, Mr. Levitt, and Mr. Turner. Thank you very much, ladies and gentlemen.

Let me just say that, before I came to this position in the Senate, I was Secretary of State in Georgia for some 12 years. In that State, the Secretary of State is the commissioner of securities, that is, the State regulator of securities, primarily responsible for looking after the small investor. I am fortunate to be served now as my administrative assistant by Wayne Howell, who was then the assistant commissioner of securities. So we have been together in this business of securities regulation or trying to detect fraud and prevent it for quite a while.

I will say that while I was Secretary of State, we saw various examples of fraud. We were the first State to put First Jersey Securities out of business. We were the first State to come with a major fine against Drexel Burnham Lambert. We were the first State to really run the penny stock industry out of our State. So I have been dealing with the question of fraud and securities malfeasance for quite a while.

I will say that if the allegations here in this case of Enron are true, it is the worst case of lying, cheating, and stealing that I have come across in my public life and in 20 years, almost, of dealing with the securities industry.

We, in the Congress, will be hearing volumes of testimony and evidence related to this collapse, but it really does come down to this: Enron possibly lied, cheated, and stole from its own investors and employees. That is the bottom line.

It is interesting that in combat, officers eat last. It is obvious in the combat in the marketplace, Enron officers ate first and left the troops to fend for themselves. That is unconscionable. It is unconscionable in war, it is unconscionable in peace, and it is unconscionable in our economy.

We are actually here in this Committee to see if this is true, if these allegations were indeed the case. We have got hearings, subpoenas, and so forth. The bottom line is that this is real. It is real in my State. We have a teacher retirement system there. We have an employees' retirement system there. They have already lost \$127 million from the Enron collapse.

There are people in my State who worked for Enron. I came across a family the other day that, through their 401(k) program that they thought was very solid and sound, they invested their life savings. The head of that family is now sacking groceries—in the background himself—and does not really have a substantial future.

There were really two Enrons: One run for the insiders and the big boys at the top; the other Enron run for the employees and the public.

Some interesting facts: If you were an Enron insider, from the sale of company stock last year, you made \$130 million. But if you were just a shareholder, you took a \$63 billion hit.

The average compensation for just a board member of Enron, \$400,000—but the average loss if you were just an investor was 71 percent.

If you were an insider and one of the big boys that ran that operation, you put together 900 partnerships that were based offshore, and then Enron itself paid no Federal taxes last year.

These numbers really paint a tale of two corporations, basically a corporation that the average citizen and the average employee could not get a handle on in truth. But there is Ken Lay giving employees in an online chat in September these words, when he said about Enron stock it was "an incredible bargain."

Now, basically, the two Enrons had a powerful negative effect. It is fascinating that over \$1 billion has been lost by retirement funds, pension funds of people like teachers, firefighters, and other public employees. What an irony. The very first responders we depend on in case of a terrorist attack were the first to get hurt by the Enron collapse.

Most pension funds, mutual funds, and institutional investors held some Enron stock, and when one out of every two Americans are invested in the market, most small investors in America now have lost money over the Enron collapse, whether they know it or not.

A sound investment is based on sound information. Georgia is a full-disclosure State. One of the things that bothers me most about the Enron situation is the lack of full disclosure, the lack of transparency. What kind of information did Enron investors have? Again, they had assurances from Ken Lay in September that "the company is fundamentally sound." An outright lie. They had recommendations from Wall Street's top investment firms recommending Enron as a strong buy. Wrong. And they had a stamp of approval from auditor Arthur Andersen saying that information in Enron's financial statements was reliable. False and fraudulent.

Of course, we all know what is the situation now. Having been Secretary of State as I was in charge of professional boards also, and one of those was the CPA Board in Georgia. I find it hard to believe that professional people, CPAs, sworn to do a professional job, would not only be analyzing the books but cooking the books at the same time. What an American tragedy.

Mr. Chairman, as I go over these reams of documents, and go through these hearings, I will try to keep an open mind. But I am shocked at the revelations already disclosed to the Committee, not only what were potentially illegal, but also what were the legal actions taken by the corporations, actions which were perfectly legal but designed to hide losses, evade regulators, enrich corporate insiders.

Despite all these accounting irregularities, Enron's most recent annual report included two statements from its accounting firm, Arthur Andersen. One stated Andersen's opinion that Enron's internal accounting system was "adequate to provide reasonable assurance as to the reliability of financial statements." A lie. The other stated Enron's financial reports "present fairly in all material aspects the financial condition" of the company. Wrong.

Why would Andersen make these statements? The real question is: Why not? They were both Enron's accountant and its strategic business consultant. The fox was truly guarding the chicken coop, and ultimately the people of America have had to pay a great price.

Interesting that this is not isolated. Twenty years ago, consulting fees added up to about one-tenth of the revenues for major accounting firms. Today, those consulting firms—they account for about half of the revenues for these consulting firms.

So the safeguards we thought we had in place have become little more than window dressing. Our confidence is shaken. But hopefully this Committee can address this and, through real legislation and real sunlight on the problem and real transparency in securities markets, can restore some of the lost confidence we have all suffered.

Thank you, Mr. Chairman.

Chairman LIEBERMAN. Thank you very much, Senator Cleland. Senator Bennett.

OPENING STATEMENT OF SENATOR BENNETT

Senator BENNETT. Thank you, Mr. Chairman.

We have had a lot of conversation about Enron and Enron executives, and I won't repeat any of that, but will just add this reflection:

Had the Enron business plan worked, of course, they would all be heroes. That is a little like saying had the roulette wheel come up red instead of black, the investor who put his money on red would be considered a really smart guy, because what Enron management was doing was almost as dangerous, if not as dangerous, as going to Las Vegas and putting their chips on one number or another as far as the roulette table is concerned. But they were the management. They were running the company, and they decide that was the right thing to do.

What distresses me is that nobody who was looking over their shoulders pointed out that they were gambling in such a high-risk circumstance.

We have heard about Arthur Andersen. The auditors didn't. We have heard about the analysts who didn't look as deep as they should but were anxious to hang on to their relationships. We haven't heard anything about the outside directors. I have served on boards of public companies, and I can give examples, as everyone in the room can, of outside directors who said, "Wait a minute, we have a fiduciary responsibility as outside directors to call a halt to this."

My first experience with a major bankruptcy was when I was serving in the Nixon Administration on the Penn Central Railroad, which in its own way was as glittering an example of corporate success as Enron was, and it ended up going belly up.

The people who called that shot, who blew that whistle, who raised the specter of bankruptcy were the outside directors. I remember very clearly when they came to the Nixon Administration and said there is a serious problem. And I won't go into the details of what we then dealt with in trying to ameliorate the failure of the then Nation's largest railroad, with all of the implications that had for transportation policy throughout the country. But it was the outside directors who said we have a fiduciary responsibility to the shareholders to point out the fact that management is on a very dangerous course and this railroad is going to go under.

So there is a broader blanket to be thrown out here than just beating up on the top executives of Enron, and I concur in the beating up that has gone on. I am not trying to defend them. But we investors depend on auditors; we depend on the analysts from the big investment firms; and we depend on the system of outside directors. I think there is a requirement that X percentage of the directors be outside directors, not insiders. And that system has failed us.

I am not sure we can resolve it by passing laws that say every outside director will henceforth take his duty seriously. I know some outside directors, potential outside directors who refused to accept appointments because they said you don't have adequate insurance for the kind of class action lawsuits if I take this on.

But this is an opportunity for us to examine all aspects of the way public companies work in this country and see what we can do to improve it.

Thank you, Mr. Chairman.

Chairman LIEBERMAN. Thank you, Senator Bennett. Senator Carper.

OPENING STATEMENT OF SENATOR CARPER

Senator CARPER. Thank you, Mr. Chairman. I will not attempt to match the outrage or the eloquence of my colleagues who have spoken before me. I would observe that I have never had the pleasure of hearing Mr. Levitt or Mr. Turner testify. I am going to get that chance, and I am looking forward to that opportunity, and I am going to be real brief.

Mr. Chairman, I have a statement I would like to enter for the record, if I could.

Chairman LIEBERMAN. Without objection, so ordered.

[The prepared statement of Senator Carper follows:]

OPENING PREPARED STATEMENT OF SENATOR CARPER

I know we've all read a lot in recent weeks about Enron's collapse and I know most of my colleagues and I will have multiple opportunities to study more closely what happened and what we can do to prevent it from happening again. The Justice Department and a number of congressional committees are also looking into this matter. As we go about our work, however, I believe it is important to recognize that Enron is not an isolated incident but instead the latest, and certainly the largest and most high-profile in a series large-scale corporate accounting mishaps. While not on the same scale, Sunbeam, Waste Management, Rite Aid, Lucent and Xerox have all had problems similar to Enron's.

We're not here this morning to hunt down the juicy details about who at Enron, Arthur Andersen or even the Bush Administration knew what and what they were doing about it. What we are doing is taking a look at some of the broader public policy questions raised by this company's failure.

While the United States still has the best auditing and accounting standards in the world, and thus the strongest capital markets, Enron illustrates areas where these standards must be improved. I don't know yet which is the best course of action but we need to take steps before we hear about the next Enron to address the independence of auditors and analysts, the oversight of the accounting profession and the transparency of corporate disclosures.

In recent years, more and more Americans at all income levels have put more and more of their retirement savings in the stock market. Enron's failure raises serious questions about the accuracy of the information investors have access to when making investment decisions. Investors have lost millions on their Enron stock, and countless Enron employees have watched their retirement savings vanish as their company collapsed in a matter of months. Congress, regulators and the accounting profession must act now to restore investors' confidence.

Senator CARPER. Senator Voinovich, alluded earlier to his participation in the State of Ohio's pension plan for its employees when he was governor. My guess is he also nominated those who served as members of the board of trustees to oversee that pension plan. I had a similar responsibility as governor for Delaware for a number of years. I took that responsibility seriously, as I am sure he did.

There is more to this than the outrage that we feel on behalf of those Enron employees who have lost their life savings. There is more to this than the outrage we feel for those who might be members of the Ohio or Delaware State employee pension plans who have lost measurably their retirement savings.

There is a bigger question, and that is the confidence that the rest of the world, which is looking for places to invest their money to ensure that we continue to enjoy their confidence; and as trillions of dollars move throughout the investment community and many of them end up here, that we continue to be an attractive environment in which to invest those funds.

One of the best ways that we can do that, once we have completed flogged verbally those who have caused this disaster, is to bear down and stay with this issue when the media maybe loses attention and to continue to probe and to find the answers to the questions so that we can ensure that not only have we just gotten some satisfaction from venting our spleen at the outrages we have learned of, but we have actually done something real to ensure that other employees of companies but also other investors from around the world will continue to invest in the securities within this country with the kind of confidence that has enabled us to be the most successful Nation on Earth.

Thank you, Mr. Chairman.

Chairman LIEBERMAN. Thank you, Senator Carper. That is certainly our intention, which is to be judged by the ultimate product of our oversight and investigation.

Senator Bunning.

OPENING STATEMENT OF SENATOR BUNNING

Senator BUNNING. Thank you, Mr. Chairman.

Obviously what we have before us today is a mess. There is no other way to look at it. We have an energy trading company basically in ruins, thousands of employees with little or no retirement savings, a major accounting firm under a cloud, and investors left holding the bag.

We have heard allegations of shredding documents, shady business deals, and insider trading. Every day it seems a new revelation comes to light.

As it has been mentioned, in the year 2000, *Fortune* magazine listed Enron as the seventh largest corporation in America. Now the company has filed bankruptcy, the largest business ever to do so in U.S. history.

Enron's fall was relatively quick, but it seems to come on the heels of several years of questionable business deals. Enron's financial transactions are also extremely complicated, and we are only beginning to understand exactly what happened to this company.

We are going to be asking who, what, when, where, and why for a long time. I am confident that Congress and the Federal agencies will move as quickly as possible to get the answers to these questions.

This is just the first of, I imagine, many hearings the Governmental Affairs Committee will hold, and at last count, there were almost a dozen other congressional committees digging into this Enron problem. Combine that with the investigations by the SEC, Justice, Labor, the IRS, and all the private lawsuits that have been filed, and you have definitely got a full-blown financial meltdown.

Some people have already started offering ideas about ways we can prevent this from happening again. While ideas are always helpful, the last thing we need is a knee-jerk reaction.

Before we charge in the middle of it and start making changes, we have to understand exactly what happened before we can seriously propose legislation or regulatory changes. The story of Enron employees who not only lost their jobs but also their retirement savings should be a major wake-up call for all of us to look at the companies that require their employees to invest their 401(k)'s in their own stocks.

I am looking forward to working with the Committee as we get to the bottom of this Enron mess and consider the changes that need to be made.

Thank you, Mr. Chairman.

Chairman LIEBERMAN. Thank you, Senator Bunning. Senator Carnahan.

OPENING STATEMENT OF SENATOR CARNAHAN

Senator CARNAHAN. Thank you, Mr. Chairman.

America has the most vibrant and dynamic economy in the world. The foundation of our economy is our capital markets, which are robust and resilient. But the success of these markets depends on the free flow of accurate and reliable information. Our markets are the envy of the world because of the confidence that investors have in the private and public institutions that produce, verify, and analyze this information.

The collapse of Enron, however, represents a dramatic failure of these institutions. These failures will have repercussions for years to come. There were a number of failings, and let me mention just three.

The first failing was committed by the company executives who had a legal duty to act in the best interest of the shareholders. And while I do not want to prejudge the facts in this case, based on what we now know, it is fair to say that Enron executives did not make full and candid disclosures of the company's financial condition until they were forced to do so.

The next failure came when the accountants who were charged with auditing the information that Enron presented certified that it was consistent with the generally accepted accounting principles. In this instance, the same firm who was auditing Enron's financial records was also advising Enron on its business operations and accruing lucrative fees. We do not know the total effect of this blatant conflict of interest, but we know that the accountants failed to protect investors.

And, finally, there was the failure of government agencies. The SEC is charged with regulating the financial activities of publicly traded companies. They should ensure that the information provided to investors is accurate.

But with all of these safeguards in place, what went wrong? Why didn't the alarm bells go off sooner? These multiple failures have created multiple victims. I feel for the employees who worked for Enron, those who dedicated themselves to that company for so long and now find themselves financially devastated.

And I sympathize with those who invested in Enron. They had no reason to mistrust the information that Enron published to the world. The massive debt hidden in partnerships was not known to them or to the hundreds of analysts and advisors upon whom they relied.

Public employees in Missouri have suffered large losses. The Missouri State Employees Retirement System has an impeccable record of making conservative, prudent investments of employees' pension funds. Still, the system owned just under 750,000 Enron shares prior to the collapse and lost \$8.7 million. Missouri teachers fared even worse. Their retirement plan lost \$22.8 million from investments in Enron.

If these sophisticated investors could not detect that Enron was in poor financial condition, how could the average investor, putting aside money for college or for retirement, how could they have known?

Let me also suggest that the victims are not limited to those who invested in Enron. Every person who owns stock or a mutual fund or has a pension will suffer due to the collapse of Enron. The action of Enron's executives and its accountants together with the failure of our oversight agencies have eroded investor confidence in our markets.

Investors never had to consider that a large, reportedly profitable company might go belly up in a span of months. Now they do.

Investors never had to question whether a prestigious accounting firm would certify balance sheets that were grossly misleading. And now they do.

Investors never had to wonder whether respected, highly compensated executives were playing a risky shell game with billions of dollars. But now, thanks to Enron, they do.

This scandal will have an impact on investors' confidence, stock prices, and access to capital for many years to come. The task of this Committee and the Congress as a whole is to identify where the system failed, fix those problems, and begin to remedy them.

We need a greater transparency and an earlier warning system. One warning system that a company may be in trouble is when its executives are selling large amounts of stock. I have learned, however, that information about insider trading is not easily accessible. When I directed my staff to request information from the SEC about sales by Enron executives, they were told that I would have to file a written request and wait 15 days. The SEC also stated that 95 percent of the reports of insider trading were not filed electronically. This is unacceptable in a computer age.

So, today, I will introduce legislation that requires information about insider sales of publicly traded companies to be filed elec-

tronically on the day of the sale. The bill will also require the SEC to make this information available to the public on the Internet.

This single reform could dramatically level the playing field between insiders and ordinary investors. Never again would company executives be able to dump large amounts of company stock without facing immediate scrutiny about the financial health of their company.

I know my colleagues will be proposing many other new ideas in the coming days, and I hope these hearings will result in reforms, for never again should workers and investors be violated as they have been by an American corporation.

Thank you, Mr. Chairman.

Chairman LIEBERMAN. Thank you, Senator Carnahan. Senator Dayton.

OPENING STATEMENT OF SENATOR DAYTON

Senator DAYTON. Thank you, Mr. Chairman. I want to commend you for holding this very important hearing. I also want to say to my colleague, Senator Carnahan, please put me down as a cosponsor of your bill.

Mr. Chairman, I hope that this and subsequent hearings will discover and disclose the truth about this financial debacle, especially the actions of Enron's officers and directors who caused it and of the auditors at Arthur Andersen who abetted its concealment. The recent shredding of documents by both Enron and Andersen personnel shows how much they don't want us to know about their irresponsible and possibly illegal actions.

This hearing properly focuses on the failures of government regulation and oversight which permitted or failed to detect the company's questionable dealings, the mounting losses, and the resulting financial collapse.

While we must identify those regulatory shortcomings and propose the necessary remedies, it is very important, I believe, not to imply that they bear the primary responsibility for Enron's disastrous collapse. In my view, that blame and shame belong first and foremost to the Enron officers and directors who devised, approved, and then concealed these unwise and unsound financial schemes; and, second, to the Andersen auditors who abetted them.

These were not a few honest corporate mistakes. They appear to be a multitude of deliberate actions taken over several years to maximize profits—nothing wrong with that—but also to cover up losses, evade taxes, enrich company insiders, and then deceive employees, stockholders, and regulators.

These corporate misdeeds have caused enormous damage to thousands of Enron employees. It is heartbreaking to read about the honorable, hard working Americans who have lost their jobs, their retirement savings, and their life's security, and who also were lied to by Enron's top management about the company's actual condition.

Enron's investors have lost over \$80 billion from the stock's collapse. Like the employees, they didn't know about the company's concealed dealings, 881 offshore accounts, successive disasters, and mounting debt. Enron's top executives certainly knew. They unloaded over \$1 billion of their stock before its collapse.

Someone who should have known about Enron's true financial condition, and who was responsible for telling everyone else about it was the supposedly independent auditor, Arthur Andersen. I know something about auditing from my 4 years as Minnesota's State Auditor. The auditor exists and is paid for one essential purpose: To assure everyone else that a company is reporting its financial condition completely, honestly, and accurately.

Whatever the complexities of corporate transactions, the auditor has one simple standard: The truth. Is the client telling the truth and all of the truth? Everyone else in our economic system, financial institutions, capital markets, investors, and other companies, all rely upon the auditor's ability and integrity. There is mounting evidence that Arthur Andersen in this instance violated that trust.

In 1997, the auditors reportedly determined that Enron's stated earnings of \$105 million were \$51 million too high. Nevertheless, Andersen agreed to invoke a materiality provision and signed off on \$105 million as Enron's reported earnings. That is deceitful, dishonest, and wrong. And no one needs an accounting manual to know it.

Last October, when Enron reported a third-quarter loss of \$618 million, it also disclosed that it had overstated its profits by nearly \$600 million during the prior 5 years. Enron's CEO also mentioned that the company's value had declined by \$1.2 billion as a result of its deals with certain partnerships.

Those disclosures precipitated the stock's collapse, and at the time both Enron and Andersen employees were reportedly shredding documents.

If time permitted, Mr. Chairman, I would present more damning evidence. However, I also want to address the inadequacies in government rules, disclosure requirements, and oversight which permitted and then failed to detect these egregious abuses.

I believe that this and subsequent hearings must investigate the following matters: In 1993, the Chairwoman of the Commodity Futures Trading Commission, just before her departure, persuaded that board to exempt energy futures from its regulation and oversight. Shortly after her departure, that Chairwoman joined Enron's board of directors.

Then 2 years ago, when Congress was updating these commodity regulations and oversight responsibilities, Enron reportedly lobbied aggressively and successfully to keep energy financial transactions exempted from any government regulation or oversight. William Rainer, then the Chairman of the Commodity Futures Trading Commission, testified that he was "deeply concerned" about exempting energy trades from regulation, because those dealers had no one else regulating them, whereas the dealers in financial derivatives were still subject to other Federal financial regulation. His warning went unheeded and proved to be prophetic.

Recently, Charles Bowsher, who served as the Comptroller General of the United States from 1981 to 1996, observed, "Money allowed the Enron leadership to come to town. If you look back over the last 5 years, what they did get was no oversight."

In another area, then-Chairman of the Securities and Exchange Commission, Mr. Levitt, tried repeatedly and courageously to pass legislation that would prohibit an auditor from both conducting the

annual independent audit and also providing extensive accounting services. Andersen pocketed \$52 million from that dual role in its last reported year. Yet, the accounting industry has strongly opposed this and other proposed reforms.

And now the person who led the industry's successful opposition has been appointed by President Bush to chair the Securities and Exchange Commission. Addressing an accounting industry conference, the new chairman lamented that previously the SEC had not been a "kinder and gentler place for accountants," but that would change. Henceforth, he told them, the SEC will have a "continuing dialogue and partnership with the accounting profession, and we will do everything in our power to evidence a new era of respect and cooperation."

Unfortunately, what is needed now is a new era of higher standards and stricter accountability for the accounting industry. Financial relationships which compromise auditors' independence should be prohibited. Existing peer reviews in which firms exonerate each other must be replaced with a strong, independent governing board. That board or another independent entity must regularly review and update existing audit standards and the generally accepted accounting principles which comprise them. And neither the standards nor the principles nor the enforcement of them should be adjudicated by Congress.

If these shortcomings are not swiftly remedied, there will be more Enrons, not in the sense of companies failing, which is an unpleasant but inescapable feature of capitalism, but in the sense that these failures are caused by mistakes and misdeeds previously hidden or misreported. This oversight laxity benefits a relatively few but well-connected corporate cowboys, who want to play fast and loose with other people's capital and the people they pay to lie with them. But it is terribly harmful to everyone else in this country, the millions of businessmen and businesswomen, company employees, and investors whose livelihoods depend upon an honest and reliable economic system. It is our responsibility to ensure that system.

Thank you, Mr. Chairman.

Chairman LIEBERMAN. Thank you very much, Senator Dayton.

I want to thank all my colleagues on the Committee for their opening statements. I appreciate them. As Chairman of the Committee, I am proud of them. I think what is reflected here is a shared sense of outrage about what happened as we know it now in the Enron scandal and a shared desire to end this investigation, whenever we conclude it is ended, with a series of proposals for reform that will do as best as we can to ensure that the Enron scandal or anything like it never happens again.

So I appreciate very much what was said in reflection of the experience and the insight that is here on the Committee, and it gives me confidence that the goal that all of us have, which is to conduct a rigorous, nonpartisan investigation producing concrete proposals for reform, will be accomplished.

We will go now to our witnesses. Mr. Levitt and Mr. Turner, thanks very much for your patience as this Committee begins what I have described as a long journey, an important journey ahead of us. Arthur Levitt, we couldn't have a better witness to start this

off than yourself. You worked on Wall Street. You were the chairman of the American Stock Exchange, worked as chairman of the New York City Economic Development Corporation. In an unusual chapter of your life, you owned the *Roll Call* newspaper here on Capitol Hill, but then most directly and significantly related to these matters, for 8 years, from 1993 to 2001, you were the Chair of the Securities and Exchange Commission.

Lynn Turner, a background in education and in business accounting, served for 3 years as chief accountant of the Securities and Exchange Commission during the time that Arthur Levitt was chairman.

I would say, as you have heard these statements, that I appreciate very much that both of you are here. There are several investigations of Enron going on. They are fact-intensive. We have begun one ourselves, and those are going on both in Congress and in prosecutorial offices around the country. But it seemed to me that as we started our investigation, we would benefit greatly from having you two and the expert witnesses on the panel to follow, if you will, to take us up to the mountaintop and, based on what we know about Enron and what happened to it today, help us understand the facts as we know them, looking backward, but also give us some guidance as we begin our investigation as to what the most critical questions are we should ask and perhaps even suggest to us what you would guess based on your considerable experience some of the answers to those questions might be.

So, with that, and our thanks, I now welcome the testimony of Arthur Levitt.

**TESTIMONY OF HON. ARTHUR LEVITT, JR.,¹ FORMER
CHAIRMAN, U.S. SECURITIES AND EXCHANGE COMMISSION**

Mr. LEVITT. Mr. Chairman, Senator Thompson, and Members of the Committee, thank you for the invitation to share my thoughts on the failure of Enron and its implications for our financial markets.

Today, there is an emerging crisis of systemic confidence in our markets. What has failed is nothing less than the system for overseeing our capital markets. I do think we have an opportunity to repair trust in those on whom investors depend, and in the process, trust in the numbers that are the backbone of our markets. But our response must be comprehensive. Healthy and resilient financial markets depend on the accountability of every single one of its key actors—managers, auditors, directors, analysts, lawyers, rating agencies, standard setters, and regulators.

Enron's collapse did not occur in a vacuum. Its backdrop is an obsessive zeal by too many American companies to project greater earnings from year to year. When I was at the SEC, I referred to this as a "culture of gamesmanship"—a gamesmanship that says it is OK to bend the rules, to tweak the numbers, and let obvious and important discrepancies slide; a gamesmanship where companies bend to the desires and pressures of Wall Street analysts rather than to the reality of the numbers; where analysts more often overlook dubious accounting practices and too often are selling poten-

¹The prepared statement of Mr. Levitt appears in the Appendix on page 75.

tially lucrative investment banking deals; where auditors are more occupied with selling other services and making clients happy than detecting potential problems; and where directors are more concerned about not offending management than with protecting shareholders.

Any reforms must recognize the importance of the gatekeepers in safeguarding the interests of investors and the fundamental need to preserve and enhance those gatekeepers' independence. Certainly these steps, or any steps, are not a panacea, but we have got to begin to reinvigorate the financial checks and balances that over the years, as a result of nothing less than a cultural change, has eroded in America.

First, we must better expose Wall Street analysts' conflicts of interest. For years, we have known that analysts' compensation is tied to their ability to bring in or support investment banking deals. In early December, with Enron trading at 75 cents a share, 12 of the 17 analysts who covered Enron rated the stock either a hold or a buy.

Two years ago, I asked the New York Stock Exchange and the National Association of Securities Dealers to require investment banks and their analysts to disclose clearly all financial relationships with the companies they rate. That rulemaking—still not finalized—should go further and mandate that analysts disclose how their compensation is affected by their firm's investment banking relationships. And Wall Street's major firms—not its trade group—need to take immediate steps to reform how analysts are compensated.

As long as analysts are paid based on banking deals that they generate or work on, there will always be a cloud over what they say. Analysts also should not be allowed to trade the stock of any company for which they have issued a recommendation in the last 30 days.

Second, company boards, unhappily, fail to confront management with tough questions. Stock exchanges, as a listing condition, should require at least a majority of the directors on company boards to meet a strict definition of independence. That means no consulting fees, use of corporate aircraft without reimbursement, support of director-connected philanthropies, or the kinds of corporate seductions that are present in all too many board rooms in this country. In Enron's case, at least three so-called independent board members would have been disqualified under this test of independence.

Third, many accounting rules need to be updated to better reflect changing business practices to give investors a better understanding of the underlying health of companies.

Because the Financial Accounting Standards Board is funded and overseen by accounting firms and their clients, its decisions have become agonizingly slow. This well-meaning group must defend itself as well from congressional pressure, which is often applied when powerful constituents hope to undermine a rule that might hurt their rulings. FASB's funding should be secured not just through the accounting firms and the corporations for whom they establish standards, but also a number of market participants from the stock exchanges, to banks, and to mutual funds.

The Financial Accounting Foundation, which chooses FASB members, should be composed entirely of the best qualified people, the people with the best judgment, not merely those who neatly represent constituent interests. I have never favored constituent boards and I think the way this board is structured really defies the kind of standard setting that is cried out for in this situation. The FASB should then be able to focus more on getting the standards right and avoiding delays and compromises that ill serve investors.

I will turn briefly to probably the most urgent area of reform. Like no other, the accounting profession has been handed an invaluable but a fragile franchise. From this Federal mandate to certify financial statements, the profession has prospered greatly. But as an edict for the public good, this franchise is only as valuable as the public service it provides and as fragile as the public confidence that gives it life.

It is well past time to recognize that the accounting profession's independence has been compromised. Two years ago the SEC proposed significant limits on the types of consulting work an accounting firm could perform for an audit client. An extraordinary amount of political pressure was brought to bear on the Commission. We ended up with the best possible solution, given the realities of the time. I would now urge, as a minimum, that we go back and reconsider some of the limits originally proposed, namely, a prohibition on the auditor designing or installing information technology systems and performing the internal audit.

Auditors, I believe, should also be barred from consulting on precisely how to structure transactions, such as the kinds of special purpose entities that Enron engaged in. This type of work only serves to help management get around the rules.

I also believe that the audit committees, not company management, should pre-approve all other consulting contracts with the audit firm. Such approvals should be granted rarely and only when the audit committee decides that a consulting contract is in the shareholders' best interests.

And last, I propose that serious consideration be given to requiring companies to change their audit firms, not just the partners, every 5 to 7 years to ensure that fresh and skeptical eyes are always looking at the numbers.

More than 3 decades ago, Leonard Spacek, a visionary accounting industry leader, stated that the profession could not survive as a group, obtain the confidence of the public unless, as a profession, we have a workable plan of self-regulation. Yet all along the profession has resisted meaningful oversight. Rarely, of all the groups that the Commission oversees, has this group ever spoken of the public interest.

We need a truly independent oversight body that has the power not only to set the standards by which audits are performed, but also to conduct timely investigations that cannot be deferred for any reason, and the ability to discipline accountants. All of this needs to be done with public accountability, not behind closed doors.

To preserve its integrity, this organization cannot be funded in any way by the accounting profession. The rise of the baby-boomer

generation, changing retirement patterns and markets that sometimes defied the laws of gravity brought more and more first-time investors into our markets. These are our friends. These are our neighbors, whose hopes and aspirations became inextricably linked to the health, the resiliency of our markets.

We assault those dreams if company executives sell out our shareholder faith and if those purporting to be independent are anything but. Enron, like every other financial failure before it, proves that investors bear the ultimate cost. It is time to repair what has been lost.

Thank you.

Chairman LIEBERMAN. Thank you, Mr. Levitt, for an excellent statement. Mr. Turner.

TESTIMONY OF LYNN E. TURNER,¹ FORMER CHIEF ACCOUNTANT, U.S. SECURITIES AND EXCHANGE COMMISSION

Mr. TURNER. Mr. Chairman, Senator Thompson, and Members of the Committee, Enron highlights two issues. The first is that accounting standards are meaningless unless fully complied with and enforced through a rigorous, unbiased, and independent audit. The process needs to be improved so as to yield more timely and higher quality standards. That is our accounting standard setting process.

But keep in mind that no matter how quickly information is reported to the public, or what information is reported, if it is inaccurate its value is lost. Even worse, bad information leads to counterproductive decisions.

To the first issue, we know that under the existing rules, Enron's financial statements should have presented a clearer picture than when they were first presented to investors. Based on filings the company made with the Securities and Exchange Commission in November of last year, there were four instances of non-compliance with existing rules. Three of these errors have resulted in Enron restating its financial statements for improperly recording an approximately \$1.2 billion in additional equity; the company failing to book audit adjustments, decreasing income by \$51 million or 48.6 percent of the reported net income of \$105 million in 1997, as we already heard from Senator Dayton; and the company failing to consolidate or include the numbers, including debt, from partnerships commonly referred to as special purpose entities in Enron's financial statements.

These special purpose entities, or SPEs, are typically designed for a specific transaction. SPEs come in various forms, including partnerships like Enron established, corporations, or even trusts. SPEs are used for many purposes such as financing buildings or equipment, raising capital by transferring receivables, and providing capital to a bank that has troubled loans that are shifted out at the bank. While SPEs are sometimes used for legitimate business purposes, they are also used to hide liabilities away from the unwary investor.

SPEs usually involve at least four parties when they are set up: The company who sets it up, called the sponsor, in our case Enron;

¹The prepared statement of Mr. Turner with an attachment appears in the Appendix on page 78.

the SPE itself, as you have read about in the paper, with names like LJM1, Chewco or Jedi; a lender to the SPE, who is willing to finance its activities; and an investor from the outside who will own the SPE. In a nutshell, the sponsor establishes the SPE which in turn acquires or builds an asset. The funding is provided by the lender who in turn may look to the sponsor for some form of support for the loan such as a guarantee or credit enhancement.

The SPE is owned by an independent investor who puts in, in the form of equity, at least 3 percent of the amount of capital needed to acquire the asset. The debt of the lender is then paid back through lease payments or securitization of the SPE's assets. There is an expanded discussion of SPEs in my written statement. I would be happy to respond later to any questions you might have.

The fourth question raised with respect to the financial statements of Enron involves the adequacy of the disclosures, the transactions Enron entered into with related parties such as SPEs. The description and discussion of these related party transactions are significantly greater in detail in the November 2001 filings than had previously been disclosed. One can only ask if now, why not before?

New accounting rules were not needed to prevent the restatements of Enron's financial statements or to improve the quality of some of its disclosures. Compliance with and enforcement of the accounting rules that have been on the books for years would have given investors a timely and more transparent picture of the trouble the company was in. And the security rules also currently require disclosures that are intended to give the investor an opportunity to look at the company "through the eyes of management."

While Enron has correctly been described as a business failure, in the end it was also a failure that the audited numbers did not report the true economic condition of the company in an accurate or timely manner to the investors. To correct this lack of compliance with accounting standards I urge you to consider the imperative need for an effective, independent professional oversight body for the accounting profession that has the following critical elements: It is conducted by an adequately funded organization. Its members are drawn from the public and not currently practicing accountants. It has the ability to effectively and expeditiously investigate and then effectively and expeditiously discipline those who failed to follow the rules. It must have the power to establish auditing and quality control standards that serve the interests of investors, especially those when these vary from the interest of the profession. And it inspects the work of auditors on an ongoing basis to ensure they have made the investing public, and not the amount of consulting fees they can generate, their number one priority.

In studying this issue, I would encourage you to consider various types of regulatory organizations that have already been established, including the NASDR, the National Transportation Board and the recently created foundation in the United Kingdom.

Let me just briefly mention the second issue, which deals with accounting disclosures. We need to enhance disclosures regarding events and transactions that, should they occur, would result in a company being required to make payments to a third party. We have now seen this type of meltdown, as we have seen in Long-

Term Capital Management, in Enron, and those disclosures need to be made to prevent that in the future.

In addition, greater disclosure should be required of key performance indicators that provide investors with the ability to identify at an early stage trends in the business that may have predictive ability about what is going on.

Second, as Chairman Levitt has noted, our standard-setting process for issues such as SPEs has taken longer than it has taken my children to graduate from high school. If the SEC is to continue to look to the private sector to set standards, which I do very strongly support, then the SEC and investors have the right to expect timely resolution of this and other important issues. If the FASB were unable to rectify the SPE issue by the end of 2002, then I would urge the SEC to take action.

Third, FASB can accomplish its goal of publishing guidance in a timely fashion only if unimpeded by the constant lobbying of special interests who seek to slow down its processes with issues that lack relevance and who too often run to our government to seek its intervention in order to keep investors in the dark about the numbers.

Fourth, the FASB's emerging task force is comprised entirely of representatives of industry and the accounting profession and lacks representatives from the investing public and community. Its mission does not mandate standards that result in the most transparent reporting for investors. In fact, it has at times seemed to be more intent on grandfathering poor accounting from the past. This should change.

And finally, one of the stark realities the FASB has faced in the past when setting standards is that before the ink dries, the investment banking community and accountants are joining forces to find ways to structure transactions, just as we have seen in the Enron case, to get around new rules. It is time to get away from this mentality and a good starting point would be to prohibit auditors from designing and structuring transactions that result in less rather than more transparency for investors.

Thank you.

Chairman LIEBERMAN. Thank you, Mr. Turner, for a very helpful statement. We are going to go around now and have 7 minutes for each Senator to ask you questions.

I wanted to start with a broader baseline question, if I can, Mr. Levitt, and put it in this context: Congress and, in fact, State legislatures, etc., all over the country pass laws which are aimed at encoding our best aspirations for our behavior, encouraging good behavior and prohibiting and ultimately punishing bad behavior. Notwithstanding that, human nature being what it is, people will violate those laws.

So as you look at what we know now about the Enron collapse, which we now call the Enron scandal, is this one of those situations where these folks were just going to do what they did regardless of what the law was? Or is it a situation where we can now look back and say if the laws had been different, perhaps—as your opening statement indicated—self-regulation of professions had been different, if the agencies had had more authority, we could have prevented the collapse of Enron? Or we certainly could have

prevented some of the damage that was done to the thousands of employees and investors who lost their life savings?

I think you understand what I am asking. If the laws and agencies were better prepared, could we have protected a lot of the people who were hurt by Enron's collapse?

Mr. LEVITT. I have thought about that very question many times, and I think it is another case of the nail in the shoe of the horse. Any of the elements around the rating agencies, the standard setters, the regulators, the board, the analysts, the auditors, at different points in time could have blown the whistle, could have turned up what a sham this really was.

But these things, I do not think, happen in a vacuum. The fact that any one of them might have been able to do it says something about the confluence of all of them in this unhappy event, which I believe occurs only when there is a kind of cultural economic erosion created by a business community that is highly competitive, certainly a desirable characteristic, but where some of them begin to push toward the lines, and go over the line, others cannot afford not to follow. And almost everybody else is playing catch up.

And when you have an incidence of guile of this magnitude, playing catch up just is not enough.

Chairman LIEBERMAN. Of course, one of the functions or effects of law often is to effect the kind of culture that you have talked about. I think in one sense that comes to mind we have done that with regard to the environment over the years. We have changed the ethic out there so that a lot of what used to pass as business as usual now does not, and it does not require law everywhere. Potential polluters are cleaning up on their own. So part of the question is can we change the ethic that you have described quite correctly by what we do here?

Mr. LEVITT. Absolutely, you can change behavior. You can begin to get lots of those of us in this game to focus on it differently, to deal with our responsibilities differently. Right now this event has been a clarion call to America's boards of directors. Whether they stay with it depends on whether you can be focused in terms of a direction which will encompass the elements that led to this background. And they are very broad.

To focus merely on the auditors I think would be a mistake. This goes far beyond that.

Chairman LIEBERMAN. I agree. That is one of my hopes for this investigation and the others that are occurring, that by trying to tell the story—and obviously we are being assisted greatly by the media at this point—about what happened with Enron, we create a fact situation, an exposure, that presumably will alter the ethic as well. And then it is up to us and the professional groups that are out there, in terms of self-regulation, to encapsule that ethic as we go forward.

You talked in your opening statement about the importance of shoring up the independence and resolve of the gatekeepers which keep our markets honest—and, of course, I agree with you—the auditors, the analysts, the corporate directors, and the folks who set accounting standards.

I want to ask you, as a former Chairman of the SEC, about what its role is. Because I would guess that most investors, average in-

vestors, assume that it is the Securities and Exchange Commission that is the watchdog that makes sure that disasters like Enron do not occur. So I would like to ask you to give us a baseline here about what the SEC's role is in the system of gatekeepers guarding the integrity of the markets. And tell us if you think there is anything that should be done, particularly in the light of what we know about Enron now, to alter that role?

Mr. LEVITT. The SEC's role is multifaceted. It ultimately, I believe—and every chairman will view this from a different perspective. I think the most important constituent that this government agency has is America's individual investors. Nearly all of you have commented on confidence in our markets, and preserving that confidence by protection of the American investor is the primary goal of the SEC.

It is done in many different areas. The Commission has the responsibility for maintaining markets where competition is both fair and fierce. They have the responsibility for overseeing the standard-setting process which we delegated to the FASB. We have the responsibility that our regulation is based not on merit regulation but on full and on fair disclosure. And in that connection, we monitor thousands of filings every year. We have the responsibility when the system fails, when fraud enters into the picture, of bringing enforcement action.

Those are the multitude of responsibilities. Now I have learned through years in the private and public sector that to expect any government agencies to operate so comprehensively that they can eliminate all fraud and deception simply will not work. The SEC and investor protection in the United States is determined by a trilogy of private rights of action, of self regulation, and of the SEC's enforcement arm. Any one of those three could not do it alone.

Chairman LIEBERMAN. I believe my time is up. There is a question that maybe someone else will ask—and perhaps we can talk about it another time—which is whether there is a larger role here for the SEC, including as I gather occurs—and I am not proposing this, I am raising it. I gather it occurs in some developed economies in Europe, for instance, where there is a public auditor. There are public employees who audit the books of publicly held corporations, so that they are obviously thoroughly independent and do not have any of the conflicts that we have seen occur here with regard to private auditors. I am going to hold on that and just leave the question with you.

I will now yield to Senator Thompson.

Senator THOMPSON. Thank you, Mr. Chairman. And, gentlemen, thank you for your analysis and suggestions as to what we might do. It is remarkable the things that are so self-evident that need to be done have to really hit home to us in the context of a crisis like this. But now we have the crisis, and perhaps we can do some things that we should have done a long time ago.

I think you rightfully point out the problem with the gatekeepers and what seems to be just an inherent conflict of interest for all of them. I guess a lot of it cannot be avoided. But we have a situation here where the numbers are so great, a tremendous amount of dollars with so many people dependent on the company making

the numbers, the analysts pushing it. And obviously the accountants and the auditors have a great deal of responsibility.

But I guess even more perplexing to me are these outside analysts. We criticize Mr. Lay for touting his own stock. I think the latest was September 26. Then October 16 Enron posted a loss of \$618 million. And then, as you pointed out, Mr. Levitt, you may be looking at another date, but as late as October 25, when Enron stock was in free fall, 15 out of 17 analysts tracking the stock still had buy or strong buy recommendations, despite the fact that analysts for more than a year were complaining that they could not figure out how Enron made money. Plus, you had the corporate executives selling stock. Plus, you had the CEO leaving in August.

What in the world were these analysts looking at when they made these buy recommendations? Was their desire to be deceived so great that they refused to look at the facts before them? Or were the transactions so complicated that they just could not figure it out and went ahead on hope and expectation that things would work out in the end? What do you think?

Mr. LEVITT. I think that it is a little of all of that. I used to run a large brokerage firm which had many analysts. And an analyst, I have found, hates to prove himself wrong. So if an analyst is recommending a stock at 80 and it goes to 60 and 50, boy, it was a good buy then, it is a better buy now. And sell-side analysis has become both conflicted—and one of you mentioned the multitude of conflicts in this whole system. They clearly have been conflicted, and there is every reason that they might not want to interfere with an important investment banking client.

Senator, you said something which struck me as being critically important as we work through this process over the course of coming weeks and months. You said that real scandal is not what is illegal but what is permissible. And certainly, with respect to analysts and their conflicts which are hidden from public view, that is one of many examples that responds, that resonates to that statement of yours.

Senator THOMPSON. Can an American investor today depend on Wall Street analysts?

Mr. LEVITT. I think Wall Street sell-side analysis has lost virtually all credibility. So much of the revenues of firms depend upon investment banking that the importance of the analyst to acquiring and maintaining an investment banking relationship becomes a primary concern.

Senator THOMPSON. And, of course, the average investor certainly cannot analyze these complex financial statements.

Mr. LEVITT. It is difficult.

Senator THOMPSON. So they are basically left with total guesswork in the end, it would seem to me.

With regard to the auditors, it looks to me like one could make the case that the era of self-regulation should be over. I am not sure what the alternative would be. Obviously, the SEC would turn into a different organization, in some respects. But we have these outside entities now supposedly conducting oversight. I think some try to do a good job. The Financial Accounting Standards Board, as you say, are very slow on things such as rules with regard to some

of these complex new-type transactions, special purpose entities, and so forth.

Now, Chairman Pitt and I would appreciate your views for his recent suggestion for yet another independent entity that perhaps is financed differently and so forth. What difference that would make? What do we need to do in that regard? Do we need to continue to try to develop some kind of pristine entity out there that can oversee these boards, that will finally get it right?

And last, what is SEC's role in this? As I understand it, since the 1930's, the SEC has had the authority to set standards themselves, if you want to step in, if FASB is that slow in doing something that important, why does the SEC not step in?

So two or three or four questions in there for you.

Mr. LEVITT. I think the SEC does have the authority to set standards. I have found several areas of public policy in which the political process simply does not work. One is closing military bases and the other is setting accounting standards. I have just resisted getting the SEC directly involved in that. In this effort to work toward auditor independence, the pressure on us was so enormous that if you get to—

Senator THOMPSON. But if you are getting that kind of pressure, and with your stature and ability to withstand it and resist it, think of the pressure that these so-called independent boards of citizens will be getting.

Mr. LEVITT. Well, there is no perfect solution. What I would suggest, however, is a group similar to the POB, which is made up of some of the finest citizens in our community—

Senator THOMPSON. Who just retired en masse, as I understand.

Mr. LEVITT. But who had such an amorphous mandate and funding by the industry cheerleaders, rather than independent sources, that they were absolutely impotent. But if you gave a group of that caliber a firm mandate and the responsibility that only Congress can give to them to get at documents, to subpoena them, to get at it not just from the auditors but from the clients as well, because doing it otherwise is doing half the job. Give them the mandate, give them the funding.

Will that answer the problem? It is one important link, and it is one that I believe would begin to reassure the public.

Three years ago if you asked the typical American what he knows about accountants, they would shrug their shoulders. I went to my dentist here in Washington about 7 months ago, and before I began the painful process, the dentist turned to me and said, Arthur, those accountants are really scalawags, are they not? Well, when dentists begin to understand what accountants are, we have got a problem.

Senator THOMPSON. Maybe even we might, right? Is that what you are suggesting?

What do you think about Mr. Pitt's recommendation?

Mr. LEVITT. I would have to hear more about how the funding would take place, whether there could be the kind of deferral that I think has held up processes for years. I would have to know whether this would be a truly independent group. There are many more details to be worked out.

Senator THOMPSON. Mr. Turner, do you have ideas on that?

Mr. TURNER. I actually commend Chairman Pitt for heading, I think, in the right direction and trying to pull that all together in one organization. I think, as Chairman Levitt said, it is a step in the right direction, and I think it can work if we give it the independent funding and we have a real public board of the nature that you just heard about.

I think probably there are a lot of details to still hear about that we do not know. From what we have seen, I would say we probably have advanced the ball out of the end zone and up to about the 30, and we have probably still got about 70 yards to go.

Senator THOMPSON. Thank you, Mr. Chairman.

Chairman LIEBERMAN. A very seasonally appropriate metaphor. So you have told us what dentists think about accountants. What do you think accountants think about dentists?

Mr. TURNER. My wife is a dentist.

Chairman LIEBERMAN. So you want to recuse yourself. Senator Levin.

Senator LEVIN. Thank you, Mr. Chairman.

I would like to press you a little bit further on the Pitt proposal because it has been severely criticized, it seems to me. When we have a former U.S. Comptroller General and head of the GAO who is resigning apparently in protest in a mass resignation, as I understand, it is intended to be a protest to this new Pitt proposal because it does not have the features of independence which you both proclaim are so important. That has got to resonate a bit with us.

So I would like to press you a little bit further frankly on that issue. I know there are a lot of details still to be unveiled, but from what you know of the Pitt proposal, does it have the characteristics of an independent oversight body that has the power, in your words, not only to set the standards by which audits are performed but to conduct timely investigations that cannot be deferred for any reason, and to discipline accountants? From what you know, does it meet that standard?

Mr. LEVITT. If you had asked me that question a year ago, I probably would have answered in the affirmative. The environment today calls for very different remedies, very different actions. A year ago had you asked me whether I felt a legislative solution was desirable, I would have said no because of the unintended consequences. Today I would answer that in the affirmative.

You have to be, and I do not have to tell you because you often are in a situation where a crisis erupts right underneath you. And you have got to come out with an instant response. The press is at you, the legislature is harassing you. The world at large is demanding an action. I think in those instances perhaps the first action is not as thoughtful as it could be.

So I think that we have got to put a lot more teeth into the proposal than the initial proposal would appear to have come out.

Senator LEVIN. You are talking about the initial proposal of Mr. Pitt?

Mr. LEVITT. The initial Pitt proposal I think needs more teeth. Frankly, I need to see more about how it will be implemented.

Senator LEVIN. As you would approach it, which is now legislatively, as I understand it, that issue of having an independent

board oversee the auditors to make sure that there are, in fact, teeth, as you put it, who would select the members of that independent board? What should we look at? Should it be selected by the SEC? Should we try to set forth some kind of representation of various kinds of backgrounds and experiences? Give us some hint. Who, first, would make the appointment?

Mr. LEVITT. Every time I have gone down the road of selecting boards—and I have done this many times and I worked out a formula—I have always regretted it. There is no perfect way of doing it.

I certainly think that the SEC would be in a good position to start the ball rolling. And I know that Chairman Pitt has great confidence in the members of the POB. I think the POB might be a logical starting point for this. I have no doubt that Chairman Pitt will be in consultation with Mr. Bowsher, who is recognized for integrity and probity and understanding of these issues. He has the public's confidence.

Senator LEVIN. The Federal Accounting Standards Board, FASB, as you pointed out, has had tremendous pressures placed upon it and has not moved quickly in terms of the adoption of accounting standards. For instance, what should be on the balance sheet, what should be off the balance sheet. This is not the discipline side, which we have just discussed, but the standards as to what accountants should go by in making accounting decisions.

How would you change FASB to give it greater independence, an independent source of financing, and to represent, for instance, the investing public which has not been represented and to overcome other kinds of shortfalls? Should that be looked at legislatively? How do we go about that?

Mr. LEVITT. I believe that the FASB must be—the structure of it which is, their members are chosen by a constituent board made up of the securities industry, the accounting profession, a whole group of people not known necessarily for competence, although they are headed by a very effective leader, but known because of whom they represent. So I think the way the board is chosen should be reconsidered.

The fact that the board is funded by the very firms for whom they set standards, who often come back to them and say if you are going to set this standard we are going to cut off your funding. That is wrong. We have got to change their funding.

But ultimately, I think the SEC must get a little bit more involved in terms of being ready themselves to create a standard in the event that FASB is too slow to do their job. It is not something that I think is a comfortable position for the Commission to be in, but I see no other way around it.

Senator LEVIN. As you know, Mr. Levitt, I proposed a bill about 10 years ago which would have required stock options be treated the same way in company tax returns and in their earnings statements. Now they are allowed to treat them differently, not show them as an expense in their earnings statements, and therefore give a very different impression, a much more positive impression of the company in terms of its earnings and profits, at the same time taking a tax deduction in their tax returns.

What is your reaction to that? Should we change that? Treat them one way or the other, but to treat them consistently? So that when executives get these huge amounts of stock options—which resulted, in part, by the way, in Enron being able to show itself as being highly profitable—that they have got to then reflect it on the books the same way they reflect it on their income tax returns so that investors and stockholders understand that those options are a cost to the company?

Mr. LEVITT. I believe that clearly options have great value or we would not have seen the lobbying effort that we saw when this issue came up. During my first 4 months at the Commission, I had a policy of seeing anyone that wanted to see me. I spent nearly half my time talking to the business community that objected to that treatment, partially correctly because at that point the board was unable to establish a way of creating a value for those options.

I look back upon that period now and say that my greatest mistake was not pushing FASB harder to do that. Right now we have the International Accounting Standards Board ready to go down that road where international standard setters are doing that very thing. So I would be, in general, supportive of your recommendation, and I regret that I was not more aggressive in that area when I was at the Commission.

Senator LEVIN. Thank you. Thank you for your service, as well.

Just in closing, I will point out that in the October 1999 issue of the magazine that is put out by the chief financial officers, the so-called *CFO Magazine*, they handed out awards for the finest in finance. One of their winners was the chief financial officer of Enron, Arthur Fastow, who was applauded for developing “remarkably innovative financing” techniques. [Laughter.]

That is what we are investigating right now, but there is a lot of work to be done in terms of both setting independent standards and making sure that the accountants themselves are held accountable to those standards. That is going to require a lot of action on our part and I think your support for that kind of legislative action here today is really critical.

Thank you.

Chairman LIEBERMAN. Thank you, Senator Levin. Senator Collins.

Senator COLLINS. Thank you, Mr. Chairman. Mr. Levitt, it is nice to see you once again and to hear your testimony.

I have a particular concern for the small investor who relied on a strong buy recommendation from a sell-side analyst, who relied on a system that let the investor down totally, and then bought Enron stock for a retirement savings or for any other purpose. In that regard, I want to go back to the issue that Senator Thompson raised about the conflicts of interest that affect the analysts.

We allow retail brokerage firms to earn enormous sums of money underwriting the securities of companies about which they are expected to give objective and disinterested advice to their clients. That seems to me to be an inherent conflict of interest.

When you look at Enron’s case, if you look at the recommendations of the sell-side analysts, most of them stayed with a buy or a strong buy recommendation. By contrast, however, the inde-

pendent analysts were telling their subscribers through the fall to dump their Enron stock.

I think it is very significant that the two brokerage houses that did downgrade Enron were those that had fewer ties to Enron or its potential merger partner. By contrast, the firm that advised Dynergy in merger negotiations, which stood to make a large sum of money had the merger gone through, rated Enron a strong buy throughout the fall. So it seems to me that the whole system is just rife with conflicts of interest that make it very difficult for the small investor to rely on the advice of the analysts.

Now you have mentioned that you think we need greater disclosure. Is something beyond the disclosure of business relationships needed?

Mr. LEVITT. I would be very reluctant to go beyond that. The tensions that exist in our society between legitimate business interests and what is a conflict, I find is best resolved by embarrassment and humiliation rather than by rulemaking and legislation, unless it becomes so pernicious and so obscure that it cannot come to the public's attention.

The analysts' problem is, I think, on the margin of what went wrong at Enron. I think it is an important problem. I think there are, because it goes way beyond Enron, and I think the way to deal with it would be to disclose much more clearly when they have a conflict and see to it that they cannot trade in the stock that they are recommending for a longer period of time. I think it is unfortunate that the self-regulating organizations have not yet gotten to this. It has been 2 years since we talked to them about it. I think that is the way to deal with them.

They are not, in my judgment, really at the core of this. The core of this, we are talking about boards, we are talking about auditors and how they are supervised. We are talking about regulators and standard setters and how they work together.

Senator COLLINS. Let me move to one of the core issues that you just mentioned and ask you and Mr. Turner your opinion. Mr. Turner, you mentioned briefly in your statement that in 1997 Andersen wanted Enron to make a change that would have reduced Enron's annual income from I think it was \$105 million to \$54 million. Despite Enron's refusal to make that change, Andersen nevertheless approved and certified its financial statements. Yet, later on, that \$51 million was part of the \$591 million adjustment that Enron made last November. Had Andersen held its ground we might not have gone down the road that has led us to these hearings today.

I asked the CFO of a large non-profit entity in Maine how this could have happened. And his response to me was: "Oh, that is easy. Whenever we get an audit finding that we do not like, we sit down with our auditors and we negotiate what the findings are going to be."

I must say I was surprised to learn this and his assumption that this is very common. Should not the auditor be reporting to the audit committee and not to the managers of the entity, whether it is a for-profit corporation or a non-profit group?

Mr. TURNER. Senator, I could not agree with you more, and I have been out there as an audit partner on hundreds of these au-

dits myself, and I think your observation is right on point. A couple of years ago there was a very prestigious panel of businessmen that came out and said we really need to create a system where the auditor does, in fact, report to the audit committee directly. I think if we can get it to where it is the audit committee who turns around and engages the auditor, if it is the audit committee who turns around and pre-approves any consulting contracts so that they can find whether or not these really do benefit the shareholders, I think that would be a tremendous help.

At the Commission we have seen time and time again, including some of the cases that were cited on Mr. Torricelli's board, where the auditors actually identified the issue. It was not that they were bamboozled by the management team. They saw it and they knew it was there and yet continued to issue the report.

I think they are out there. They are humans. They also know they are trying to get the consulting. They are trying to serve two masters. They are trying to serve a management team. I have been a CFO. They are trying to impress you because they want the next contract and they know what it takes to get that.

At the same time, they have to serve the investors. That is a tough job. There is a lot of good people in the industry that do a good job, but we put them in one of the most difficult jobs you could be in. I would encourage people to look at tying this more into the audit committee than the management team.

Senator COLLINS. Thank you. Mr. Levitt, would you like to add anything to that response?

Mr. LEVITT. No.

Senator COLLINS. Thank you, Mr. Chairman.

Chairman LIEBERMAN. Thank you very much, Senator Collins. Senator Cleland.

Senator CLELAND. Thank you very much.

Mr. Turner, maybe I am missing something here. There is a lot of this that is just unbelievable to me. Back in my life as Secretary of State, I not only was the commissioner of securities but, as I said, handled the professional licensing boards. These boards were made up of professionals. They had a staff, they had investigators.

And in the case of the accountancy board in Georgia, it is a very strong board made up of wonderful professionals, all CPAs. And they administered the CPA exam, I mean certified public accountant.

What I am hearing here is that somehow, some way the public interests of accountancy in America has gone by the wayside here. I cannot believe a lot of what I am hearing, not just in terms of Enron but in this sense that there is so much conflict of interest, how in the world do you get a clear audit now? And that the public is actually dependent on that in its investment decisions.

I think we have just slipped a long way from the public entity, the public interest here. But there are a lot of good people, the CPAs around America. You would think that somewhere, some way, some certified public accountant that was licensed by the State, that was accountable in a professional way to the public for their license, and they are all licensed, would stand up and say this is ridiculous. This violates everything I learned on the first day I went to accountancy school.

I mean, it is hard for me to believe, for instance, that the average small business person in my State would be treated, as Enron was treated, by their auditors and accountants. For instance, it has been alleged that Enron overstated \$1.2 billion in shareholder's equity since 1997, including listing \$172 million as an asset instead of a reduction for the year.

Now, Joseph Berardino, CEO of Arthur Andersen, has stated that this transaction "fell below the scope" of their audit. Do you not think any average American who has been subjected to an audit in this country would have a hard time understanding how \$172 million escaped the notice of an auditor?

Mr. TURNER. That is what my dentist tells me. The answer is yes. And in fact, while the chairman and I were at the SEC, we put out some guidelines that said when people are doing these type of things and they are intentional, it did not matter whether it was \$100 billion or \$1 million. For a CPA to be intentionally cooking the books like this, and for the auditor to pass on it when they know it is an intentional-type error, and in the \$1.2 billion, that is quite simply Accounting 101. That is black and white, there is no gray to it. I cannot comprehend that.

The rule that we put in place back in August 1999 would clearly say that something like this you just can not do.

Mr. LEVITT. Senator Cleland, I would have to call to your attention, as you go through the airport at National or in Atlanta, just look at the signs on the walls that the accounting firms put up. They call themselves multi-disciplinary professional firms. If this was your first day on Earth walking through those airports, and you were asked what these people did, the last thing in the world you would say is they had their roots in public auditing.

Senator CLELAND. Yes, I agree. Good point.

By the way, Mr. Levitt, I appreciate your public service. I have been in hearings where you have testified over the last few years, and we appreciate all you have brought to the table with your public service. Thank you for your testimony today.

Mr. Turner, one more point here. One of the things I am learning here, and it is hard for me again to believe that just the average person or the investor or small business person in my State would think OK, you have things that are on the books and then whoops, you have things that are off the books. And it is OK to have things off the books. They are called special purpose entities.

Do you think the SEC rules should require disclosure of all special purpose entities in order to allow credit rating agencies and analysts the information to provide sound advice to their clients?

Mr. TURNER. First of all, as a former business executive, I think those financial statements should, without a doubt, provide clear transparency with what is going on with the business. And if I am going to go out and finance something and I am going to have the obligation to pay it, whether I do it in an SPE or not, that should be on my financial statements. Otherwise, quite frankly, I am just lying to my investors, and I think that is a shame.

So I do think the rules need to be quickly changed here to bring all of these back onto the balance sheet. Let us make the balance sheets look like the business actually looks like. And to the extent we need additional disclosure so that someone can read this and

understand it, which I clearly do not think the average investor could in these cases, yes, we need to enhance those disclosures.

Senator CLELAND. I hate to say it, but it sounds like we are having a hard time finding out what "is" is.

Steve Shepherd, the editor-in-chief of *Business Week Magazine* has stated, "Enron was really a systemic failure of all the checks and balances we have on corporate governance."

That is kind of scary. Basically the editor of *Business Week Magazine* says this is just kind of a failure of the system. There are a lot of corporations out there. Are we looking at more Enrons, Mr. Levitt? Do we have such a systemic failure going on here that there are not checks and balances any more out there?

Mr. LEVITT. I am not certain as to the presence or extent of fraud in the Enron case, so I cannot say whether that is a factor. And I certainly have no reason to believe that there is that kind of potential fraud in other companies.

I can say, however, that with respect to managing the numbers, to massaging the numbers, to deceiving the public, in effect, by talking about pro forma numbers, earnings after certain charges, I think that is prevalent throughout the system. And I think the restatements that we are about to see, that Senator Torricelli mentioned in his chart, that the frequency of these restatements which have cost America's investors billions and billions of dollars is a phenomena that will be on the business pages for the foreseeable future.

So that Enron's problems, apart from fraud, are problems that exist, in my judgment, in many other American companies, some of them really great companies whose competitive zeal has moved them to embrace some of the kind of obfuscation that I think represents a systemic problem.

Senator CLELAND. Thank you very much for that very strong testimony. Thank you very much, Mr. Turner.

Mr. Chairman, I would like to ask unanimous consent for my opening statement to be put in the record.

Chairman LIEBERMAN. Without objection, so ordered.
[The prepared statement of Senator Cleland follows:]

OPENING PREPARED STATEMENT OF SENATOR CLELAND

INTRODUCTION

I was Georgia's Secretary of State for more than thirteen years and in my role as the Georgia Commissioner of Securities, I was charged with administering the provisions of the Georgia Securities Act including the registration of securities issuers, the licensing of broker-dealers, stockbrokers and investment advisers. I was also responsible for the disciplining of the professionals involved in the offer and sale of securities to Georgia residents. During my tenure I insisted on a vigorous enforcement program utilizing administrative, civil and criminal sanctions that were available to me under the law. I am concerned that the regulatory agencies have relaxed their monitoring and oversight functions without an increase in a focus on strong enforcement of our securities laws. A strong regulatory enforcement program and an expedited criminal prosecution of persons willfully engaging in fraud and deceits in our markets will provide a major deterrent against financially related misconduct.

The securities markets are, and must continue to be, an integral part of our nation's economy. Unfortunately, the successes experienced in recent years have led to what appears to be an alarming increase in instances of major fraud and abuse. These markets exist as a result of the public confidence that we have demonstrated in the industry's integrity. Billions of dollars change hands every day on the mar-

kets as a result of a telephone call, head nod or a hand shake. Should this integrity be replaced with an era of mistrust, this confidence would quickly erode and the markets would suffer. The public confidence and trust has emanated, in part, from the confidence our citizens have in the regulatory system that has been in place for over sixty years.

The market collapse and meltdown of Enron Corporation ("Enron") has raised serious doubts and concerns over corporate and regulatory oversight of the securities markets, even for major corporations whose securities are listed on national exchanges.

I am extremely upset and concerned that Enron was able to conceal financial practices that were not detected by our financial regulatory systems, our credit reporting agencies and financial analysts. As a result, Georgia's retirement systems suffered a loss of about \$127,000,000 over the three year period preceding the bankruptcy filing by Enron. Thanks to the diligent work of our Georgia's analysts and investment officers, I was pleased to learn that this loss only resulted in a 2/10 of 1% decline in investment earnings over that period and that they were still able to report a 10.1% return on investment for this period. However, many individuals in Georgia and around the country suffered real economic hardship.

Based on my review of documents and news reports, I am appalled at the alleged conduct of certain Enron executives. In my statement today I will outline some of the major problems that have come to light as a result of corporate conduct and serious financial irregularities engaged in by these officials.

ENRON CORPORATION

In July, 1985 Kenneth Lay ("Lay") was appointed chairman and chief executive officer after Enron was formed from the merger of Houston Natural Gas and InterNorth, a natural gas pipeline company. In December of 1996 Jeffrey K. Skilling ("Skilling") became Enron's president and chief operating officer. Kenneth Lay remained as Chairman of the Board.

Enron conducted business as a pipeline company and grew to be a dominant force controlling major pipelines throughout the United States. During the 1990's Enron ventured into the trading of oil, gas and electricity. It was instrumental in the development of an energy trading system utilizing a relative new breed of financial instruments that allowed them to manage their risk such that they became the dominant energy trader in the United States. This quick success let Enron to move away from the traditional energy business into other emerging markets involving telecommunications, broadband and other Internet related businesses.

Enron maintained its headquarters in Houston, Texas. Its securities were listed on the New York Stock Exchange and it was required to file reports with the United States Securities and Exchange Commission ("SEC") pursuant to the federal securities laws. In August, 2000 Enron was ranked by *Fortune* magazine as the seventh largest company in the United States based on market capitalization. At that time its common stock was trading in the \$90 range, having increased 1,700% since its first shares were issued in the 1980's.

On October 16, 2001 Enron reports its first quarterly loss in over 4 years after taking charges of \$1 billion on poorly performing businesses and a \$1.2 billion charge against shareholder' equity relating to dealings with "off-balance" sheet entities. This disclosure resulted in the announcement of an SEC inquiry.

THE BANKRUPTCY FILING

In June 2001, after questions arose about the validity of Enron's stock valuation, the company's top executives were apparently engaged in a systematic effort to sell off many of their shares resulting in an estimated \$1.1 billion return to these executives. CEO Skilling announced his resignation in August and Kenneth Lay resumed the position of chief executive officer.

On October 22, 2001 Enron reported a third quarter loss of \$618 million and the SEC announced an inquiry into its operations. On November 8, the company amended and restated its financial reports back to 1997 showing that profits had been overstated by \$586 million. As a result of its financial practices, credit reporting agencies, financial analysts and the investing public lost confidence in the company resulting in a total collapse of its business operations and its share value.

Sophisticated financial engineering, risky corporate ventures, overstatements of asset value and understatement of liabilities forced Enron into bankruptcy on December 2, 2001 in a New York bankruptcy court. This represents the largest bankruptcy filing in U.S. history. At the time of the petition, the assets of the company were estimated to be about \$50 billion and its liabilities approximately \$40 billion.

ENERGY TRADING

Enron engaged in a successful and sophisticated financial trading system involving the trading of energy contracts including oil, gas and electricity. By the development of a state of the art trading environment, Enron was able to engage in massive bilateral trading contracts that were outside the overview of the SEC or the United States Commodities Futures Trading Commission (“CFTC”). The CFTC overview of such contracts was excluded or exempted as the result of a recent amendment to the federal commodities futures trading law, even though these contracts are similar to other futures contracts regulated by the CFTC.

This type trading is risky but apparently necessary in order to provide an open market in these commodities. For example, by engaging in appropriate risk management techniques a supplier can assure a future market for its products and a user can assure the availability of the product at an established price. In order to track supply and demand it is necessary to have state of the art hardware and software and the personnel resources trained in such trading environments.

Even though energy futures contract trading is a risky business, the meltdown of Enron was accelerated as a result of action by credit reporting agencies that downgraded them from investment grade to junk status. An energy trading entity will not be able to remain in the market once they have lost financial integrity and confidence by their trading partners. The disclosure of their serious financial problems, the lost value in their shares, the off-balance sheet financial engineering and the decline in the broadband telecommunications business, all came to light much in the manner of the weather systems in the movie “The Perfect Storm”.

ENRON’S QUESTIONABLE CORPORATE, AUDITING AND FINANCIAL PRACTICES

- The use of off-balance sheet transactions involving entities that were formed by, and controlled by, Enron or its executives, that were created without complying with Rule 140 of Financial Accounting Standards Board. It has been reported that certain of these entities were created by Enron executives borrowing funds from Enron’s bankers using Enron compensating balances and its shares as guarantees.
- Enron failed to disclose the formation of these entities resulting in the failure to disclose material financial transaction and the understatement of corporate liabilities. This resulted in continued positive ratings by credit rating agencies and financial analysts.
- The use of mark to market evaluation reports of certain Enron assets by these entities resulted in false and significant valuations of Enron’s assets.
- On October 17, 2001 Enron apparently decides to change plan administrators for its employee’s 401(k) plan resulting in significant restrictions being placed on Enron’s employees ability to dispose of their Enron shares. Enron later issued press releases stating that the lock-down period was from October 29 through November 12, 2001. This lock-down was eventually lifted on or about November 19, 2001 after Enron shares declined approximately 71% to \$9.06 per share.
- The downgrading by major credit agencies of Enron’s bonds to “junk” status on November 28, 2001.
- Enron’s filing and disclosure of materially false financial statements that were relied on by the markets, credit reporting agencies and financial analysts.
- The financial practices engaged in by Enron may have resulted in its executive employing a device, scheme, or artifice to defraud market investors and engaging in acts, practices, or a course of business that operates or would operate as a fraud or deceit upon a purchaser or holder of Enron securities.
- The financial practices engaged in by Enron resulted in omissions to state material facts necessary in order to make the statements made, in the light of the circumstances under which they are made, not misleading.
- Enron executives sold approximately \$1.1 billion of their shares on the market. As an example, on August 14, 2001, Skillings, Enron’s president and chief executive officer, resigns citing a decline of share price and personal reasons after selling shares for an aggregate value of approximately \$17.5 million. The sale and distribution of Enron shares by its executive officers may constitute the offer or sale of securities by means of insider information not available to the investing public. The questions that must be answered regarding these transactions include what information the executive knew, or should have known regarding the ques-

tionable financial transactions engaged in by Enron and when did such information become known to each of them.

- The compensation and profits paid to Enron employees engaged in the off-balance sheet entities.
- The use of market appraisals from affiliated, off-balance sheet entities that resulted in inflated mark to market asset values.
- The use of over-valued and misleading broadband and telecommunications assets to maintain its bond rating status.
- The failure of the Arthur Andersen auditing team to explore and report on the questionable financial transactions and accounting practices.
- The destruction of audit records and documents by employees of Arthur Andersen.
- The payment of significant compensation, reported to be \$55 million to 500 executives, on the eve of the bankruptcy filing.
- Possible conflicts of interest charges involving Enron, its accountants and consultants and an investment advisor's employee being a member of the Enron board.
- The untimely and questionable selection of a new plan administrator that resulted in Enron employees being unable to dispose of their Enron shares for an extended period of time when the Enron shares were declining in value as a result of newly reported material changes to Enron's financial condition.
- The use of plan restrictions limiting the ability of employees to dispose of their company match shares prior to age 50.
- The SEC oversight and reviews of the filings of public companies.
- The changes in the Commodities Futures Trading Act that exempted or excluded energy trading futures from CFTC oversight.
- The Enron campaign contributions further reveals the flaws in our system of financing the campaigns of candidates for the Congress, the President, and other federal officeholders.

THE RISING TIDE OF SECURITIES FRAUD

Top securities watchdogs in the United States have constantly warned investors that the explosion in the stock market has brought with it a sharp rise in securities sales fraud and stock price manipulation. The past year or so have proved them to be correct. At a town meeting in Los Angeles, Former SEC Chairman Levitt cautioned that investors are "more vulnerable than ever to fraud." This concern continues to be echoed by others who point to a disturbing rise in the level of securities fraud and allegations.

What is unusual about the increasing evidence of wrongdoing in the stock market is that shady practices usually go unnoticed in the heady days of a strong bull market. As in the Enron matter, the misconduct is normally uncovered only after a sharp market drop. This has many in the regulatory community wary about what they will be facing if we continue to see other Enron type market collapses.

The challenge to government and industry self-regulators in keeping up with the job of policing a marketplace that is undergoing explosive growth was graphically illustrated several years ago in *Forbes Magazine* ("Swindlers' Paradise"). *Forbes* writer Gretchen Morgenson cautioned that "greed makes people careless" but that investors "shouldn't count on the cops to protect them." In this regard you must also include the financial market regulators.

Make no mistake about who it is that suffers at the hand of securities fraud. It is retirees living on fixed incomes, families struggling to make ends meet and save a little for their children's education, teachers, factory workers, bankers, and others; it is, in short, the everyday man and woman who works so hard for every dime they earn.

The Enron matter, while considerably larger, compares to the losses suffered by the 8,000 shareholders who collectively lost more than \$300 million in the Comaparator fiasco. Records reveal that although there were a smattering of well-to-do investors among the group, for the most part the investors were common folk: Retirees, school teachers, engineers, police officers, small-business owners, and maintenance workers.

Poignant letters from victims of the recent Towers Financial Ponzi scheme—a scheme which defrauded investors of \$460 million—demonstrate the personal hardship and financial ruin that follows in the wake of a securities fraud:

“This was almost all of [my mother’s] retirement money. She has now obtained a part-time job with Burger King restaurant to supplement her Social Security income. . . .”

“I am a 69-year-old woman who has been a teacher in the public schools . . . for most of my adult life. I invested almost all of my life savings, \$112,000. . . . Mr. Hoffenberg has taken away what would have been a nice retirement income for me. So, as a result, I have returned to teaching and will probably have to do so as long as I am able.”

“My husband and I were just married when we invested our \$12,500 with Towers, which was the first and only investment we have ever made In the last two years we have been heartbroken . . . to learn that invitro fertilization is our only hope for having a child. The \$12,500 would have covered . . . two full attempts at having a child. At this point, we have no child and no hope of having the money it would take to try. . . .”

Each day, equally devastating cases are brought to the attention of securities regulators, law enforcement officers, and attorneys representing the interests of defrauded investors. Financial fraud is a serious and growing problem that must be addressed by the United States Congress.

THE PRIVATE SECURITIES LITIGATION REFORM ACT (PSLRA)

As Georgia’s Secretary of State for more than twelve years, I dealt with securities regulation on a daily basis. It was my role to regulate the offer and sale of securities to Georgia residents and to license, regulate, and discipline issuers of securities, underwriters, broker-dealers and stockbrokers. However, the monitoring and oversight of major corporate entities such as Enron was primarily the task of the SEC and the private bar.

Georgia has long recognized the right of private investors to seek remedies against those persons selling fraudulent investment products. I have supported an investor’s right to seek redress through mediation, arbitration and civil litigation. While we should work to streamline the registration and reporting process, I vigorously opposed, and will continue to oppose, any changes in the federal regulations that impair the ability of the SEC and state governments to protect its investors and for the right of investors to use state courts to redress their losses.

I am not yet convinced that the PSLRA will provide sufficient protection to defrauded investors. If the courts ultimately interpret the PSLRA in a way that makes recoveries under federal law too difficult, state remedies will be the only means for defrauded investors to redress their injuries.

The Enron collapse may provide the opportunity to determine whether the changes resulting from PSLRA will streamline procedure without having a detrimental impact on the right of individual investors ability to recover losses from fraudulent transactions.

CONCLUSIONS

It is my firm belief that the United States Senate must fully explore the Enron financial collapse in order to present for debate and consideration changes in our financial and market regulatory programs that will deter the use of illegal and improper financial engineering practices to conceal losses and overstate assets resulting in a market confidence that is bound to collapse.

In this regard I think the United States Senate should carefully consider the following areas:

- A thorough examination of the facts and circumstances surrounding the rise and fall of Enron with a focus on determining
 - who knew what regarding the improper financial practices and other material matters relating to the value of Enron shares;
 - when these facts were known to them; and
 - whether or not such executive officers or others, knew or should have known about such facts.
- A regulatory program for accountants, credit reporting rating analysts, and financial analyst that will provide for competency standards, training, conflict standards, and a strong penalty for violations of established standards and fraudulent practices.

- A review of accounting standards used in reporting “off-balance” sheet transaction.
- A thorough review of the destruction of records by Arthur Andersen employees to determine the destruction time table and whether or not such records were destroyed after notice of subpoenas or in clear anticipation of them.
- A determination about when off-balance sheet transactions should be disclosed to the SEC, credit reporting rating agencies and financial analysts.
- An overview and examination of current SEC overview and monitoring programs of entities offering their shares to the public that will be traded on the national markets.
- An overview of the role of the self-regulatory organizations that are currently in place to assist the SEC and state regulators in their oversight responsibilities, as well as a major emphasis on investor education and awareness.
- A review of the PSLRA and the current arbitration requirements, to determine if the recent amendments are adequate to offer access to the state and federal courts for recovery in the case of fraudulent activities.
- A review of the disposition of share requirements and restrictions that are placed, or should be placed, on senior executive officers of major corporations.
- A review of the 401(k) retirement programs to determine what restrictions, if any, should be placed on employee’s shares by:
 - regulatory authorities, such as limiting the % ownership of company shares in their plan or by a requirement that an employee’s shares received in any manner must contain no trading restrictions;
 - the retirement plan; and
 - by unofficial employer coercion or representatives.
- While the energy trading industry appears to have survived the Enron collapse, I think it is appropriate to review energy trading practices involving risk management practices, bilateral futures trading contracts and other sophisticated financial investment tools in order to determine whether or not the public interest requires CFTC or other federal oversight of such trading practices and transactions.
- While I have not heard credible evidence of improper political influence or actions, I feel that we need a thorough review of the political contributions made by Enron and its senior officers to candidates from either political party to determine what, if any, improper influence may have existed as a result of such campaign contributions. The public reaction to such political contributions should be sufficient for the Congress to reform our campaign financing laws.

Chairman LIEBERMAN. Senator Bennett.

Senator BENNETT. Thank you, Mr. Chairman.

I am having all kinds of reactions to all of this, some of it coming from my Senate activities, and some of it going back to my business experience. I have never run a company as big as Enron, and it may be that there is a dividing line somewhere in terms of size.

Just picking a number of issues in the time I have, your suggestion that there be a prohibition of consulting activity in the part of auditors. In the company I ran, the auditor was enough of a partner in understanding what we had and where we were, it was PriceWaterhouse at the time, that I wanted to go to him to get his advice on certain things I was doing and have him say no, wait a minute, you cannot do that. No, that would not be a good idea. This is the better way to structure that. Instead of incurring the extra expense of going to somebody else and then taking the time to have the somebody else familiarize himself with our company as well as PriceWaterhouse was.

It would have been an extra cost that, in terms of the services to the company, would not have been a value. Now I was not creating any SPÉs and so I can have sympathy with the idea that if

you are going to create this separate set of transactions you ought to have an independent group do that and then have your auditor look over the shoulder. I have no problem with that.

But with the generic sense that we have heard in the past that says if you are in auditing you should not be in consulting, and there should be a clear bright line and total separation, out of my own experience I have a little trouble with that because I think it does represent, for small and medium-sized firms like the one I ran, an unnecessary expense. I would like you to comment on that.

And then while we are doing that, make another comment in the same area, Chairman Levitt, about your suggestion that every 5 to 7 years you change audit firms. I was involved in changing an audit firm and, quite frankly, it had nothing to do with we want fresh and skeptical eyes. What happened is that the partner that we were depending on got transferred. He got promoted. And we looked at the kind of service we were getting out of the audit firm and the new people that were put into the Salt Lake office, and we said we do not think these folks are competent anymore.

Now it was the same Big 5 name on the door, but it was a different partner and a different set of folks come to see us. And we had a lot invested in the old partner and we were delighted he got promoted, glad to see him move on up. But we said we have got to get better service and more competence out of our auditor. And so we switched from one Big 5 firm to the other.

So these are two related issues that I have raised here, about the capacity of an accounting firm to add value to a client firm simply by virtue of the amount of expertise that they bring to the table and the amount of experience that they have with the firm.

Mr. LEVITT. I started with, I think all of us do, with the assumption that the accounting industry essentially is a private industry but with a public responsibility. And I am certain that you can take the position that a business person develops a relationship with his auditor that is comfortable and trusting.

Senator BENNETT. And synergistic, helpful to the stockholders.

Mr. LEVITT. In many instances, it is helpful to the stockholders.

During our debate on this issue, as we imposed relatively modest change in this area and backed away from a change that I think is terribly important, which is to remove IT from the consulting services that can be performed for the audit client, two arguments were raised in opposition. One argument that was raised was, and we had public hearings on this and the heads of the firms testified to this and I attended hearings of the Banking Committee and the Energy Committee and I was confronted with the same issues on the part of members who said Arthur, this is a question of perception. That is all, it is just perception.

And second, where is the smoking gun?

Senator BENNETT. I asked that question.

Mr. LEVITT. As you know, we had a briefing and members of the Banking Committee attended that briefing. We went over the details of cases that were about to be brought.

Well, I do not think the question about the smoking gun is being asked any longer. There is an exploding gun and there are smoking guns yet to explode.

With respect to perception, I think it matters enormously in terms of investor confidence, which is the basis of our markets. Now if you tell me, Senator, that PriceWaterhouse had the unique ability to provide a certain kind of consulting service, I would suggest to you that there are only four other firms today. Two of them have gone out of the business totally. There is someone else out there who could provide that service at no greater cost, in my judgment.

I think the question, we could debate it at great length, about the relative value of perception to the relatively modest disruption to the company. But I can tell you, having been on audit committees and serving on a number of boards, that more and more independent directors are taking the position that it is wrong to hire a firm for consulting services that is the auditor for that firm. That it looks bad, it feels bad, and it smells bad. And if that is the case, whatever modest costs might be involved, I think, is a small price to pay for restoring public confidence.

Right now we are in a crisis of public confidence.

Senator BENNETT. Thank you.

Chairman LIEBERMAN. Thank you very much, Senator Bennett. Senator Dayton.

Senator DAYTON. Thank you, Mr. Chairman. This degree of separation between us gives me a perspective on the expanse between a freshman Senator and a Committee Chairman.

Chairman LIEBERMAN. I feel very close to you, Mark.

Senator DAYTON. I am not even sure we are in the same time zone.

I want to thank both of you for your very, very distinguished service and for all you have tried to accomplish. I have to ask first: Do you feel completely or absolutely, totally vindicated by the events, which, unfortunately have transpired?

Mr. LEVITT. No, I think this is work in process. I think that what this Committee does is so important. I know that there are philosophical differences among all of us in terms of how far to go. I am a great believer in our markets and how they work. I have been a major beneficiary of that.

But my conviction about public confidence and a system that has seen a cultural erosion suggests to me that you must be focused in terms of the few demonstrations that you give that you care about this issue and setting it right. And there is no rule or regulation that is going to do it in and of itself. It is going to require continual attention by an SEC that has the resources to do the job, and by the legislative process which will see to it that they are on target.

Mr. TURNER. Senator Dayton, I think Senator Lieberman absolutely had it right when he said you are beginning a long journey. And Senator Thompson had it absolutely on the nail when he said this is a systemic problem. It is pointed out, probably no better than the charts that Mr. Torricelli had, and I think Senator Carnahan highlighted one of many things that it is going to take to fix this systemic problem.

This is not an issue of vindication. This is an issue of the fact that I would hope that you will be strong, you will aim high. Someone made the comment let us take you to the mountaintop. I think when you get to that mountaintop you are going to find out there

is about 5,000 green eyeshades on the other side coming over the top of the hill.

So you have got a big battle ahead of you. I would just urge you to stick to your guns, stay the course, and let us make this problem fix. The investors over the last half dozen or so years have lost close now to \$200 billion. When you talk about the cost to a company, and I have been in the same position that Senator Bennett has in selecting auditors myself, when you start thinking about the cost to investors in this Nation at \$200 billion, and what that does to our market, and the fact that that market is our crown jewel that no other country has, and it fuels this economy. We can no longer sit back and say are you vindicated or not. That is not the issue. The issue here is sticking with it, staying the course, and getting this fixed for the American public once and for all.

Senator DAYTON. Could each of you depart from your testimony and just give us, give the American people, a scorecard. What are the essential reforms, one, two, three, four, or more, that Congress must enact, in your view, so that people can have reasonable confidence in the integrity and truthfulness of these reporting systems?

Mr. LEVITT. I believe that the creation of an oversight body for the accounting profession with the appropriate powers to do the job of setting auditing standards and having disciplinary ability and subpoena ability and the ability to examine clients as well as accountants is something that I am now persuaded can only be done by legislation.

I believe that other issues, such as the standard setting process, I would hope that could be addressed outside of a legislative framework but with strong legislative persuasion.

I believe, with respect to the analysts, that is something that can be handled by the New York Stock Exchange and the NASD.

I think the issue of seeing to it that all corporate boards have a majority of independent directors is something that the Stock Exchange and the NASD can deal with effectively, again with appropriate persuasion.

And I think there are marginal issues such as a 2-year cooling off period for employees of firms being able to join clients of the firms, and the question of changing auditors periodically.

I think these do not require a legislative fix, in my judgment.

Mr. TURNER. I agree with the Chairman. I think that we need to create legislatively an honest to goodness oversight body under the supervision of the SEC. I do not believe the SEC, in itself, I do not think I would put it there. I agree with Chairman Pitt in trying to do something out there with active oversight by the SEC, though.

I think the need to move forward by the stock exchanges on the analysts issues and disclosures will help a tremendous amount.

I actually think the business community, too, needs to pay a key role here. A couple of years ago, on some of the corporate board and governance issues, there was an outstanding panel chaired by a couple of very distinguished businessmen and the former Deputy Secretary of State, John Whitehead, and Ira Milstein, head of Wilde Gottschalk. And they came up with some phenomenal rec-

ommendations that then the Commission and the stock exchanges and the profession acted on.

And I would hope that we will see some leadership again from the business community and that they will play a role here, that it does not need to all be done by Congress, it does not all need to be done by the SEC. But to the extent that these things do not get fixed, then I think it would be appropriate, given how you have had thousands of lives impacted, hurt, I went into a classroom the other day—

Senator DAYTON. I have to squeeze in one more question.

Help me to assess and evaluate this shredding of documents by auditors and accountants. My experience with them is that they are very thorough and factually oriented people. That is their profession. And shredding documents goes against that training; it may violate their professional standards; it may be illegal.

For them to shred documents despite those inhibitions, says to me that there must be a huge amount of compelling and damaging information that they just do not want revealed.

Mr. LEVITT. I do not know exactly what the extent of that may be, but shredding documents obviously is a red flag to anybody in an enforcement capacity and is a criminal offense.

Senator DAYTON. Thank you, Mr. Chairman.

Chairman LIEBERMAN. Thank you, Senator Dayton. Senator Voinovich.

Senator VOINOVICH. Thank you. Most of the questions that I had have already been answered, but in this room I suspect that we have representatives of analysts, brokers, mutual fund managers, auditors, financial consultants, you name it.

Mr. LEVITT. Lawyers.

Senator VOINOVICH. Lawyers. The question that I have is do you think they get it? What advice would you have to all of the people that are part of this financial market system that we have in this country, as to what they ought to be doing right now?

You are saying that we are going to have people on one side and the other, but what would your candid advice be to some of those people that are in this room today about the attitude they ought to take toward this hearing and the ones that we are going to be having and the new changes that you think need to be made to restore people's faith in this system. Because if it is not restored, I believe it is going to have irreparable damage to our financial markets, which have been the mainstay of this country for years and years, and frankly, impact on their respective pocketbooks.

So I will give you a free shot at advice to all of those that are here in the room and maybe those that are watching on television.

Mr. LEVITT. What a great question. I think that all of those parties, and I would throw in rating agencies as well to that package of people who are impacted by this. I would say to them all of us are in this together. And if there is a systemic problem, and I think there clearly is, while it may hit company A today, it is going to hit B, C and D very shortly.

No amount of rulemaking or legislation will ultimately change human behavior except at the margins. And that those people who are parties to all of this themselves must consider their behavior and their attitude toward the public interest, recognizing the im-

portance of the capital of the profitmaking motive in a capitalistic society.

But we have to have a system that is trustworthy, and that begins with participants who are trustworthy. And too many elements of this system are not trustworthy today. Too many elements have failed us because of self-dealing and self interest.

And to recognize that right now we are in a crisis mode, but this will be responded to. But if we do not learn a lesson from this, which is an enduring lesson, we will be back here. And we will be back here in ways where the primacy of America's capital markets will no longer be assured because too many other areas of the world are dealing with issues in different ways. And if you lose trust, you lose everything.

So we are all in this together.

Senator VOINOVICH. Mr. Turner.

Mr. TURNER. I do not think I could say it any better than what the chairman said, and I think it starts with each and every one of us. I grew up in the State that Senator Bennett is from and had a set of wonderful parents fortunately. And I think they made it clear to me the difference between what is right and what is wrong. And when I sit in there at the seat, as the CFO, even though the heat gets turned up at times, and you know it can get hot, you know if you are in the kitchen you have to make it work.

And I think it starts with all of us. It cannot be done by just the auditors. There has been a lot of focus on Andersen. It is not just Andersen. It starts with the management team. Directors and everyone has to contribute here. And it has to be an effort of people. It cannot just be Congress. It has to be everyone working on this.

Senator VOINOVICH. Thank you.

Chairman LIEBERMAN. Thanks, Senator Voinovich. That was a very important exchange and it does, in my opinion, go to the heart of what this is all about, this inquiry. As others have said before, and you have said, there has been a remarkable democratization of capitalism in our time with average people having the opportunity in this country to buy a piece of the rock through 401(k)'s, through mutual funds, through stock options, in fact.

And there is, as you said now, a crisis of confidence. I will tell you what the question is that I get most asked, and I am going to ask you this and then I am going to thank you for your testimony and go on to the second panel.

People have been shaken by the Enron story in this sense. The question they ask me is do you think my 401(k) is OK? The reason for that is we have now heard of tales of boards of directors that are not truly independent, of analysts who recommend stocks without understanding the books of the companies they are recommending, of auditors who have conflicts of interest, of regulatory bodies that—for one reason or another that we will get into as this investigation goes on—were not there to be the watchdogs that presumably they were supposed to be.

So how would you answer that question if people asked you? Is my 401(k) OK, or am I going to run the risk of having it tank the way Enron did?

Mr. LEVITT. I would not give them a blanket reassurance that their 401(k) is necessarily OK. I think one of the greatest needs we

have in America, and it is a mission the SEC has undertaken in recent years, is to educate investors. The problem with the 401(k), and I know this will be the subject of extended discussion in the future, is that very often participants really do not understand what is going on in that 401(k) and companies do not have the ability to legally explain to them what is going on.

The 401(k) is kind of a stepchild of ERISA and I think there should be some thought of giving some kind of legislative certainty to the 401(k). I personally believe that there should be a prohibition on the amount of a company's stock that an employee can invest in. Not the employer, because that is all voluntary and I would not want to discourage that.

But I think employees get caught up in the hype of the company and feel that if they are not putting the maximum in somehow or another management will look at them as being less than loyal employees. And that is wrong. The attitude of skepticism that is so important just does not exist there.

No, I would not want to panic people who have participated in this very important program, but I would say that we cannot take it for granted and there have to be changes and we are looking into that and we are going to make changes and help investors become wiser investors.

Chairman LIEBERMAN. That is exactly what I hope will result from our deliberations and our investigations here. Senator Thompson.

Senator THOMPSON. Just a comment. I think what Mr. Levitt said is very important, that it is not all a matter of skullduggery. You cannot guarantee the safety of a 401(k), for example, if the business involved is making bad business decisions. Sometimes when everybody is obeying the law and doing the best they can, in the stock market people lose money.

Mr. LEVITT. Yes, and always will.

Senator THOMPSON. And we will never be able to, and never should try, to institute a system where people speculating in the stock market, either directly or indirectly, are guaranteed that there will not be any losses. I think it is important for the American public to understand that they have a responsibility to keep up with what is going on with their own company and the stocks that they invest in.

Mr. LEVITT. They need to trust the numbers.

Senator THOMPSON. That is assuming that everybody else is doing their job. The gatekeepers are doing their job, and you can take a look at that and make your decision. But there is an awful lot of people who lose money in the stock market where people are not violating the law. They lose money the old fashioned way.

Chairman LIEBERMAN. I agree with what you have said, and, of course, I know we also all agree that the disclosure and transparency is critically important here to make the market function. Somebody said long ago that market capitalism is by far the best means ever devised by humans, not only to create economic growth, but to expand those who are enjoying the benefits of it.

But market capitalism has inherently no conscience. That is why we set up gatekeepers and watchdogs. The gatekeepers were not

keeping the gate here, the watchdogs were not watching; and average people got unnaturally taken advantage of.

We can go on a long time. We will probably ask you back at the end of these deliberations as we shape the recommendations we want to make. In the meantime, I thank you both very much for your previous public service and frankly, for the public service you are doing today, even though you are out of public service. Have a good day.

I will call the second panel now. Bruce Henning, Director of Regulatory and Market Analysis for Energy and Environmental Analysis, Incorporated. John Langbein, a Sterling Professor of Law at Yale Law School. And Frank Partnoy, Professor of Law at the University of San Diego School of Law.

I thank you all for being here and for your patience. We look forward to your testimony now.

This panel will give us a kind of focus briefing on some of the specific areas of concern that the Enron episodes raise in your minds. Just as the previous panel, hopefully they will help us understand what we know now, but also to guide us as we go forward in our investigation.

Mr. Henning, thanks for being here.

TESTIMONY OF BRUCE B. HENNING,¹ DIRECTOR, REGULATORY AND MARKET ANALYSIS, ENERGY AND ENVIRONMENTAL ANALYSIS, INC.

Mr. HENNING. Thank you, Senator. My name is Bruce Henning and I am Director of Regulatory and Market Analysis at Energy and Environmental Analysis.

For the past 24 years, I have been an analyst in natural gas, electricity, and energy markets, and I am here today to discuss the behavior of natural gas and electricity markets in the wake of the Enron bankruptcy.

Enron has been an important player in energy markets. Enron was the largest marketer of natural gas and electricity in the United States, operating in both the wholesale and retail energy markets. Enron owns and operates interstate gas pipeline systems and has interests in electric generation in more than a dozen States.

The Enron failure caused some disruptions in natural gas and electricity markets but these were relatively minor. Given the scope of Enron's activities, the absence of significant disruption in energy markets is a credit to the markets and to its people. Throughout the collapse of Enron supplies of gas and electricity have continued to be delivered to the consumers. The reliability of the energy delivery system has not been compromised.

Moreover, gas and electricity prices that the retail customers have seen have not been significantly affected. Enron's retail gas customers have been able to migrate to other suppliers at prices that are substantially below what they were a year ago today.

Under the regulatory oversight of the Federal Energy Regulatory Commission, natural gas has evolved into a highly competitive

¹The prepared statement of Mr. Henning with attachments appears in the Appendix on page 84.

commodity market. Competitive wholesale electricity markets are less mature than their gas counterparts but significant progress has been made. Examination of the wholesale prices since September indicates that gas and electricity markets have behaved reasonably well during a period in which the largest market participant was in turmoil.

The Enron bankruptcy impacted market participants in a number of ways. When Enron Online, Enron's electronic trading platform, went dark the market lost an important source of price information as well as a low cost transaction method of trading. Fortunately, there were other sources of price information and other, albeit much smaller, electronic trading platforms. Within weeks most participants had largely adjusted to the loss of Enron Online.

The financial exposure to companies involved in transactions with Enron is a much more complicated issue. As a general matter, energy companies work to limit the size of their exposure to any individual company, even a company as large as Enron. As Enron came under increasing pressure, many participants began to reduce their exposure. Even so, these exposures remained large, but they are manageable for most of the companies and should not interfere with the physical delivery of energy to consumers.

Beyond that, Enron had entered into a number of longer term contracts with buyers and sellers of gas and electricity. The status of these contracts is unclear and will be determined through the bankruptcy proceeding. It is possible that parties will find themselves back in the marketplace, even though they had thought that they had hedged their stream of future production or their future energy needs.

The loss of Enron has created an opportunity for other companies to capture market share. However, the ability of these companies to act aggressively in pursuit of market share has been tempered with the need to ensure that these companies remain financially strong.

The equity prices and bond ratings of a lot of energy companies have come under pressure in recent weeks. As a result, these companies have begun to take actions to strengthen their balance sheets and to restore lenders' confidence. As part of these actions, companies are reducing their capital budgets and cancelling or delaying power plant project constructions or delaying their commitments to new gas pipeline expansions.

However, the cancellation of power plant projects does not necessarily foretell an impending electricity shortage. In our opinion, there was significantly more generation capacity proposed than was going to be needed for the next 5 years. We felt like many of these generation projects would be delayed or cancelled even without the Enron bankruptcy.

That being said, the decline in the bond ratings and equity prices for many companies will increase the cost of capital for many of the needed infrastructure projects. This increase will have an effect on the energy markets for a number of years and if confidence is not restored in the relatively near future, the fallout from the Enron bankruptcy could be much more troublesome.

The events surrounding the Enron bankruptcy have been tragic for thousands of Enron employees and investors and raise a number of serious questions regarding the corporate accounting and disclosure of corporate information. All of us who work in energy have seen individuals who have been hurt and I know the pain involved for those people. But from the relatively narrow perspective of energy markets, the events show an ability to respond to a major disruption without the interruption of delivery to energy consumers and without significant energy price increases.

The electricity markets forged by Federal and State regulators, and in accordance with Federal and State laws, performed well in the face of an event that had never been seriously contemplated.

I would like to thank the Committee and the Chairman for the opportunity to express my views, and I would be happy to answer any questions I can.

Chairman LIEBERMAN. Thanks, Mr. Henning. That was very interesting. I have some questions that I will ask when we get to that point.

Professor Langbein, thanks for being here.

**TESTIMONY OF JOHN H. LANGBEIN,¹ STERLING PROFESSOR
OF LAW AND LEGAL HISTORY, YALE LAW SCHOOL**

Mr. LANGBEIN. Thank you. Mr. Chairman, Members of the Committee, I have been asked to talk with you about the pension consequences of the Enron bankruptcy.

The bad news is that there are millions of other American workers at risk of suffering similar losses in their 401(k) pension plans and in other types of defined contribution pension plans. Worse still, it does not take Enron-style corporate wrongdoing to cause such losses. Businesses fail all the time, for many reasons. Competition produces failures as well as successes. The bankruptcy of Kmart, currently in the news this week, illustrates that point. If Kmart had had pension arrangements which were of the character of Enron's, full of employer stock, the Kmart employees would have been as devastated as were the Enron employees.

In other words, if Enron had been a bunch of angels, the problem would be the same. It is the bankruptcy that causes the loss. The cause of the bankruptcy, which is very important for some of your other purposes, is not what we are focusing on when we talk about the pension problem.

The good news is that we know exactly what the problem is and how to fix it. Indeed, the particularly good news is that Congress already fixed it almost 30 years in the original enacting process that produced ERISA. Congress fixed it by imposing a diversification requirement on pension plan investments for defined benefit plans.

Unfortunately, in 1974 when ERISA was enacted, in the early 1970's when ERISA was working its way through Congress, defined contribution plans of the 401(k) sort and others, defined contribution plans were not important. They were regarded basically as supplementary plans, extra savings for fat cats. They were not important parts of the pension process.

¹The prepared statement of Mr. Langbein appears in the Appendix on page 93.

For very complicated, fascinating reasons, some of them troublesome, we have had across the last 20 years or so a major revolution in the way in which the private pension system is structured. The defined benefit system has matured. It is not growing. Almost all the growth in the pension system today, in the private pension system, is in the form of defined contribution plans, and they have many advantages.

In my prepared testimony I have mentioned a couple of the most obvious: The tremendous transparency that people understand what is in an account when it is an individual account; it is mine; I get the numbers. That encourages more pension saving. There are other major advantages to defined contribution plans. It is not all a one-way story of danger.

But the big danger, the big difference associated with a defined contribution pension plan is that instead of the employer bearing the investment risk, it is the employee. It is just in these plans, where the employer has now shifted the risk to the employee, that we now have practices that the employers do not follow and would not be allowed to follow by ERISA; namely, concentrating everything in employer stock. That is exactly what we do not allow in the defined benefit plans where the employers bear the risk. But in the defined contribution plan where the employee bears the risk, we let the employer stuff employer stock into these plans.

There is just universal consensus in financial circles that concentrating all of your assets in the stock of any company, no matter what it is, is stupid. It is dangerous. We have a technical term for it in the financial literature. It is called uncompensated risk, bearing uncompensated risk. I do not want to go into the details of that. Delighted to take questions on it. But the key point is, nobody who knows anything about how to run a pension plan would ever do this.

Yet we allow it to be done over in these 401(k) plans, and even worse in something called ESOP's, employee stock ownership plans. That is where the big congressional failure has occurred. It is the failure to bring over into this new world of employee-operated investment decisions the same basic norms that we are used to over in the world of defined benefit plans.

Chairman LIEBERMAN. I do not want to show preference to a Yale law professor, but if you are in the middle of making another argument, do not be deterred by the red light for a few moments.

Mr. LANGBEIN. Thanks so much. I think I probably ought to stand down, but let me just conclude this by saying, I have more detail in my prepared remarks. I have, in particular, the further suggestion that if Congress is not able to make the big fix which is needed, which is to get proper diversification standards over from the defined benefit world where you solved—remember, nobody is in here telling you about their losses. You solved it. You did a wonderful job.

If you cannot fix it over in the defined contribution world in the way that I think you should, which is to go ahead and impose diversification, there is another alternative which I call the Surgeon General cigarette pack solution, which is to require the summary plan descriptions in defined contribution plans to warn employees about the dangers of employer stock so that they value it properly,

and also exercise their own option to move away from it in the part of those plans that they control.

Let me just conclude, Senator, by saying that I can predict to you, with absolute certainty, that you will see many more pension catastrophes just like Enron, a similar sort of magnitude. We have already had them in the past: Color Tile, many others—until the basic rules get changed to stop allowing employers to stuff all this employer stock in these pension plans. And to move us toward a system in which the same diversification rules that are followed elsewhere in the financial community get imposed on defined contribution plans.

Thank you.

Chairman LIEBERMAN. Thanks, Professor. That was very helpful and in its way riveting, because of the warning at the end. I will come back to you with some questions.

Professor Partnoy.

**TESTIMONY OF FRANK PARTNOY,¹ PROFESSOR OF LAW,
UNIVERSITY OF SAN DIEGO SCHOOL OF LAW**

Mr. PARTNOY. I want to thank Senators Lieberman and Thompson and the Committee for inviting me to testify. We have heard a great deal today and in previous months about various aspects of Enron's problems. I am here today to talk to you about what I regard as an even bigger problem: That is Enron's involvement in the unregulated derivatives market.

Please let me make three brief points. First, Enron was primarily a derivatives trading firm, not an energy firm.

Chairman LIEBERMAN. Take a minute to explain what that means.

Mr. PARTNOY. Enron was involved in various aspects of derivatives markets, including what we call the over-the-counter derivatives markets which are, at \$95 trillion, 90 percent of the derivatives markets. So derivatives are basically financial instruments whose value is linked to some other instrument or index. Enron was involved not in the exchange traded derivatives, which constitute about 10 percent of the markets and are regulated already. Those are not at issue here. Enron was involved in the over-the-counter markets, which are the bulk of derivatives trading right now.

Chairman LIEBERMAN. Are not regulated?

Mr. PARTNOY. Which are not regulated. It may surprise investors to learn that Enron was in fact a speculative trading house chock full of these derivative instruments. The best way to see that is just to look at this building, look at Enron's building. Executive offices overlook the crown jewel of Enron's empire which is essentially a cavernous derivatives trading pit.

Chairman LIEBERMAN. Like a trading exchange?

Mr. PARTNOY. Just like a trading exchange, except that it is not regulated.

In fact Enron has been compared today and previously to Long-Term Capital Management. Long-Term Capital Management, as you know, is a hedge fund that collapsed, lost billions of dollars,

¹The prepared statement of Mr. Partnoy appears in the Appendix on page 103.

and was rescued in a private bailout engineered by the New York Federal Reserve. There are some similarities, but what I am here to tell you today is that Enron makes Long-Term Capital Management look like a lemonade stand.

Enron made more money from derivatives in 2000 than Long-Term Capital made in its entire life. Enron lost 20 times more capital than Long-Term. Enron had 100 times more employees. It had public investors, and no one bailed out Enron.

I have told you a little bit about what these derivatives are. Enron's derivatives ranged from natural gas prices and interest rates, to dot-com stocks, and rights to fiber-optic bandwidth. As I have mentioned, let me repeat, these markets are largely unregulated markets. That is point No. 1.

Point No. 1, Enron shows we cannot trust derivatives disclosure more generally. Derivatives were the key to Enron's abuse of these special purpose entities we have talked about today. Enron's list of these entities, just the list is 60 single-spaced pages long. Many companies have similar lists, and their disclosure is now suspect. If we cannot trust Enron, can we trust General Electric, or IBM, or Coca-Cola.

Special purpose entities are very common and can be used for good or for ill. Unfortunately, Enron used them for ill. It hid spectacular losses on technology stocks, it hid billions in debts, it inflated the value of speculative assets. Many of these trades did not involve energy at all.

Just let me give you one example. Enron bought a technology stock called Rhythms Net Communications that skyrocketed during 1999. Enron sold that stock to one of these entities and recognized a gain of several hundred million dollars. Then Enron used a sham transaction with the entity, including—and this is the key—a \$1 billion derivatives trade to avoid recognizing losses as the stock plummeted the next year. This was true even though Enron retained the economic risk of its investment in that stock.

The important point here is that Enron, like many companies, manipulated its numbers to meet analysts quarterly estimates.

Chairman LIEBERMAN. What is the source of your information on the story you have just told us?

Mr. PARTNOY. The troubling part about this is that much of the source of this information is from Enron's financial statements. If you look at Enron's financial statements you get a sense of how broad its involvement in derivatives is. The specific information about this company and some of the others that I allude to in my written testimony come from the more recent 10Q. If you just look at the difference in size—I will show you—just in thickness. This is the most recent 10Q Enron filed. This is where some of the information comes from.

Chairman LIEBERMAN. With the SEC.

Mr. PARTNOY. With the SEC. This is after information had already come out. But much of the information, and one of the troubling things about this, is alluded to in the documents and the gatekeepers failed to uncover some of that information.

Chairman LIEBERMAN. That was the point of my question. They had some of this information that you just relied on but did not ei-

ther understand it or did not bother to report it to the investing public.

Mr. PARTNOY. That is exactly right. That, Senator, leads to my third point, which is that the gatekeepers failed to tell investors that Enron was so risky. Enron's officers and directors, of course, are to blame. But we should look carefully at the gatekeepers as well. Too much focus on Enron's officers misses the mark.

If I could just finish this thought.

Chairman LIEBERMAN. Go right ahead.

Mr. PARTNOY. Enron's officers clearly knew that there was some derivatives use going on within the firm. Enron even distributed a derivatives training manual to new employees. But gatekeepers also had information. Gatekeepers include accounting firms, law firms, securities firms, and very importantly, credit rating agencies. They are supposed to monitor even conflicted managers. Gatekeepers, of course, should and will be held liable when appropriate. In Enron's case the accountants, as we know, already are at risk and others may or may not be.

My point here is that credit rating agencies in particular have great market power. They have been given market power by the law, and they are largely undisciplined by the threat of liability, and that should change.

In closing, ultimately Congress must decide whether after 10 years of steady deregulation the post-Enron over-the-counter unregulated derivatives markets should remain in this regulatory black hole, exempt from the rule that covers most investment contracts. The basic message I would like to leave with you is that I believe it is time to shine some much-needed light on these unregulated derivatives markets.

Chairman LIEBERMAN. Thanks very much. Again, the three of you have been very helpful and I thank you, Professor Partnoy, and others, for what looks to me to be the fresh work that you have done in the testimony that you have presented to us, particularly in analyzing the Enron situation.

Professor Langbein, I was thinking as you were talking, I once said to somebody about 10 years out of law school that I was ready to go to law school then because I thought I would understand better my professors. I think you helped teach me a lot today.

Mr. LANGBEIN. We have an LLM program if you would like to come back.

Chairman LIEBERMAN. It is beginning to look pretty good actually. [Laughter.]

The question I wanted to ask you is about your main point which is that through ERISA Congress regulated so-called defined benefit, normal pension plans, but as the 401(k)'s defined contribution programs came along and expanded, millions of people now having their dreams of future security resting on them, we did not have similar protections.

The one you have talked about is diversification. If you had your druthers, if you were King, what is the rule that you would promulgate with regard to defined contribution 401(k)'s?

Mr. LANGBEIN. It would take some technical drafting but I would basically insist that the same diversification standards apply to 401(k)'s as apply to ordinary pension plans.

Chairman LIEBERMAN. Just for the record, tell us—and I understand you cannot cover every nuance, but in basic terms what are they? In other words, some of the proposals that colleagues here have made is that there should not be more than 20 percent, for instance, of a company's stock in a 401(k) of its employee. Is that an appropriate number?

Mr. LANGBEIN. That is roughly 20 percent more than I believe we ought to have. In other words, in a defined benefit plan today we have only trivial amounts of employer stock. That is the right answer. The single most important thing for workers to understand is that employer stock is the single worst investment you can possibly have.

Chairman LIEBERMAN. Why?

Mr. LANGBEIN. The reason is that the worker is already horribly underdiversified vis-a-vis the risks of that firm because he is what we call human capital. His employment relationship has him already deeply exposed to the risks of that firm. What ordinary finance theory tells you is, the last thing in the world you should do is to take the little sliver of diversifiable capital, your finance capital, namely your pension savings, take the one bit that you have that you can invest elsewhere and tie it back up with the employer. That is the fundamental fallacy of employer stock plans. They are a fundamentally bad idea.

Chairman LIEBERMAN. So if you had your druthers you would pretty much prohibit employers from putting its own stock in a 401(k)?

Mr. LANGBEIN. I would not say it just that way. There are circumstances in which trace amounts show up. For example, you do not want General Motors in its pension plan not to be able to buy the S&P 500 type funds which have some General Motors stock in it. We get the result that we are talking about, basically no employer stock, without saying so, under existing ERISA rules for defined benefit plans by imposing a prudence requirement and then allowing that to sort itself out. No investor can prudently invest heavily in employer stock.

Chairman LIEBERMAN. Let me go on to another subject.

Mr. LANGBEIN. Senator, may I just say one other thing? Your question was about the 20 percent proposal in the Boxer-Corzine bill.

Chairman LIEBERMAN. Yes.

Mr. LANGBEIN. Look, it is a lot better than nothing. If you have got to compromise, compromise. There are a lot of political pressures out there, there are a lot of reasons why employers and their pals want to stuff employer stock down pension plans.

Chairman LIEBERMAN. You do not have to compromise so I appreciate hearing exactly what—

Mr. LANGBEIN. That is exactly right. I am just a schoolteacher. I can go home and leave you to have to cut the compromises. And if you have got to compromise, that is an awful lot better than we have got now.

Chairman LIEBERMAN. Incidentally, I do want to note for the record, as you know—and I have been reading this in the media—some of the great companies in America have 401(k)'s in which

they have got 60, 70 percent of their stock. That alarms me as I hear your testimony.

Mr. LANGBEIN. Senator, as of 2 years ago Enron was one of the great companies in America.

Chairman LIEBERMAN. There you go; exactly.

Mr. LANGBEIN. That should tell you what the danger is.

Chairman LIEBERMAN. Good point. Anything else besides the diversification requirement that you would say we might do by law to protect people's investments in their 401(k)'s? If you want to think about it and submit later testimony, that is OK.

Mr. LANGBEIN. I think the main—99 percent of what has gone wrong here is having large quantities of any stock, especially employer stock, in these plans. If there is one piece of advice I could give your constituents it is, to the extent that you have discretion over your own employee contributions in these plans, resist the pressure to show your loyalty to the firm by investing back in the stock of your employer. Your loyalty should be shown by what a good employee you are, but not by concentrating investment risk back in employer stock.

Chairman LIEBERMAN. Let me ask one other question related to this. One of the parts of the Enron story that infuriates all of us is the question of the period of time during which the Enron employees were locked into their 401(k)'s. The stock price is falling. We now know from public records that the executives are selling their stock, cutting their losses, making a lot of money, and the employees cannot get out. They say this was because of a transition in plan administrators.

I want to ask you whether as a matter of law, technology being what it is now, in terms of transition of plan administrators we should prohibit lockdowns of that kind to make sure that employees always have mobility as the market moves, and their company moves or other companies move, to sell their stock?

Mr. LANGBEIN. Senator, I think the answer is that the law is in place to deal with this. The basic way in which we handle these details of plan administration is to impose a requirement, which you have done, and done on defined contributions as well as defined benefit plans, that they be administered by people who are fiduciaries. Then we impose fiduciary duties in Section 404 of ERISA, including one of prudent administration.

The question of whether or not Enron should have been changing plan administrators in a period in which its stock price was under great pressure is, in my view, a very serious one and one which I think is likely to raise fiduciary liability on them for having done so.

Chairman LIEBERMAN. You think they may be subject to lawsuits by their employees—

Mr. LANGBEIN. Those lawsuits are pending right now.

Chairman LIEBERMAN. Do those suits include this element?

Mr. LANGBEIN. Yes, the lockdown period is the subject of plaintiff's litigation ongoing right now.

The precise question you have asked is, how long the period ought to be. In the case of the Enron plan there was, I think 11 trading days involved, some such thing. I do not think Congress should attempt to micromanage this. I think the proper standard

is the one which we have under fiduciary law, which is that which is reasonable in the light of all the circumstances, bearing in mind the fiduciary duty to maximize the best interest of the employees under Section 404(a)(1)(A) of ERISA. You have got this right already in the law.

That is not where your efforts ought to go. Your efforts ought to go on the diversification problem.

Chairman LIEBERMAN. Thanks. My time is up. Senator Thompson.

Senator THOMPSON. Thank you, Mr. Chairman.

Mr. Partnoy, educate me a little bit further with regard to the use of derivatives. I take it derivatives are neither inherently good or evil, that they can be used for speculative purposes, they can be used as insurance policies to hedge. It seems that, as you pointed out, Enron used derivatives in deals with its own special purpose entities that it set up, and by trading with what looks like pretty much itself in many cases, it was able to hide debts and losses and to make sales to these special purpose entities at inflated prices and book the profits. So apparently that is the way they were using them for their purposes.

Then you look at the regulatory structure, and as you pointed out, some derivatives are regulated and some are not. Apparently this has been the subject of a good deal of debate over the years and we have come up with a situation where energy derivatives, for example, are exempted, financial derivatives are exempted from regulation under the CFTC.

The working group on financial markets under the previous administration recommended in 1997 that these exempt derivatives be exempt, as I understand it, for reasons that they were deep markets. Unlike the agriculture field, for example, there was likely price manipulation, and there were big, deep markets in these areas and so forth. So a lot of good people apparently thought that a lot of these things should be unregulated.

So tell me what—and I am not trying to make a point here. I am really curious as to, when we talk about regulation what is it exactly that would be regulated with regard to the derivative markets, if they were regulated? I mean, they would have to go through an exchange and file certain reports, I guess. But what does it actually mean?

More importantly, what would it mean to the Enron case? What part of what they did, which in large part seems to me to be a failure to properly disclose more than the inherent activity itself perhaps, which may have been legal and proper. What part of what they did that gave us bad results could have been avoided, in your opinion, had there been regulation of these derivatives?

Mr. PARTNOY. Senator, I think you have the story absolutely right; derivatives can be used for ill or for good, and there are perfectly valid reasons to say we should have some derivatives traded on an exchange, and some derivatives traded in some other venue. But I think you have isolated the key point, and that is disclosure.

Whatever these investments and instruments were—and it turns out that what they were is quite troubling—they should have been disclosed. We easily could require that they be disclosed. There

should not be an argument that just because these are something different that they can be left off the financial statements.

Senator THOMPSON. Would regulation as such, in and of itself, bring about that disclosure? Or is it a disclosure issue and not necessarily a regulation issue?

Mr. PARTNOY. There is a separate matter which is, why is it that we are treating these sorts of financial contracts differently than other investments? What is the rationale for that? In some derivatives there is a very good rationale. Interest rate swaps, for example. There is a very deep market, trillions and trillions of dollars with sophisticated actors. There are not problems of somebody ripping off somebody else. There are not problems of public investors losing money. That actually is the vast majority of the over-the-counter derivatives market.

But there is a decent chunk of the over-the-counter derivatives market that has problems. I think a lot of those problems could be corrected by recognizing the fact that these are investment contracts just like anything else, and recognizing that they should be disclosed.

Senator THOMPSON. But I still do not understand what unpleasanties we could have avoided in this case had these derivative markets been regulated.

Mr. PARTNOY. I would draw your attention to footnote 16 of Enron's 2000 annual report.

Senator THOMPSON. I am very familiar with it.

Mr. PARTNOY. If you can tell me what is going on—

Senator THOMPSON. Just kidding.

Mr. PARTNOY. You should take a look at it. It is about a page long and it would be very well worth your time. It is chock full of derivatives transactions of all sorts. You literally cannot tell who the derivative transactions are between, what they are. If we had clear disclosure about those transactions then the Enron situation might not have happened.

Senator THOMPSON. Couldn't we have disclosure without regulation?

Mr. PARTNOY. If somehow magically companies were to say, and some hopefully will, we will tell you all of our derivatives contracts—this relates to accounting actually. This relates to the accounting issue. Because if we had strong accounting standards and strong auditors they would say, hey, just because these are derivatives contracts does not mean you can push them off over into this off-balance sheet transaction and not list them.

So I think that it is possible you could accomplish what you want through more rigorous disclosure requirements that apply to derivatives.

Senator THOMPSON. Mr. Henning, do you have an opinion on this?

Mr. HENNING. Yes, I do, Senator. Appreciate it.

One of the things to recognize is that derivatives, and basically the financial contracts, are very important in energy markets, in addition to the fact that the energy markets are quite liquid, and the data shows that we did not see great deviations in the prices as a result of that. It is very important to be able to trade in a whole variety of locations.

Natural gas is exchange traded at the Henry Hub in Louisiana. But in order to move natural gas around the pipeline system and in order to be useful to hedge on the behalf of consumers you have to be able to deal with trades that are happening at lots of other places around the pipeline system. This happens in the over-the-counter market.

Over this last summer there has been a big emphasis within the State regulatory commissions to look at ways to use hedging strategies in order to try to insulate customers from those kind of movements.

Senator THOMPSON. So what? Are you making the case for these derivatives not to be regulated?

Mr. HENNING. I am making the case that they are very important. I am making the case that the regulated entity in terms of their involvement should not be forced into any additional disclosure that an unregulated entity is involved in, and that fundamental issue in my opinion is a broad accounting issue in terms of the disclosure of information and the way we get that disclosure out into the marketplace.

Senator THOMPSON. I am not sure I know any more than when I started, Mr. Chairman, but we will revisit the issue.

Chairman LIEBERMAN. I think maybe you and I both should go back to that LLM program.

Senator THOMPSON. Thanks.

Chairman LIEBERMAN. Thanks, Senator Thompson.

I have some good news to report that my staff just informed me of. This is how terrible events sometimes produce in their wake also good results and reaction, which is that—you will be happy to hear this, Fred—that they have just obtained the 218th signature in the House on the discharge petition for campaign finance reform.

Senator LEVIN. Bravo.

Chairman LIEBERMAN. Bravo is right. So that bill will go to the House floor, and hopefully it can match up with the campaign finance reform bill that passed the Senate last year and we can at least close the loophole in the law through which the large unregulated, unlimited soft money contributions are made.

This goes back to something said before, I believe by Senator Thompson, about this matter, which was, sometimes the most scandalous behavior is legal. There is some scandalous behavior I think in Enron that is illegal. But in the campaign finance laws the most scandalous behavior is the legal end run of soft money. So anyway, good news.

Senator Levin.

Senator LEVIN. Thank you. That is good news indeed. I want to go back to footnote 16. I have not read it either, but you say that it does disclose something there, and that if certain people had really been on the ball perhaps they would have forced a greater disclosure. Auditors never should have agreed to it to begin with, but if analysts had been on the ball perhaps they would have asked questions about that disclosure because it was so obfuscating and unclear. Is that right?

Mr. PARTNOY. That is exactly right. I would not have recommended that anybody buy this based on that footnote. It is really only a page. Just take a look at it. Would you have recom-

mended Enron stock if you read that footnote? I do not think anyone would have.

Senator LEVIN. So what we are talking about here then is not just disclosure, you are talking about disclosure which meets certain standards of clarity. Is that why you want this to be regulated, because a regulator could force clearer disclosure standards? Is that the purpose of the regulation that you are proposing?

Mr. PARTNOY. Sure. Clearly, uniformity is important. If we just have people off making disclosures on their own we may not be able to understand or compare. One of the points of disclosure is to be able to compare companies, so that we can look at Company A and Company B and say, OK, they have this many derivatives and they have this many derivatives, so we should buy this one instead. We want it to be comparable.

Senator LEVIN. Other than disclosure, which is what regulation could require in greater clarity, is there any specific action in the creation of these entities, in all of the havens, the offshore entities that were created as well as the special purpose entities, 800 or 900 entities that were created, are there any specific actions of Enron that a regulatory body in your judgment would have prohibited, other than the disclosure issue?

Mr. PARTNOY. Some of these derivatives transactions with the special purpose entities are very troubling and the question would be, if they were put in the context of a securities regulation, a standard investment contract, what would a securities regulator say about that? What would the SEC say about that? I think they would have problems with these transactions. They are very troubling.

Senator LEVIN. Who, in your judgment, should regulate this over-the-counter derivatives market? Is it the SEC or the CFTC? Who would you recommend for that?

Mr. PARTNOY. That has been a very difficult question for 20 years. As you know, I am sure, there was a turf battle between the SEC and the CFTC over some of these issues, and I do not have a lot of good answers. I would be happy to think carefully about it. I think the important point, and it sounds like the message has gotten through, is that these are unregulated markets and maybe that is not such a good idea.

Senator LEVIN. I think that message has probably come through, but we have to take the next step. If they are going to be regulated, who would do the regulation? I think we need the advice of folks on that as well. Mr. Chairman, I would ask that perhaps this be supplied for the record, if you would just allow that to happen. That goes for any of our other witnesses, by the way.

On the question of the 401(k)'s, you made a reference, Professor, to ESOP's.

Mr. LANGBEIN. Yes.

Senator LEVIN. I am someone who has supported ESOP's. I remember Russell Long here talking about the importance of employee ownership, and we wanted people to have a stake in the enterprise because they would really feel then a keen interest in the quality of their work, and a number of other positive things. But ESOP's were viewed around here as something which would help those who worked to become owners of the enterprise. So your com-

ment was somewhat disparaging, I think, about ESOP's, if I heard it right. But I would like to hear your—please testify about ESOP's.

Mr. LANGBEIN. You have just repeated the standard theology of ESOP's, which is that they are wonderful things that help workers own their own firms, and therefore, cause them to identify with capitalism.

Senator LEVIN. Could I just interrupt for one second? First of all, these are employee stock ownership plans, for anyone out there who does not know what an ESOP is. I should have said that. But, second, would you distinguish in your answer between stock which is owned now by an employee and stock that goes into a retirement fund; is there any distinction in that regard?

Mr. LANGBEIN. Yes. Let me take that one first. The most troubling part of the 401(k) phenomenon, and to some extent the ESOP phenomenon is that these concentrations of employer stock are coming in the form of a displacement of conventional pension plans. Russell Long and the other people who gave us ESOP's did not foresee or want that. It was always thought that ESOP's—that is, back in the days when they came into ERISA in 1974—would be supplementary plans and that they would not have the effect that they have had in all too many companies of becoming really the substitute for a private pension plan.

A very simple solution—simple to enunciate, difficult to draft, but it is doable—would be to insist that no firm run an ESOP without first having run an adequate private pension plan, a non-ESOP type plan.

Now, with respect to the question, what is wrong with these plans, with ESOP's and with large concentration of employer stock, it is the point I made earlier, which is that the employee already has his future tied up with the firm. Remember that these ESOP's and 401(k)'s are, in an important way, public plans as well as private. They are privately created, but they would not exist in practical significance in their present extent, they would not exist but for the tax subsidy that is inherent in them.

These are all what we call tax-qualified plans. There is a huge tax deduction for this employer stock, and there is the advantage of tax deferrals across the years which works out to be—I think it is the second largest so-called tax expenditure item in the tax expenditure budget. These are hugely subsidized. They are there for public purposes.

The idea that somebody should come along and be able to relabel his own company's effort to get the employees to identify with it, whatever good that does for the company, to relabel that a pension plan entitled to have this massive Federal tax subsidy is a very peculiar notion.

Senator LEVIN. My time is up. I think that I agree with what you say for the most part, but I am not sure that I would label this totally as employers stuffing stock into a plan, because I think there is a real legitimate public policy purpose in having people own a piece of the enterprise. I think that there is an added incentive there to make the enterprise successful that people might not realize to the same extent through simply being an hourly paid worker.

Mr. LANGBEIN. I agree with that completely, but I would say to you—I used to be in Chicago and at one point there was a proposal to build some power plant or something out in the lake, and the opposition group put together some bumper strips. When I was in Chicago all the guys had these bumper strips, and the bumper strips said, “Don’t do it in the lake.” My suggestion for the bumper strip here is, “Don’t do it in the pension plan.”

If you want people to have employer stock and you want to make it advantageous, we do that right now with discount stock purchase plans and so on, but they are not tax-qualified pension plans. What is wrong with the present structure is that we allow employers to get tax deductions and tax subsidies of other sorts for putting massive quantities of employer stock in things that employees are relying on as pension plans.

Senator LEVIN. I think that is a very important distinction. So that you are not talking about employee stock ownership that does not have those tax benefits and are not part of pension plans, but only the ones that are. I think that is a huge important distinction.

Mr. LANGBEIN. Yes, and I will go further. For high level executives, I think it is particularly important that they be exposed, they be at risk with the company.

Chairman LIEBERMAN. Thanks. Very interesting. Senator Bennett.

Senator BENNETT. Thank you. I could engage in this conversation some more, but within the limited time let me switch to the issue of derivatives, because this has come up before. We were on the Banking Committee when the Orange County failure occurred and the headlines said, it was because they traded in derivatives. As we dug into it we found that the failure occurred because they made stupid decisions. As Alan Greenspan said to us, the use of derivatives simply made the effect of those decisions more efficient. If the man had made intelligent decisions, the use of derivatives would have been a wise thing because there would be greater efficiency in getting this.

What it boiled down to is he was making the wrong bet on interest rates. When the interest rates moved against, because he had always been right in the past, he doubled down on his bet, and he used derivatives to do it. Then he destroyed the entire pension plan of Orange County employees, and taxes had to go up in Orange County for decades after.

In a sense, is that not what we have here, where the executives of Enron, filled with the hubris of their success said, we are so smart that everything we bet on is going to come up roses, so we will go bet on bandwidth, we will go bet on dot-coms, we will go invest. And we have figured out this nifty way to do it with somebody else’s money and all we have to do is guarantee it with our own stock. And since our own stock is going to be going up perpetually forever, that is no risk. And it is too hard to explain to somebody so we will put it in a footnote that nobody can figure out. And everything is going to be wonderful.

It turned out that they were as stupid as the controller of the Orange County pension plan and it all collapsed on them, and then they started shredding documents. But is that a correct description of what happened? If it is, then let’s talk about the sunshine that

we put on, or the spotlight that we shine on the derivatives trading. Instead of starting with the spotlight, let's go down to a base understanding of what happened. Am I correct in my description of what happened?

Mr. PARTNOY. Yes. Let's start with the facts. You are largely correct. The paradox of Enron is that the company actually made huge amounts of money from its derivative trading, even in the last year. Where it lost its money is on all of these other bets, many of which you have mentioned: Fiber optics—they have been covered in the media extensively. But at its core it actually made a lot of money trading derivatives.

One of the problems that I have been trying to think about is what should be disclosed about that trading operation? Maybe Enron actually could have been a viable entity as a derivatives trading shop. But the problem is, investors did not know that. When you looked at Enron's financial statements it did not say, hey, we are a derivatives trading firm. It said, hey, we have all these other businesses going on, and by the way, it looks like we are making a lot of money over time.

The reality is, the only thing Enron was making money on was trading its derivatives, and trading derivatives was making up for all the losses in all of these other bad bets that you just described.

Senator BENNETT. Losses in what was perceived by the investment community as being its core business?

Mr. PARTNOY. That is correct.

Senator BENNETT. So we come back to the old adage, where is the best place to hide a leaf? The answer is, in plain sight on the floor of the forest surrounded by all of the other leaves. I have had to produce 10Ks and 10Qs in my life and I know how impenetrable they are.

Maybe the issue we should be focusing on with the accounting firm is how to write plain English sentences. Maybe the summary of the 10K or the 10Q should be: This is what is happening in the core business. This is what is happening in the areas we are experimenting with. This is where we are taking a risk, in bold print right up front rather than the arcane language of an accountant that drives you—and then the lawyers. By the time those two groups get through with the English language it becomes almost impossible for somebody who is not trained in both to understand what they are saying.

Maybe the focus should be—General Grant. There is an anecdote. General Grant had as one of his closest staff a fellow who was not very bright. People would say to him, why do you have that dummy on your staff. He said, because I read my general orders to him first, and if he can understand them, then I know the commanders in the field will not misunderstand them. Maybe we ought to have a house dummy somewhere at these accounting firms that has to sift through this language and say, yes, it is now clear.

Obviously, we cannot pass legislation to that—

[Laughter.]

Mr. PARTNOY. There is a plain English requirement and financial statements have gotten a lot clearer. But I went through Enron's financial statements, and my written testimony is 32 pages, and it

is as clear as I could make it. And if you gave it to an average investor it would be quite daunting, I think.

Part of the problem is that these things really are very complicated and we have problems with the rules. So the rules, even if this was clearly described, an investor would say, this is crazy, do you mean to tell me the accounting does not match up at all with economic reality? But that is what the rules say, all of these complicated rules basically allow managers to have accounting statements that do not match up with economic reality.

Even if that had been clear to investors I still think you would have this problem because within the clarity there still are things that can be moved off the balance sheet. In other words, say nothing; it is not on the balance sheet. And say nothing cannot be made any clearer, right? So improving clarity, I think, is a very important goal but will not solve the entire problem because many of these, the problematic transactions, are because of these rules.

As Senator Thompson mentioned before, one of the problems is a lot of these accounting issues are arguably quite legal. If they are, even if they are clearly described they still would lead to these problems.

Senator BENNETT. My own problem with this process, a word that I never learned until I got to the stage in my career where I was dealing with 10Ks and 10Qs, was materiality. What is material? We would have towering arguments as to what was material. Basically what that comes down to is, we do not think this is important to disclose.

We have just found out that you have done something really horrible, but we have put a dollar figure on it and the dollar figure compared to the total value of the enterprise says that it falls below the statistical level of materiality. So we say, the fact that you have just raped your secretary and stolen goods off of the company, etc., when we add up all of the dollars connected with that activity we say that is not material, so we are not going to disclose that. Whereas, somebody that was looking at you as a responsible executive would say, that is a very material fact.

So I guess what I am saying here is that we ought to examine what we think people really need to know rather than the legal structure that is currently there that says, if you comply with this and this and this you are within the law, even though you are ignoring all of the rest of this, that we just say, it is not material.

Mr. PARTNOY. Senator, I think you are right. The problem, of course, is that what is really material, if it is bad, the managers do not want to tell shareholders because that will cause the stock price to go down. So the question for regulation has to be, how do we create incentives that will either force managers to give up that information, or to have gatekeepers who will effectively look at the managers and force the managers to give up that information?

But I think you are absolutely right, there are all sorts of information that investors would think would be very important that is not reflected in that information. That is why, quite frankly, we have seen stocks going down in price recently, because investors are worried that there could be other disclosures that accountants said, this was not material, but it is still there and it is not reflected in the financial statements.

Senator BENNETT. Thank you.

Chairman LIEBERMAN. Very interesting. I could not agree with you more about the clarity of the reporting. Because part of what happened, because these are inherently complicated, is that the people we rely on to translate the complicated verbiage, the analysts, etc., failed as well.

Incidentally, Senator Levin wanted me to clarify that when you used the term house dummy you were not referring to his brother. [Laughter.]

Senator LEVIN. That was just a private joke. You just ruined a 66-year-old relationship.

Senator BENNETT. I have no comment, Mr. Chairman.

Chairman LIEBERMAN. A quick question and then Senator Thompson has a final question. This panel is too interesting.

Professor Partnoy, do you have any idea of what the dollar value annually is of the over-the-counter unregulated trading in derivatives?

Mr. PARTNOY. It is estimated at \$95.2 trillion. That is trillion with a "T." The estimate is almost certainly an understatement. The over-the-counter derivative transactions that Enron privately would enter into, for example, with some of these special purpose entities, would not be included in that statistic. So we are talking about a number that is seven times the regulated exchanges. We are talking about a number that is significantly larger than the U.S. stock market, for example.

Chairman LIEBERMAN. That is what I was going to ask you. When you said regulated exchanges, regulated sales, you are talking about derivative sales it is seven times greater than?

Mr. PARTNOY. Exactly, the regulated U.S. options—

Chairman LIEBERMAN. Can you compare it to—what is the annual volume of sales on the New York Stock Exchange?

Mr. PARTNOY. The total market capitalization fluctuates a lot but we are talking \$15 trillion, \$20 trillion, in that ballpark.

Chairman LIEBERMAN. So unregulated derivatives trading is that much larger every year?

Mr. PARTNOY. Yes, this is in notional terms. The amount at risk we are talking about in those contracts—even the people from the financial services firms, the lobbyists will come and say, no, that figure is wrong. It is the amount that is at risk. But we are still talking about trillions and trillions of dollars that are at risk.

Chairman LIEBERMAN. That is astounding.

Mr. PARTNOY. And in the U.S. stock market it is basically the same story.

Chairman LIEBERMAN. We will come back in a separate hearing to the question of whether that should be regulated or not. On that question, my final question, I will begin with you, Mr. Henning—Professor Partnoy, if you want to add anything, I welcome it—which is the whole question of deregulation of energy markets; not derivatives trading.

Last summer we had these rolling power blackouts in California and price spikes all around the country. Now we have got Enron, the largest energy trader, which that trading was obviously growing in part, some of it, all because of the deregulation of energy, electricity, for instance, markets. So obviously some critics of de-

regulation point to these events as evidence that deregulation should be reversed. I wanted to ask you what you think the lessons are for the way in which—from Enron, and perhaps the California experience—for the way in which energy markets should be regulated?

Mr. HENNING. Senator, I think the movement towards competitive commodity markets for energy have benefited consumers. I think that if you look back at the history of natural gas and you look at the—even with last year's high natural gases, in real terms natural gas prices were lower than they were back in 1983. So it has moved to the benefit of consumers. It, in fact, prevented the need for the same kinds of situations that you had back in 1976 and 1977 where you literally had to close schools in the State of Ohio because there was not any natural gas to heat them that winter.

So the lesson learned from deregulation was that you have to set up, and you have to set it up in a strong market. The FERC has been involved in doing that, and the one thing that, I guess, I believe is somewhat of a misnomer is energy is still highly regulated. The structures of the markets are being determined for electricity in regional transmission organizations. That is work in progress, but the FERC is doing a good job with that.

The market monitoring that the FERC is doing is going forward. So from that perspective, yes, you had events, driven largely by inadequate infrastructure and a confluence of weather events and so forth that affected the California market, as well as perhaps a poor original market design in the State of California. But by in large, the marketplace has wound up working.

The regulation has continued, and I guess I would just finish in saying that the FERC is doing its job in oversight for these energy markets. The question was asked earlier about where derivatives should be looked at, should it be CFTC or the SEC? I am not qualified to say, but the one thing I would say is, have the FERC continue to do what it is doing in energy markets and not have them impose additional things exclusively on the regulated entities there.

Chairman LIEBERMAN. I appreciate the answer. It is helpful. This Committee got into the crisis in California last year. I must say, there we felt that FERC was not doing its job. Ultimately, it did come in and create some regulation on the prices that were being charged by producers and wholesalers to people in California.

Dr. Partnoy, do you want to add anything?

Mr. PARTNOY. Could I just add one brief point to this because I think you have hit on something very important.

Chairman LIEBERMAN. The basic question is, should we go back and urge the other State legislators around the country to go back and take a second look at deregulation—deregulating the energy markets?

Mr. PARTNOY. I think you have hit on a very important point and it is part of what Senator Bennett and I were talking about, which is how did Enron's derivatives operation make all this money? In your dealing with, when you are trading with people who are less sophisticated than you are it is a better business. You are going to make more money in those kinds of markets.

That is one of the reasons—and Senator Thompson raised—why should we have regulation here? One reason might be, when you have parties who are dealing with substantially less sophisticated entities—and the securities markets generally they have claims, and rightfully so, to make the markets more efficient. In the derivatives markets those claims are much more difficult to make. How is it that Enron was making billions of dollars a year trading? It had an advantage in trading those markets.

Chairman LIEBERMAN. OK, very helpful. Senator Thompson.

Senator THOMPSON. Thank you, Mr. Chairman. It seems to me that Mr. Henning's earlier point is the valid one here, and that is that it is real proof that free markets do work and have worked. There has been no price spike and no lack of product or anything like that, at least not for these reasons.

But Mr. Partnoy, you mentioned another entity here kind of in passing that I think is very important. The credit rating companies, bond rating companies which presumably have access to detailed company financial data, as recently as October both Standard & Poor's and Moody's gave solid ratings for Enron's debt. I do not see the conflict of interest with them that we have been talking about with these other gatekeepers and so forth. How do you, any of you, how do you account for that?

Mr. PARTNOY. They are paid directly by the issuers, first of all, and we do not know exactly how much they are paid.

Senator THOMPSON. So there is a conflict issue there?

Mr. PARTNOY. There is an issue. The principal problem with credit rating agencies—and thank you so much for bringing up this question because I think it is critical to this story—is that credit rating agencies essentially have a legislative monopoly. Congress and the SEC and many regulators have given credit rating agencies a monopoly lock on their business. There is no one else who can enter and there are hundreds of legal rules that depend substantively on what rating you get. That is why they have so much power, from these legal rules.

If we got rid of those legal rules and made credit ratings a competitive business, we would not have these issues where it is dramatic if you get downgraded below BBB. Why is that? Why does it matter if Standard & Poor's, this private agency, downgrades you below BBB? Because you are toast in financial markets if you are below BBB. It is much more expensive to borrow. It is more expensive for people to hold your debt.

So that is where—there are two pieces to this. One is credit rating agencies make money. Moody's has a market capitalization of about \$5 billion. It is a huge and very valuable franchise.

The second point is, the reason they have that franchise is that we, I think quite lazily, adopted legal rules that defer judgments about investments to these credit rating agencies.

Senator THOMPSON. Are these legislative enactments that we have passed or are they regulations coming out of the SEC or other—

Mr. PARTNOY. They are regulations pursuant to various statutes that Congress has passed. It has been going on for almost 30 years. I would be happy to give you hundreds and hundreds of pages on this. I have been writing about this problem with credit rating

agencies for many years and I think it is central to why Enron collapsed, especially at the end.

Senator THOMPSON. We will follow up on that. Thank you very much.

Chairman LIEBERMAN. Thank you. Senator Levin tells me that I asked the question he had in mind; not about his brother, but about the value of the over-the-counter unregulated derivatives markets.

The three of you have been a superb panel. I appreciate very much the time you took in preparing your testimony and in being with us. Thank everybody who participated today. I think we are off to a good substantive start with a lot of work yet to do.

The hearing is adjourned.

[Whereupon, at 2:05 p.m., the Committee was adjourned.]

A P P E N D I X

OPENING STATEMENT BY ARTHUR LEVITT

Mr. Chairman, Senator Thompson, Members of the Committee:

Thank you for the invitation to share my thoughts on the failure of Enron and its implications for our financial markets.

Today, there is an emerging crisis of systemic confidence in our markets. What has failed is nothing less than the system for overseeing our capital markets. We have an opportunity to repair trust in those on whom investors depend, and in the process, trust in the numbers that are the backbone of our capital markets. But our response must be comprehensive. Healthy and resilient financial markets depend on the accountability of every one of its key actors – managers, auditors, directors, analysts, lawyers, rating agencies, standard setters, and regulators.

Enron's collapse did not occur in a vacuum. Its backdrop is an obsessive zeal by too many American companies to project greater earnings from year to year. When I was at the SEC, I referred to this as a "culture of gamesmanship" –

...a gamesmanship that says it's okay to bend the rules, tweak the numbers, and let obvious and important discrepancies slide...

...a gamesmanship where companies bend to the desires and pressures of Wall Street analysts rather than to the reality of numbers...

... where analysts more often overlook dubious accounting practices and too often are selling potential investment banking deals...

...where auditors are more occupied with selling other services and making clients happy than detecting potential problems...

...and where directors are more concerned about not offending management than with protecting shareholders.

Any reforms must recognize the importance of gatekeepers in safeguarding the interests of investors and the fundamental need to preserve and enhance these gatekeepers' independence. These steps are certainly not a panacea, but we must begin to reinvigorate the financial checks and balances.

First, we must better expose Wall Street analysts' conflicts of interest. For years, we've known that analysts' compensation is tied to their ability to bring in or support investment banking deals. In early December, with Enron trading at 75 cents a share, 12 of the 17 analysts who covered Enron, rated the stock either a hold or buy.

Two years ago, I asked the New York Stock Exchange and the National Association of Securities Dealers to require investment banks and their analysts to disclose clearly all financial relationships with the companies they rate. That rulemaking -- still not finalized -- should go further and mandate that analysts disclose how their compensation is affected by their firm's investment banking relationships. And Wall Street's major firms -- not its trade group -- need to take immediate steps to reform how analysts are compensated. As long as analysts are paid based on banking deals they generate or work on, there will always be a cloud over what they say. Analysts also should not be allowed to trade the stock of any company for which they have issued a recommendation in the last 30 days.

Second, company boards often fail to confront management with tough questions. Stock exchanges, as a listing condition, should require at least a majority of the directors on company boards to meet a strict definition of independence. That means no consulting fees, use of corporate aircraft without reimbursement, support of director-connected philanthropies, or other seductions. In Enron's case, at least three so-called independent board members would have been disqualified under this test of independence.

Third, many accounting rules need to be updated to better reflect changing business practices to give investors a better understanding of the underlying health of companies. Because the Financial Accounting Standards Board is funded and overseen by accounting firms and their clients, its decisions are agonizingly slow. This well-meaning group must defend itself as well from congressional pressure, which is often applied when powerful constituents hope to undermine a rule that might hurt their earnings. FASB's funding should be secured not just through the accounting firms and corporations, but also a number of market participants – from the stock exchanges to banks to mutual funds. And the Financial Accounting Foundation, which chooses FASB's members, should be composed entirely of the best qualified members – not merely those representing constituent interests. The FASB should then be able to focus more on getting the standards right, and avoiding delays and compromises that ill serve investors.

Let me turn briefly to probably the most urgent area of reform. Like no other, the accounting profession has been handed an invaluable, but fragile, franchise. From this Federal mandate to certify financial statements, the profession has prospered greatly. But as an edict for the public good, this franchise is only as valuable as the public service it provides, and as fragile as the public confidence that gives it life.

It's well past time to recognize that the accounting profession's independence has been compromised. Two years ago, the SEC proposed significant limits on the types of consulting work an accounting firm could perform for an audit client. An extraordinary amount of political pressure was brought to bear on the Commission. We ended up with the best possible solution – given the realities of the time.

I would now urge – at a minimum -- that we go back and reconsider some of the limits originally proposed – namely a prohibition on the auditor designing or installing information technology systems and performing the internal audit. Auditors should also be barred from consulting on how to structure transactions, such as the kinds of Special Purpose Entities that Enron engaged in. This type of work only serves to help management get around the rules.

I also believe that the audit committee – not company management – should pre-approve all other consulting contracts with the audit firm. Such approval should be granted rarely, and only when the audit committee decides that a consulting contract is in the shareholders' best interests. Lastly, I propose that serious consideration be given to requiring companies to change their audit firm – not just the partners -- every 5-7 years to ensure that fresh and skeptical eyes are always looking at the numbers.

More than three decades ago, Leonard Spacek, a visionary accounting industry leader, stated that the profession couldn't "survive as a group, obtaining the confidence of the public...unless as a profession we have a workable plan of self-regulation." Yet, all along the profession has resisted meaningful oversight. We need a truly independent oversight body that has the power not only to set the standards by which audits are performed, but also to conduct timely investigations that cannot be deferred for any reason and to discipline accountants. And all of this needs to be done with public accountability – not behind closed doors. To preserve its integrity, this organization cannot be funded, in any way, by the accounting profession.

The rise of the baby boom generation, changing retirement patterns and markets that sometimes defied the laws of gravity brought more and more first time investors into the markets. These are our friends and neighbors, whose hopes and aspirations became inextricably linked to the health and resiliency of our markets. We assault those dreams if company executives sell out shareholder faith and if those purporting to be independent are anything but. Enron, like every other financial failure before it, proves that investors bear the ultimate cost. It's time to repair what has been lost.

Thank you very much.

WRITTEN STATEMENT BY LYNN TURNER

Mr. Chairman, Senator Thompson, Members of the Committee:

Thank you for the invitation to share my thoughts on our system of accounting and the role it played in the Enron saga.

In business, we use numbers to report to investors, lenders, regulators and other users of the financial statements, the economic performance of a company. The numbers in the financial statements, just like a score on a college student's test, tell investors how a company has performed in comparison to expectations of management, the markets and competitors. Without these historical numbers, it is difficult, if not impossible, to gage the future prospects for a company. Without accurate numbers, investors are likely to be misled into making wrong decisions. When this occurs with increasing frequency, as we have seen in recent years, investors question whether they can invest with confidence without losing their money.

Two Key Issues

Enron does highlight two issues I want to focus on today. The first is that accounting standards are meaningless unless fully complied with, and enforced through a rigorous, unbiased and independent audit. The second is that our accounting standard setting process needs to be improved so as to yield more timely and higher quality standards. But keep in mind that no matter how quickly information is reported to the public, or what information is reported, if it is inaccurate, its value is lost.

A Lack of Compliance

To the first issue, we know that under the *existing* rules, Enron's financial statements should have presented a much clearer picture than they did when first presented to investors. Based on filings the company made with the Securities and Exchange Commission (SEC) in November of last year, there were four instances of noncompliance with *existing* rules.

Stock issued for a note

The first error involves the company issuing approximately \$1.2 billion of its stock and in return, receiving back a note receivable. Accounting rules of the SEC and Financial Accounting Standards Board (FASB) that have existed for over fifteen years prohibit a company from counting stock that has not been paid for, as equity on its balance sheet. This is because the company has not yet received cash (that is, the equity) it can use in the business. Enron notes this in their November 2001 filing with the SEC which correctly states: "Enron now believes that, under generally accepted accounting principles, the note receivable should have been presented as a reduction to shareholders' equity...The net effect of this initial accounting entry was to overstate both the note receivable and shareholders' equity..."

Materiality

The second error for which the company restated its financial statements resulted from the company failing to book audit adjustments decreasing income by \$51 million or 48.6% of the

reported net income of \$105 million in 1997. This is not the first time I have seen a company and its auditor rationalize why such a large number would not be considered important information to investors. As a result, in 1999, the SEC staff reiterated the rules on materiality in the form of a Staff Accounting Bulletin that I believe will prevent such abuses in the future, if properly followed.

Special Purpose Entities

The third error involves the company failing to include in its financial statements certain partnerships it had established for specific structured transactions. Special purpose entities or SPE's are typically designed for a specific transaction. SPE's come in various forms including partnerships like Enron established, corporations or even trusts. SPE's are used for many purposes such as financing buildings and equipment, raising capital by transferring receivables into an SPE that in turn raises capital, and providing capital to a bank that has troubled loans that are shifted out of the bank and into the SPE so as to facilitate improving its capital base. While SPE's are sometimes used for legitimate business purposes, they are too often used to hide liabilities from the unwary investor.

SPE's usually involve at least four parties when they are set up. The company who sets it up called the sponsor (Enron), the SPE itself (such as LJM1, Chewco or JEDI), a lender who is willing to finance the activities of the SPE, and an investor(s) who will own the SPE. In a nutshell, the sponsor establishes the SPE, which in turn acquires or builds an asset, the funding which is provided by the lender, who in turn may look to the sponsor for some form of support for the loan such as a guarantee or credit enhancement. The SPE is owned by an independent investor and who puts up in the form of equity, at least three percent of the amount of capital needed to acquire the asset. The debt of the lender is then paid back through lease payments or securitization of the SPE's assets.

A very simplified version of an SPE is as follows. Assume your household is a business and you own a home that has a mortgage on it. You want to go out and buy a second home in the Colorado mountains that will cost you \$200,000 and you will need to finance it. But you are concerned that if you take out a second mortgage on the mountain home, lenders will think your balance sheet has too much debt on it and will turn you down or charge you more to finance future purchases you are planning. So you go out and set up a partnership, and get a close friend to agree to put in 3% of the cost of the house, or \$6,000 in return for all the ownership of the partnership capital. The partnership goes to a mortgage company who agrees to finance the remaining 97% or \$193,000 of the transaction. You agree to guarantee the debt, or find someone who will, in return for you paying a fee. You also enter into a lease agreement and agree to make payments to the partnership that will be used to pay the mortgage in addition to a return to your friend on his capital. Assuming (i) you structure the terms of the lease properly, (ii) a third party (your friend) puts equity in the partnership for which he has risk of loss in a sufficient amount, (accounting practice says at least 3%) and (iii) the majority ownership of the partnership is held by someone other than yourself, you do not have to report the mortgage or maintenance costs on the second house on your balance sheet or income statement. By keeping this debt off your balance sheet, it looks to potential lenders as if your credit worthiness is better than if you had the additional

\$200,000 loan on it. Accordingly, you are able to get a better credit report and additional financing on better terms.

In the case of Enron, its SPE's did not meet the test for adequate capitalization under accounting guidelines that have been in existence since 1991. In its filing with the SEC in November 2001, the company notes that its previously issued financial statements were in error as three SPE partnerships named LJM1, Chewco and JEDI did not qualify "as an adequately capitalized unconsolidated special purpose entity..." or should have been consolidated because of "...inadequate capitalization." In 1991, the staff of the SEC wrote to the profession and stated: "The initial substantive residual equity investment should be comparable to that expected for a substantive business involved in similar leasing transactions with similar risks and rewards." This is a test that Enron did not meet.

Related party disclosures

The fourth question raised with respect to the financial statements of Enron involves the adequacy of the disclosures of the transactions Enron entered into with related parties such as its SPE's. In 1982, the FASB adopted SFAS No. 57, *Related Party Disclosures*. This is a broad general standard that requires a company to disclose (i) the nature of the relationships it has entered into, (ii) a description of the transaction, (iii) the dollar amount of the transaction impacting the income statement and (iv) the amounts due to or from the related party and how they are to be settled. Yet the description and discussion of related party transactions are in significantly greater detail in the November 2001 filings than had previously been disclosed. One can only ask why now? Why not before?

New accounting rules were not needed to prevent the restatements of Enron's financial statements or improve the quality of some of its disclosures. Compliance with and enforcement of the accounting rules that have been on the books for years would have given investors a timely and more transparent picture of the trouble the company was in.

While Enron has correctly been described as a business failure, it was also a failure that the audited numbers did not report the true economic condition of the company in an accurate and timely manner to investors.

To correct this lack of compliance with accounting standards, I hope you will consider the imperative need for an effective independent regulatory oversight body for the accounting profession, that has these critical elements:

1. It is conducted by an adequately funded organization,
2. Its members are drawn from the public rather than the profession,
3. It has the ability to investigate and discipline those who fail to follow the rules,
4. It has the power to establish auditing and quality control standards that serve the interests of investors as opposed to the interest of the profession, and

5. It inspects the work of auditors on an ongoing basis to ensure they have made the investing public, not the amount of consulting fees they can generate, their number one priority.

Enhancing Our Accounting Standards

Let me move on to the second issue I want to cover today. I believe our financial reporting system, including the accounting standards we use in assembling the numbers, remains the best in the world. That is difficult to comprehend in light of Enron, but one only has to examine closely the Asian crisis of a few years back to appreciate the quality of our financial reporting.

Yet our rules and processes can and should be improved to provide investors and regulators with greater transparency. The accounting standards need to be enhanced to ensure that the actual economics of transactions are reflected in a timely manner in financial statements. And the process for developing the standards needs to be more focused, timely and guided by a mission of improving transparency for investors.

We need to enhance disclosures regarding events and transactions that, should they occur, would result in a company being required to make payments to a third party. I believe the nature, terms, range of potential exposure and key assumptions used to determine that range should be disclosed. Investors have the right to know if a company could in fact face a meltdown as we have now seen occur with both Long Term Capital Management and Enron.

With respect to SPE's, the SEC first raised the issue in 1985 when it asked the FASB to consider the accounting for financial instruments, along with the accompanying structures that were often used. In the late 1980's, the SEC staff repeatedly stated concerns and asked a private sector task force of the FASB, the Emerging Issues Task Force (EITF) to address the issue. The end result was a set of weak rules that continue to mask from investors many off balance sheet transactions. The SEC has again highlighted its concern in its 2000 Annual Report to Congress, after a lack of success by the FASB in recent years in resolving the issue. If the SEC is to continue to look to the private sector to set accounting standards, which I strongly support, then the SEC and investors have the right to expect timely resolution of this and other important issues.

We cannot afford to wait another fifteen years. If the FASB were unable to rectify this issue by the end of 2002, then I would urge the SEC to act promptly. Hopefully the FASB will accomplish this goal, unimpeded by the traditional lobbying of special interests running to some members of Congress for their intervention in order to keep investors in the dark about their numbers.

The EITF is comprised of representatives of industry and the accounting profession. It's mission does not mandate standards that result in the most transparent reporting for investors and in fact, it has at times seemed to be more intent on grand fathering poor accounting from the past. It lacks representation from the public and investors and that is reflected in its standards. This should change.

And finally, one of the stark realities the FASB has faced in the past when setting standards is that before the ink dries, the investment banking community and accountants are joining forces to find ways to structure transactions to get around the new rules. And while the spirit of a rule may clearly say no, I have heard time and time again from a Chief Financial Officer or auditor, "where in the rules does it say I can't do it." It is time to get away from this mentality and a good starting point would be to prohibit auditors from designing and structuring transactions, such as SPE's, that result in less, rather than more, transparency for those they are reporting to.

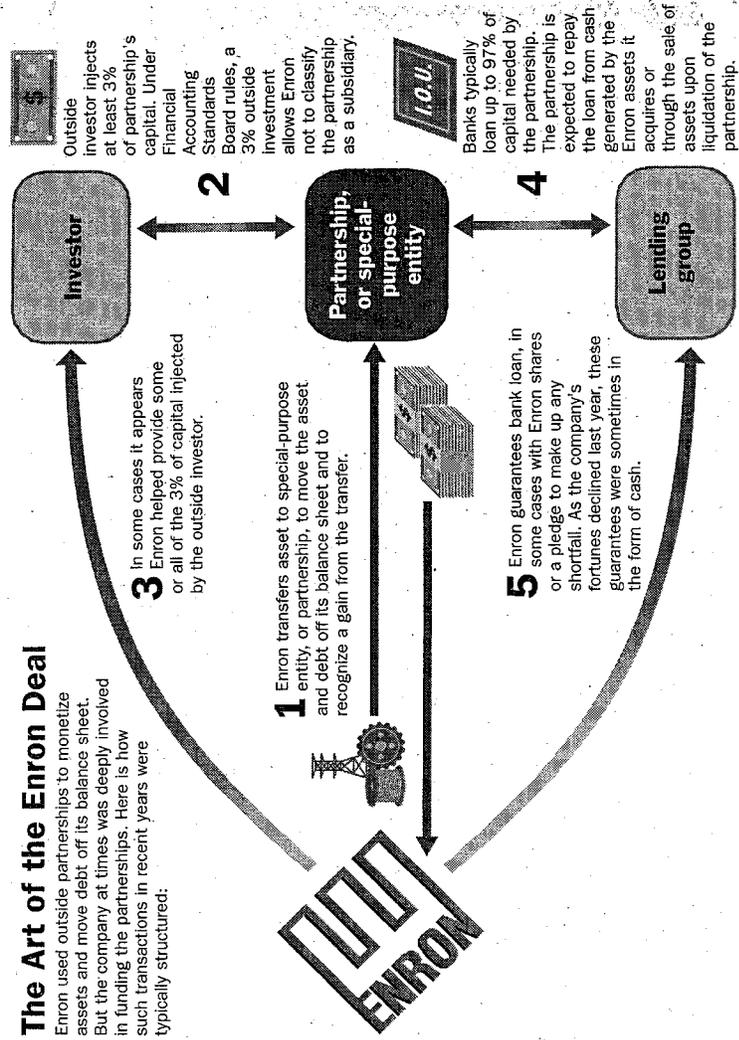
Closing

One out of every two adult Americans have invested in the U.S. capital markets that are the crown jewel of our economy. They have done so because they had trust and confidence in a system that provides the numbers investors need to make wise investment decisions. They have trusted that an independent public watchdog was on the beat.

But that trust now lies shattered and will not be easily restored. In the two hundred plus year history of the markets, every time that confidence has been shattered, our markets have sustained losses, investors have fled to safer havens and the capital vital to funding American business and job opportunities has dried up. We cannot let that happen again. We must act quickly to make real, not just cosmetic changes that will restore the confidence of investors and the American public. The public deserves nothing less from Congress, the accounting profession, regulators, analysts and other members of the financial community.

The Art of the Enron Deal

Enron used outside partnerships to monetize assets and move debt off its balance sheet. But the company at times was deeply involved in funding the partnerships. Here is how such transactions in recent years were typically structured:



**Before the United States Senate
Committee on Governmental Affairs**

Thursday, January 24, 2002

*Statement of
Bruce B. Henning
Director, Regulatory and Market Analysis
Energy and Environmental Analysis, Inc.
1655 North Fort Myer Drive
Arlington, Virginia 22209*

Introduction

Good morning. My name is Bruce Henning. I am Director, Regulatory and Market Analysis at Energy and Environmental Analysis, Inc. EEA is a privately owned consulting firm that provides analysis to institutional, governmental, and private sector clients in the areas of natural gas, electricity, and transportation and related environmental issues and policy. For the past 24 years, I have been an analyst of natural gas, electricity, and other energy markets. Along with my colleagues at EEA, I have conducted a number of comprehensive analyses of the North American natural gas markets, electricity markets, and energy infrastructure requirements. EEA provided the quantitative analytic support for the 1999 National Petroleum Council study, *Natural Gas: Meeting the Challenges of the Nation's Growing Natural Gas Demand*. EEA also authored the INGAA Foundation study, *Pipeline and Storage Infrastructure Requirements for a 30 Tcf Gas Market*, and performed the forecast and market analysis for the GTI (formerly Gas Research Institute) *Baseline Projection*. In addition, we have performed a large number of energy market analyses for private sector clients from all sectors of the energy industry including local natural gas distribution companies, natural gas producers, interstate natural gas pipeline companies, energy marketers, regulated electric utilities and independent power generation companies.

Statement of Bruce B. Henning
Before the U.S. Senate
Committee on Governmental Affairs
January 24, 2002

I am here today to discuss the behavior of natural gas and electricity markets in the wake of the "Chapter 11" bankruptcy of Enron. The views that I express are my own and do not reflect the views and positions of any of EEA's clients.

Enron has not been one of my clients or a client of the EEA Energy Group over the past five years. However, for the last several years, EEA has provided Enron with environmental regulatory and policy analysis, primarily tracking the development of environmental regulations and assessing the regulatory and permitting implications of different kinds of projects. Enron was also a member of the Clean Power Group, a consortium of power companies that EEA worked with on the development of multi-pollutant legislation.

Impact on Energy Consumers

Enron has been an important company in natural gas and electricity markets in the United States. Prior to the bankruptcy, Enron was the largest marketer of gas and electricity in the United States, operating in both wholesale and retail energy markets. Enron owns and operates three major interstate gas pipeline systems and has an ownership interest in a number of others. Enron has an interest in electricity generation in more than a dozen states.

The Enron failure caused some disruptions in natural gas and electricity markets, but these were relatively minor. Given the scope of Enron's activity within the gas and electricity markets, the absence of a significant disruption in energy markets is a credit to the marketplace and to the people who make the energy marketplace work. Throughout the collapse of Enron, supplies of gas and electricity have continued to be delivered to consumers. The reliability of the energy delivery system has not been compromised.

Moreover, gas and electricity prices to the retail customer have not been significantly affected by the events surrounding the Enron bankruptcy. Enron's retail gas customers generally have been able to migrate to the regulated utilities or to other energy marketers

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and the prices that they pay for their gas largely reflect the general market fundamentals, which are yielding substantially lower gas prices than a year ago.

Wholesale Market Impacts

Over the past two decades, the structure of the natural gas market has changed from a market that relied almost exclusively upon price regulation to a market where prices are determined by the balance of supply and demand subject to the regulatory oversight of the Federal Energy Regulatory Commission (FERC). A liquid and transparent market has developed where gas is traded on a daily basis at more than 60 locations around the nation.

Competitive wholesale electricity markets are less mature than their gas counterparts. Under the oversight of the Federal Energy Regulatory Commission (FERC) significant progress toward competitive electricity markets has occurred. Moreover, with the continuing development of FERC regulated Regional Transmission Organizations (RTOs), liquidity, transparency, and efficiency of electricity markets will likely improve further.

Prior to the suspension of trading activity, Enron was the largest participant in both the wholesale gas and electric markets. Enron traded in the physical market, as well as in the important financial market for gas and electricity. The financial market involves the trading of contractual obligations that are linked to the movement of prices in the physical markets for gas and electricity. The financial markets provide a low transaction cost method for wholesale market participants to manage price volatility risk or to take positions in the markets.

Gas and electricity wholesale markets have been quite volatile, more volatile than most other commodity markets. The day-to-day demand for energy can vary substantially

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because of the influence of weather in a way that other commodities generally do not experience. But over time, the prices for the commodity should reflect the fundamental balance of supply and demand.

Examination of wholesale prices since September indicates that gas and electricity markets behaved reasonably well during a period where the largest market participant was in turmoil. In the gas market, the fall and early winter is a critical period. One expects volatility in gas prices and indeed gas prices were volatile. However, overall the prices continued to reflect the market fundamentals and responded to soft demand, driven by warm weather and continued weakness in industrial activity, high inventories of gas in storage, and growth in gas productive capacity that resulted from the high drilling activity throughout most of 2001.

I have included in my written testimony charts showing the prices for gas at two important locations for the gas market. For each point, one chart shows two years of market behavior and a second chart focuses on the market since September. Evaluation of this data as well as the data from more than 20 other pricing points shows that prices, while volatile, have not experienced large movements by historical standards.

Specific Effects of the Enron Bankruptcy

The Enron bankruptcy impacted market participants in a number of ways. First, Enron's electronic trading platform, Enron Online, was the largest platform in terms of volume of trades and scope of the products traded. Almost all participants used Enron Online for trades and for price discovery. When Enron Online went dark, the market lost an important source of price information as well as a low transaction cost method of trading. Fortunately, there were other sources of pricing information that is collected and available to the market and other, albeit smaller, electronic trading platforms. Market participants shifted to other sources and began to increase activity on other platforms. Some of these other trading platforms have experienced trading volume increases of 60 percent or more since the start of Enron's collapse. Within weeks, market participants

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had largely adjusted to the loss of Enron Online. In addition, Enron Online or a successor may be marketed by UBS. On Friday, the U.S. Bankruptcy Judge approved the sale of Enron's trading unit, including Enron Online, to UBS. UBS may or may not become a successful player in gas and electric markets in the United States. If successful, UBS will add to liquidity and price discovery. But even without UBS, there are many sources of market transparency and liquidity to ensure the proper operation of energy markets.

The financial exposure of other parties involved in transactions with Enron is a much more complicated issue. As a general matter, companies involved in energy commodity trading work to limit the size of their exposure to any individual company, even a company that was as large as Enron. As Enron came under increasing pressure, many participants began to reduce their exposure arising from their transactions with Enron. Even so, the exposure remains large, but manageable for most companies.

Beyond that, Enron had entered into a number of longer-term contracts with buyers and sellers of gas and electricity. The status of these contracts is unclear and will be determined through the bankruptcy proceedings in the courts. It is possible that the parties that are holding contracts with Enron will find themselves back in the market when they had thought that they had hedged their future stream of production or their future energy needs. They might be worse off or they might be better off, depending upon future energy price movements, one does not know.

The loss of Enron has presented an opportunity for other energy marketing companies to capture market share. Indeed, as Enron's customers have sought to replace services obtained from Enron, other marketers have stepped in. However, the ability of these marketers to aggressively pursue market share has to be tempered with the need to insure that these companies remain financially strong.

The equity prices and bond ratings of a number of energy marketers, independent power producers, and gas pipelines have come under pressure in recent weeks. As a result,

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these companies have begun to take action to strengthen their balance sheets to re-establish lenders' confidence. As a part of the actions taken, many companies are reducing their capital project budgets, canceling or delaying power plant construction and delaying commitments to gas pipeline expansions.

EEA's analysis indicates that the cancellation of power plant projects does not necessarily foretell an impending electricity shortage. In our opinion, there was significantly more generation capacity proposed than was needed for the next five years. We felt it was likely that many of the generation projects would be delayed or cancelled even without the Enron bankruptcy. The Enron event precipitated the shakeout that was likely to occur in any event.

That being said, the decline in bond ratings and equity prices for many companies will increase the cost of capital for many needed infrastructure projects. This increase will have an effect on energy markets for a number of years and if confidence is not re-established in the relative near-term, the financial fallout of the Enron bankruptcy will become more troublesome. This country will need considerable amounts of capital investment in gas pipeline, gas distribution, electricity generation and transmission, and gas and oil exploration and development over the next 10 to 20 years. The planning, permitting, investment, and construction of these projects will be a challenge and will require a financially healthy energy industry.

Conclusion

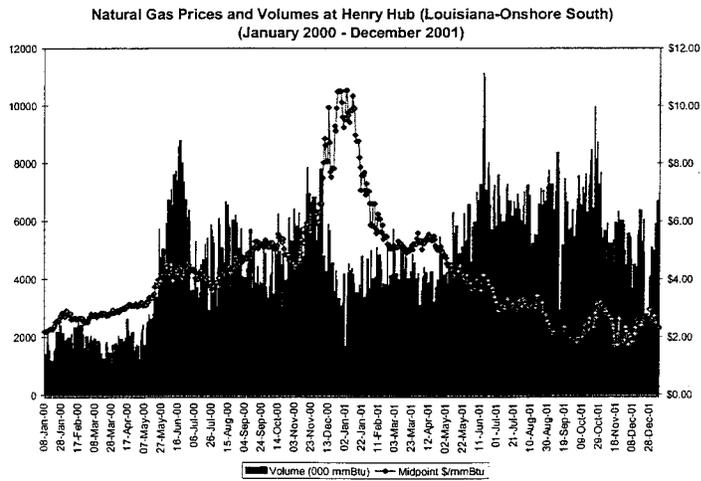
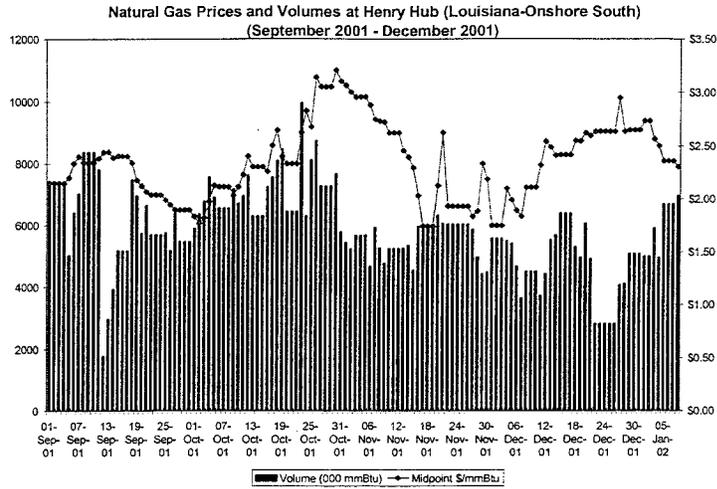
The events surrounding the bankruptcy of Enron have been tragic for thousands of Enron employees and investors and raise a number of serious questions regarding corporate accounting and disclosure of corporate information. All of us that work in the field of energy know individuals who have been hurt tremendously and have seen the personal pain of the people involved.

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But from the relatively narrow perspective of energy markets, the performance in the last several months has shown an ability to respond to a major disruption in the market without an interruption of the delivery of energy to consumers and without a significant increase in consumer prices. The events challenged the men and women in energy companies to meet their commitments to the consumer. The structure of gas and electric markets forged by federal and state regulators in accordance with the federal and state laws performed well in the face of an event that had never been seriously contemplated.

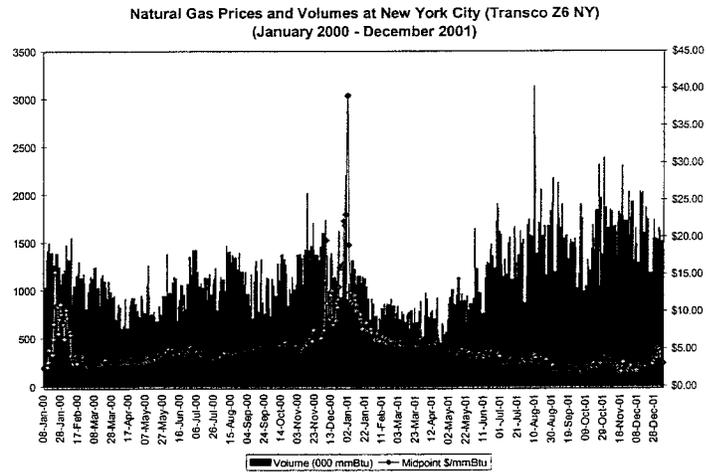
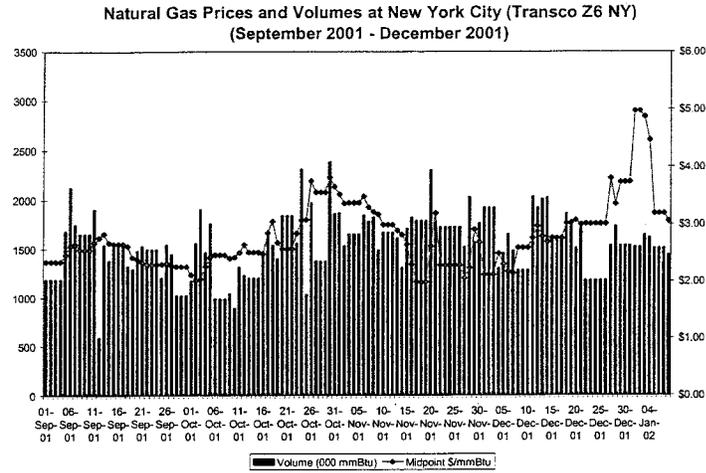
I would like to thank the Committee for the opportunity to express my views and I would be happy to answer any question that I can.

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Data Source for Charts: *Natural Gas Daily*

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Data Source for Charts: *Natural Gas Daily*

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U.S. Senate
Committee on Governmental Affairs

Enron Hearings
24 January 2000

The Enron Pension Investment Catastrophe:
Why It Happened and How Congress Should Fix It

Statement of Professor John H. Langbein
Yale Law School

I appreciate the invitation to speak with you about the pension investment aspects of the Enron Corporation bankruptcy.

I have been teaching and writing about pension law and pension policy for two decades. I coauthor the principal book on pension law that is used in American law schools.¹ I serve as a Uniform Law Commissioner from Connecticut, and I was the reporter (drafter) for the Uniform Prudent Investor Act (1994), which now governs fiduciary investing at the state level in most American states.

1. The Enron plan. Enron Corp. sponsored a 401(k) pension plan for its employees.² The plan permitted the employee to contribute up to 15 percent of his or her salary, subject to a ceiling.³ Enron made a matching contribution of half of what

¹John H. Langbein & Bruce Wolk, *Pension and Employee Benefit Law* (Foundation Press, 3d ed. 2000 & 2001 Supp.).

²The plan document is titled "Enron Corp. Savings Plan As Amended and Restated Effective July 1, 1999" [hereafter cited as Enron Plan].

³Enron Plan, § III.1.

the employee contributed.⁴ The sums contributed by both employee and employer were tax deferred under Sections 401(a) and 401(k) of the Internal Revenue Code. The plan provided that Enron's contribution would be entirely in Enron stock.⁵ The employee participant could choose to invest his or her contribution among a menu of options, including leading well-diversified mutual funds⁶ or more Enron Stock.

The plan required the employee-participant to hold the employer-contributed Enron shares until age fifty.⁷ Only at that age could he or she direct that the Enron shares be sold and the proceeds redirected into other investments. With respect to these match shares, the plan made the employee-participants into involuntary Enron shareholders until age 50.

As Enron's financial difficulties began to be revealed in the fall of 2001, the value of Enron shares, including those held in the pension plan accounts, declined precipitously. Shares that had traded above \$80 per share at the apogee are now effectively worthless. As a result, many Enron employees have lost huge portions of their expected retirement funds--both the employer match shares and those Enron shares that many employees elected to purchase with their own contributed funds.

Although some of the alleged financial skullduggery of Enron's managers, directors, and accountants may have violated ERISA fiduciary law, it is vital for Congress to understand that the key feature of the Enron plan that made it possible for these losses to occur--the large concentration of employer stock in the plan's investments--was permitted under ERISA, the federal pension regulatory law.

ERISA invited this mess, and unless you change ERISA, I can predict to you with utter certainty that such cases will happen again, as they have repeatedly in the past. What's new about the Enron calamity is simply the enormity of the losses.

⁴Enron Plan, § III.4. The matching contribution was subject to the limit that it could not exceed 6 percent of the employee's base pay.

⁵Id. § V.16(a).

⁶Including the Vanguard 500 Index Trust, the Fidelity Magellan Fund, the Fidelity Growth and Income Fund, the PIMCO total Return II Fund, and the T. Rowe Price Small Cap Fund. Source: Enron Benefits Dept., "Money in Motion: Enron Corp. Savings Plan 401(k) Plan Details."

⁷Enron Plan § IV-16(b).

2. DC plans. 401(k) plans such as Enron's are known as defined contribution (DC) plans, or in the language of ERISA, as "individual account plans." DC plans "provide[] for an individual account for each participant;" the participant's "benefits are based solely upon the amount contributed to the participant's account," plus the investment experience (dividends, gains or losses) of the account. ERISA § 3(34).

The distinctive feature of any DC plan is that investment risk rests entirely upon the account of each participating employee. The employee captures market gains, the employee suffers market declines.

By contrast, in a traditional defined benefit (DB) plan of the sort that prevails among large employers in manufacturing and transportation industries and utilities, the employer (or other sponsor) bears the investment risk. In a DB plan the employer promises the employee a certain benefit on retirement, and if the investments in the pension fund don't produce enough to pay the benefit, the employer must make up the shortfall from company assets.

3. The DC or 401(k) structure is not the problem. As ERISA now stands, the high concentration of employer stock that allowed the catastrophic losses to the Enron employees could only have occurred in a DC plan, because ERISA's diversification requirements (discussed below) would have prevented these concentrations in a DB plan. It would be a fallacy, however, to conclude that the problem lies in the nature of DC plans. The truth is that it is as easy to avoid over-concentration in a single stock in a DC plan as in a DB plan. For example, most of us who are employed in academia participate in DC plans operated by TIAA-CREF. TIAA-CREF diversifies its stock and bond investments across literally thousands of issues.

The ERISA failure that allowed the Enron employees' loss to occur is that ERISA contains an exception to its diversification requirement. ERISA allows certain types of DC plans, including 401(k) plans, to permit and/or require employees to hold these large concentrations of employer stock in their plan accounts.

Over the past two decades that 401(k) plans have been allowed⁸ there has been a huge increase in the use of DC plans, especially 401(k) plans. The Employee Benefits Research Institute (EBRI) reports that as of the year 2000, there were more than 327 thousand 401(k) plans in effect, covering more than

⁸IRC § 401(k) originated in the Revenue Act of 1978, but 401(k) plans became attractive only when the IRS issued regulations in 1981 clarifying the salary reduction mechanism that allows the employee to contribute pretax dollars.

43 million active participants, holding assets of \$1.8 trillion. There are many reasons for this complex development.

DC plans do have disadvantages,⁹ but they have two great advantages for employees that help explain their popularity.

First, DC plans offset the lack of portability in the private pension system. DC plans produce better results for the employee who works for several employers across his or her career than does a DB plan, because DB plans use career-average service formulas that favor long-service employees. DC plans are a response to the increasing mobility of the workforce.

Second, DC plans encourage employees to engage in more pension saving than usually occurs under DB plans,¹⁰ both because the transparency of the individual account mechanism is easier for the employee to understand and to value than a distant benefit formula; and because there are ways to arrange that any money in a DC account that the employee and his or her spouse do not turn out to need for their retirement will pass to their heirs. The ability to transfer the account balance on death encourages employees to make more ample provision for their retirement, secure in the knowledge that they will not forfeit the cushion.

Accordingly, the lesson to learn from the Enron debacle is not that DC plans should be restricted, but that the diversification standards that Congress wisely imposed on DB plans need to be extended to DC plans.

4. Diversification. The duty to diversify investments is a standard principle of good fiduciary investing practice, which

⁹The two most important: (1) DC plans require ordinary workers to make important investment management decisions, which in a DC plan are the work of investment professionals; (2) DB plans can deliver larger retirement benefits per dollar of savings, because they mandate annuitization as the mode of distribution, recapturing for other plan members the sums not needed to support short-lived participants and beneficiaries. For further discussion of the pluses and minuses of DC plans, see Langbein & Wolk, *supra* note 1, at 51-61.

¹⁰For evidence that "assets at retirement after lifetime employment under a 401(k) plan would typically be much higher than under a defined benefit plan," see James M. Poterba, Steven F. Venti & David Wise, *The Transition to Personal Accounts and Increasing Retirement Wealth: Macro and Micro Evidence* (National Bureau of Economic Research Working Paper 8610) (2001).

was long ago¹¹ absorbed into the trust investment law.¹² ERISA has from its enactment in 1974 imposed this duty to diversify pension fund investments. ERISA § 404(a)(1)(C).

ERISA's duty to diversify does not, however, apply to all pension plans. Rather, Congress allowed an exception for certain types of DC plans. ERISA §§ 404(a)(2), 407(d)(3). That exception is a major mistake of pension policy, and until Congress fixes it, I can predict to you with utter certainty that cases like Enron will continue to occur.

Let me say a quick word about the underlying economics of the duty to diversify. The importance of diversification is by far the most important finding in the entire field of financial economics. Over the past 40 years, we have had a stream of empirical and theoretical studies, which have led so far to six Nobel prizes in economics, conclusively showing that there are large and essentially costless gains to diversifying an investment portfolio thoroughly.

Investment risk has three distinct components: market risk, industry risk, and firm risk. Market risk is common to all securities; it reflects general economic and political conditions, interest rates, and so forth, hence cannot be eliminated. Industry risk, by contrast, is specific to all the firms in each industry or industry grouping. Firm risk refers to factors that affect the fortunes only of the particular firm. My favorite illustration is the example of the international oil companies. All of them suffered from the 1973 Arab embargo (industry risk). By contrast, only Exxon incurred the liabilities arising from the great Alaskan oil spill of March 1989 (firm risk). Holding shares in other industries helped prudent investors to offset the decline of the oils in 1973; holding shares of other oils helped offset the decline in Exxon.

Only about 30 percent of the risk of security ownership is market risk, that is, risk that cannot be eliminated by diversification. By contrast, industry risk amounts to about 50 percent of investment risk, and firm risk comprises the remaining

¹¹We have had the duty to diversify in American trust investment law for well over a century. E.g., Dickinson, Appellant, 152 Mass. 184, 25 N.E. 99 (1890).

¹²Restatement of Trusts (Second) § 228 (1959); Restatement of Trusts (Third): Prudent Investor Rule § 227(b) (1992).

20 percent.¹³ Thus, effective diversification can eliminate roughly 70 percent of investment risk.

And that is why, from the standpoint of good investment practice, a portfolio such as the Enron pension fund, so heavily concentrated in a single stock, any stock, is pure folly. But there are many plans sitting out there with even more employer stock than Enron. For example, as of January 2000, Proctor and Gamble had a DC plan with 96 percent in employer stock, Pfizer has one with 88 percent, Abbot Laboratories with 87 percent.¹⁴

According to the most recent data reported by EBRI, employer stock comprises 19 percent of all 401(k) plan assets,¹⁵ but that number, which averages plans with and without employer stock, understates the magnitude of the problem for the plans with the employer stock.¹⁶

5. What's wrong with employer stock. A pension fund portfolio holding a massive part of its assets in any one stock is bad; but holding such a concentration in the stock of the employer is worse. For the employees of any firm, diversification away from the stock of that employer is even more important. The simple reason is that the employee is already horrifically underdiversified by having his or her human capital tied up with the employer. The employee is necessarily exposed to the risks of the employer by virtue of the employment relationship. The last thing in the world that the employee needs is to magnify the intrinsic underdiversification of the employment relationship, by taking his or her diversifiable investment capital and tying that as well to the fate of the employer.

The Enron debacle illustrates this point poignantly. Just when many of the employees have lost their jobs, they have also lost their pension savings, which in a 401(k) plan they could have borrowed against (or with a penalty, withdrawn) in order to tie them over.

¹³R.A. Brealey, *An Introduction to Risk and Return from Common Stocks* 117 (2d ed. 1983). Brealey's actual numbers are 31 percent market risk; 12 percent industry risk; 37% other groupings; and 20% firm risk. I consolidate industry and other groupings as industry risk and round to 50 percent.

¹⁴Pensions & Investments, Jan. 24, 2000, at 26.

¹⁵Sarah Holden & Jack VanDerhei, 401(k) Plan Asset Allocation, Account Balances, and Loan Activity in 2000, EBRI, Issue Brief (Nov. 2001) at 1, 6 & Chart 3.

¹⁶See id. at 13 & Table 10.

6. The incentives argument. What's the case for having employer stock in pension funds? The argument is that employers want to incentivize employees to identify with the stockholders of the firm. Making employees into stockholders will motivate them to care about the firm's profitability.

There's a simple answer to that argument: Don't do it in the pension fund. If you want to sell stock to your employees for such sound business reasons, go right ahead and do so (subject to adequate disclosure of the risks--a subject to which I shall return). But you should not be able to treat such a program as a pension fund, for two very good reasons: It abuses the pension tax subsidy and it misleads employee-participants.

Congress provides two huge tax subsidies for qualified pension plans: Employee and employer contributions to such plans are tax deferred, and so is any investment buildup. Congress grants this subsidy in order to promote pension saving, hence to promote retirement income security. That policy is concerned to protect the employee and his spouse in their post-employment years. The policy has nothing to do with promoting employer interests. To the contrary, the most fundamental principle of ERISA fiduciary law is the so-called exclusive benefit rule, requiring that pension plan investing and administration must be done "solely in the interest of the participants and beneficiaries and ... for the exclusive purpose of providing benefits" to them. ERISA § 404(a)(1)(A). Ordinarily, therefore, subordinating the interests of the employees to those of the employer is a breach of the fiduciary duty to avoid such conflicts of interest under ERISA. Apart from the statutory exception that allows employer stock in pension plans, the message of ERISA is: pension plans are for employees, not for employers. Congress provides the pension tax subsidy for employee interests.

Another way to make that point is to remind ourselves that the employee has earned the pension. Employers do not offer pension plans in order to be nice guys--indeed, employers have a fiduciary duty to their shareholders not to waste the company's assets by giving those assets away to people, even employees. These plans are not gratuities. Employers offer pension plans as part of the compensation package, as what we call deferred compensation.¹⁷ Pensions are the employee's earnings, channelled

¹⁷The claim that pensions were gifts, the so-called gratuity theory of pensions, has a long history. American law decisively rejected the gratuity theory in favor of the deferred compensation theory across the twentieth century. For discussion, see Langbein & Wolk, *supra* note 1, at 16-17, 122-27. ERISA's vesting and benefit accrual rules implement the deferred compensation view.

into retirement saving at the source. We should not let supposed employer preferences interfere with the best interests of the employee.

As the Enron calamity shows, employees do not understand the risks involved in holding employer stock in their pension accounts. They rely on these accounts for their retirement. Many of the employees do not have enough years left in the workforce to be able to replace the losses in subsequent employment.

7. The plan formation argument. The other claim on behalf of the status quo is that in our voluntary private pension system, if you don't let employers stuff employer stock in these plans, they won't offer the plans at all. This is highly unlikely.

In competitive markets, if one employer won't offer a pension plan while others do, that employer will be at a disadvantage in competing for workers. The employers who offer pensions today do so in order to be competitive for workers who are pension-sensitive, and such employers will continue to want to be competitive for such workers by offering pensions even if the employers are forbidden to stuff the plans with company stock.

We heard the same argument when Congress imposed vesting rules in ERISA in 1974, and when congress mandated spousal shares in 1984. The truth is that sensible pension regulation does not discourage plan formation. To the contrary, by making pension promises more reliable, it increases the attractiveness of pension plans to employees, and causes firms to offer more of them.

As regards 401(k) plans, the argument is sometimes made that if employer stock investments were curtailed, employers might continue to offer 401(k) plans, but employers would not continue to offer matching contributions unless in employer stock. While I doubt that, there is an easy compromise: let the employer who wishes continue to contribute employer stock (and to get the tax deduction for doing so), but require that the plan fiduciary dispose of it on the open market within a short period and reinvest the proceeds in a diversified portfolio.

8. The solution is already in ERISA. If there is one bright spot for the future in the Enron pension catastrophe, it is that we know exactly how to prevent such cases from occurring again. We not only know the cause, we also know the cure.

The losses have been caused by allowing DC plans to be underdiversified. The cure is to require diversification.

Congress has successfully insisted on diversifying plan investments in DB plans for a quarter century. What is needed is to extend that regime across the DC universe, to cover all tax-qualified plans.

Congress should not prohibit employer stock from pension plans altogether, because there are situations in which a prudent fiduciary investor may choose to hold some. For example, it is common for pension investment managers to buy index funds in fiduciary accounts. Index funds hold shares in all the companies in the index, and the employer may be one of those companies.

In ERISA § 407(a)(2), Congress set a ceiling on employer stock, saying that a plan may never hold more than ten percent,¹⁸ but Congress then left it to the prudence and diversification rules of ERISA § 404(a) to govern the question of how much less than 10 percent is appropriate. The normal answer will be little or none. The one time a DB plan tried to approach the 10 percent limit, in the most famous of all ERISA investment cases, Donovan v. Bierwirth, the Second Circuit held that the investment in employer stock was imprudent. Bierwirth stands for the proposition that the prudence and diversification norms of ERISA § 404(a) govern the exercise of the up-to-ten-percent authority in ERISA § 407(a)(2).

The paradox of ERISA is that it contains both the problem and the solution to the Enron mess. ERISA contains a diversification regime that would prevent such cases from ever happening again if extended from DB to all DC plans. (Obviously, were Congress to take that step, it would be important to provide a transition period to assure orderly compliance.)

9. ESOPs. I must emphasize that everything I have said about the evils of employer stock in 401(k) plans applies equally to employee stock ownership plans (ESOPs). It has been known from the beginning in the specialist literature that ESOPs represent bad retirement policy.¹⁹ They are tools of corporate finance masquerading as pension plans.

¹⁸ERISA § 407(a)(2).

¹⁹ESOPs have been trenchantly criticized on a variety of policy grounds. See, e.g., Michael W. Melton, *Demythologizing ESOPs*, 45 Tax L. Rev. 363 (1990); Richard L. Doernberg & Jonathan R. Macey, *ESOPs and Economic Distortion*, 23 Harvard J. Legislation 103 (1986); D. Bret Carlson, *ESOPs and Universal Capitalism*, 31 Tax L. Rev. 289 (1976).

10. Disclosure. My main recommendation to you is to extend ERISA's diversification regime to all tax-qualified plans. If a plan gets the tax benefits of a pension plan, it should not hold material concentrations of employer stock.

If Congress lacks the political will to take that step, or to take it across the entirety of the DC plan universe, I would offer a weaker alternative: Congress should at least insist upon alerting employees about the risks of holding employer stock. My source of inspiration is the Surgeon General's warnings on cigarette packages. The thinking behind those warnings is that people need to be aware of the risks, so that they can alter their behavior. Transferred to the pension arena, the point is that if employees were warned about the risks of employer stock, they would be in a better position (1) to avoid electing to buy more of it in plans that offer it as an employee option, and (2) to pressure employers to move away from ESOPS and to discontinue using employer stock in the match feature of 401(k) plans.

ERISA § 102 presently requires employers or other plan sponsors to send to employees annually a summary plan description (SPD), describing key features of each plan. I would recommend that Congress require that the SPD for any plan that contains an employer stock option or employer stock match contain a Surgeon General's warning, something like this:

WARNING

Under commonly accepted principles of good investment practice, a retirement account should be invested in a broadly diversified portfolio of stocks and bonds. It is particularly unwise for employees, who are already subject to the risks incident to employment, to hold significant concentrations of employer stock in an account that is meant for retirement saving.

A disclosure solution of this sort is, I repeat, a second best solution.

The best solution is for Congress to mandate diversification across the entire universe of pension plans, as a condition of the tax subsidy that Congress grants these plans. By taking that step, Congress could tell the American worker with confidence that Congress has done what is necessary to assure that there will never again be another Enron-type pension calamity.

Testimony of Frank Partnoy
Professor of Law, University of San Diego School of Law
Hearings before the United States Senate
Committee on Governmental Affairs, January 24, 2002

I am submitting testimony in response to this Committee's request that I address potential problems associated with the unregulated status of derivatives used by Enron Corporation.

I. Introduction and Overview

I am a law professor at the University of San Diego School of Law. I teach and research in the areas of financial market regulation, derivatives, and structured finance. During the mid-1990s, I worked on Wall Street structuring and selling financial instruments and investment vehicles similar to those used by Enron. As a lawyer, I have represented clients with problems similar to Enron's, but on a much smaller scale. I have never received any payment from Enron or from any Enron officer or employee.

Enron has been compared to Long-Term Capital Management, the Greenwich, Connecticut, hedge fund that lost \$4.6 billion on more than \$1 trillion of derivatives and was rescued in September 1998 in a private bailout engineered by the New York Federal Reserve. For the past several weeks, I have conducted my own investigation into Enron, and I believe the comparison is inapt. Yes, there are similarities in both firms' use and abuse of financial derivatives. But the scope of Enron's problems and their effects on its investors and employees are far more sweeping.

According to Enron's most recent annual report, the firm made more money trading derivatives in the year 2000 alone than Long-Term Capital Management made in

its entire history. Long-Term Capital Management generated losses of a few billion dollars; by contrast, Enron not only wiped out \$70 billion of shareholder value, but also defaulted on tens of billions of dollars of debts. Long-Term Capital Management employed only 200 people worldwide, many of whom simply started a new hedge fund after the bailout, while Enron employed 20,000 people, more than 4,000 of whom have been fired, and many more of whom lost their life savings as Enron's stock plummeted last fall.

In short, Enron makes Long-Term Capital Management look like a lemonade stand.

It will surprise many investors to learn that Enron was, at its core, a derivatives trading firm. Nothing made this more clear than the layout of Enron's extravagant new building – still not completed today, but mostly occupied – where the top executives' offices on the seventh floor were designed to overlook the crown jewel of Enron's empire: a cavernous derivatives trading pit on the sixth floor.

I believe there are two answers to the question of why Enron collapsed, and both involve derivatives. One relates to the use of derivatives "outside" Enron, in transactions with some now-infamous special purpose entities. The other – which has not been publicized at all – relates to the use of derivatives "inside" Enron.

Derivatives are complex financial instruments whose value is based on one or more underlying variables, such as the price of a stock or the cost of natural gas. Derivatives can be traded in two ways: on regulated exchanges or in unregulated over-the-counter (OTC) markets. My testimony – and Enron's activities – involve the OTC derivatives markets.

Sometimes OTC derivatives can seem too esoteric to be relevant to average investors. Even the well-publicized OTC derivatives fiascos of a few years ago – Procter & Gamble or Orange County, for example – seem ages away.

But the OTC derivatives markets are too important to ignore, and are critical to understanding Enron. The size of derivatives markets typically is measured in terms of the notional values of contracts. Recent estimates of the size of the exchange-traded derivatives market, which includes all contracts traded on the major options and futures exchanges, are in the range of \$13 to \$14 trillion in notional amount. By contrast, the estimated notional amount of outstanding OTC derivatives as of year-end 2000 was \$95.2 trillion. And that estimate most likely is an understatement.

In other words, OTC derivatives markets, which for the most part did not exist twenty (or, in some cases, even ten) years ago, now comprise about 90 percent of the aggregate derivatives market, with trillions of dollars at risk every day. By those measures, OTC derivatives markets are bigger than the markets for U.S. stocks.

Enron may have been just an energy company when it was created in 1985, but by the end it had become a full-blown OTC derivatives trading firm. Its OTC derivatives-related assets and liabilities increased more than five-fold during 2000 alone.

And, let me repeat, the OTC derivatives markets are largely unregulated. Enron's trading operations were not regulated, or even recently audited, by U.S. securities regulators, and the OTC derivatives it traded are not deemed securities. OTC derivatives trading is beyond the purview of organized, regulated exchanges. Thus, Enron – like many firms that trade OTC derivatives – fell into a regulatory black hole.

After 360 customers lost \$11.4 billion on derivatives during the decade ending in March 1997, the Commodity Futures Trading Commission began considering whether to regulate OTC derivatives. But its proposals were rejected, and in December 2000 Congress made the deregulated status of derivatives clear when it passed the Commodity Futures Modernization Act. As a result, the OTC derivatives markets have become a ticking time bomb, which Congress thus far has chosen not to defuse.

Many parties are to blame for Enron's collapse. But as this Committee and others take a hard look at Enron and its officers, directors, accountants, lawyers, bankers, and analysts, Congress also should take a hard look at the current state of OTC derivatives regulation. (In the remainder of this testimony, when I refer generally to "derivatives," I am referring to these OTC derivatives markets.)

II. Derivatives "Outside" Enron

The first answer to the question of why Enron collapsed relates to derivatives deals between Enron and several of its 3,000-plus off-balance sheet subsidiaries and partnerships. The names of these byzantine financial entities – such as JEDI, Raptor, and LJM – have been widely reported.

Such special purpose entities might seem odd to someone who has not seen them used before, but they actually are very common in modern financial markets. Structured finance is a significant part of the U.S. economy, and special purpose entities are involved in most investors' lives, even if they do not realize it. For example, most credit card and mortgage payments flow through special purpose entities, and financial services firms typically use such entities as well. Some special purpose entities generate great

economic benefits; others – as I will describe below – are used to manipulate company's financial reports to inflate assets, to understate liabilities, to create false profits, and to hide losses. In this way, special purpose entities are a lot like fire: they can be used for good or ill. Special purpose entities, like derivatives, are unregulated.

The key problem at Enron involved the confluence of derivatives and special purpose entities. Enron entered into derivatives transactions with these entities to shield volatile assets from quarterly financial reporting and to inflate artificially the value of certain Enron assets. These derivatives included price swap derivatives (described below), as well as call and put options.

Specifically, Enron used derivatives and special purpose vehicles to manipulate its financial statements in three ways. First, it hid speculator losses it suffered on technology stocks. Second, it hid huge debts incurred to finance unprofitable new businesses, including retail energy services for new customers. Third, it inflated the value of other troubled businesses, including its new ventures in fiber-optic bandwidth. Although Enron was founded as an energy company, many of these derivatives transactions did not involve energy at all.

A. Using Derivatives to Hide Losses on Technology Stocks

First, Enron hid hundreds of millions of dollars of losses on its speculative investments in various technology-oriented firms, such as Rhythms Net Connections, Inc., a start-up telecommunications company. A subsidiary of Enron (along with other investors such as Microsoft and Stanford University) invested a relatively small amount

of venture capital, on the order of \$10 million, in Rhythms Net Connections. Enron also invested in other technology companies.

Rhythms Net Connections issued stock to the public in an initial public offering on April 6, 1999, during the heyday of the Internet boom, at a price of about \$70 per share. Enron's stake was suddenly worth hundreds of millions of dollars. Enron's other venture capital investments in technology companies also rocketed at first, alongside the widespread run-up in the value of dot.com stocks. As is typical in IPOs, Enron was prohibited from selling its stock for six months.

Next, Enron entered into a series of transactions with a special purpose entity – apparently a limited partnership called Raptor (actually there were several Raptor entities of which the Rhythms New Connections Raptor was just one), which was owned by another Enron special purpose entity, called LJM1 – in which Enron essentially exchanged its shares in these technology companies for a loan, ultimately, from Raptor. Raptor then issued its own securities to investors and held the cash proceeds from those investors.

The critical piece of this puzzle, the element that made it all work, was a derivatives transaction – called a “price swap derivative” – between Enron and Raptor. In this price swap, Enron committed to give stock to Raptor if Raptor's assets declined in value. The more Raptor's assets declined, the more of its own stock Enron was required to post. Because Enron had committed to maintain Raptor's value at \$1.2 billion, if Enron's stock declined in value, Enron would need to give Raptor even more stock. This derivatives transaction carried the risk of diluting the ownership of Enron's shareholders

if either Enron's stock or the technology stocks Raptor held declined in price. Enron also apparently entered into options transactions with Raptor and/or LJM1.

Because the securities Raptor issued were backed by Enron's promise to deliver more shares, investors in Raptor essentially were buying Enron's debt, not the stock of a start-up telecommunications company. In fact, the performance of Rhythms Net Connections was irrelevant to these investors in Raptor. Enron got the best of both worlds in accounting terms: it recognized its gain on the technology stocks by recognizing the value of the Raptor loan right away, and it avoided recognizing on an interim basis any future losses on the technology stocks, were such losses to occur.

It is painfully obvious how this story ends: the dot.com bubble burst and by 2001 shares of Rhythms Net Communications were worthless. Enron had to deliver more shares to "make whole" the investors in Raptor and other similar deals. In all, Enron had derivative instruments on 54.8 million shares of Enron common stock at an average price of \$67.92 per share, or \$3.7 billion in all. In other words, at the start of these deals, Enron's obligation amounted to seven percent of all of its outstanding shares. As Enron's share price declined, that obligation increased and Enron's shareholders were substantially diluted. And here is the key point: even as Raptor's assets and Enron's shares declined in value, Enron did not reflect those declines in its quarterly financial statements.

B. *Using Derivatives to Hide Debts Incurred by Unprofitable Businesses*

A second example involved Enron using derivatives with two special purpose entities to hide huge debts incurred to finance unprofitable new businesses. Essentially,

some very complicated and unclear accounting rules allowed Enron to avoid disclosing certain assets and liabilities.

These two special purpose entities were Joint Energy Development Investments Limited Partnership (JEDI) and Chewco Investments, L.P. (Chewco). Enron owned only 50 percent of JEDI, and therefore – under applicable accounting rules – could (and did) report JEDI as an unconsolidated equity affiliate. If Enron had owned 51 percent of JEDI, accounting rules would have required Enron to include all of JEDI's financial results in its financial statements. But at 50 percent, Enron did not.

JEDI, in turn, was subject to the same rules. JEDI could issue equity and debt securities, and as long as there was an outside investor with at least 50 percent of the equity – in other words, with real economic exposure to the risks of Chewco – JEDI would not need to consolidate Chewco.

One way to minimize the applicability of this “50 percent rule” would be for a company to create a special purpose entity with mostly debt and only a tiny sliver of equity, say \$1 worth, for which the company easily could find an outside investor. Such a transaction would be an obvious sham, and one might expect to find a pronouncement by the accounting regulators that it would not conform to Generally Acceptable Accounting Principles. Unfortunately, there are no such accounting regulators, and there was no such pronouncement. The Financial Accounting Standards Board, a private entity that sets most accounting rules and advises the Securities and Exchange Commission, had not – and still has not – answered the key accounting question: what constitutes sufficient capital from an independent source, so that a special purpose entity need not be consolidated?

Since 1982, Financial Accounting Standard No. 57, Related Party Disclosures, has contained a general requirement that companies disclose the nature of relationships they have with related parties, and describe transactions with them. Accountants might debate whether Enron's impenetrable footnote disclosure satisfies FAS No. 57, but clearly the disclosures currently made are not optimal. Members of the SEC staff have been urging the FASB to revise No. 57, but it has not responded. In 1998, FASB adopted FAS No. 133, which includes new accounting rules for derivatives. Now at 800-plus pages, FAS No. 133's instructions are an incredibly detailed – but ultimately unhelpful – attempt to rationalize other accounting rules for derivatives.

As a result, even after two decades, there is no clear answer to the question about related parties. Instead, some early guidance (developed in the context of leases) has been grafted onto modern special purpose entities. This guidance is a 1991 letter from the Acting Chief Accountant of the SEC in 1991, stating: “The initial substantive residual equity investment should be comparable to that expected for a substantive business involved in similar [leasing] transactions with similar risks and rewards. The SEC staff understands from discussions with Working Group members that those members believe that 3 percent is the minimum acceptable investment. The SEC staff believes a greater investment may be necessary depending on the facts and circumstances, including the credit risk associated with the lessee and the market risk factors associated with the leased property.”

Based on this letter, and on opinions from auditors and lawyers, companies have been pushing debt off their balance sheets into unconsolidated special purpose entities so long as (1) the company does not have more than 50 percent of the equity of the special

purpose entity, and (2) the equity of the special purpose entity is at least 3 percent of its the total capital. As more companies have done such deals, more debt has moved off balance-sheet, to the point that, today, it is difficult for investors to know if they have an accurate picture of a company's debts. Even if Enron had not tripped up and violated the letter of these rules, it still would have been able to borrow 97 percent of the capital of its special purpose entities without recognizing those debts on its balance sheet.

Transactions designed to exploit these accounting rules have polluted the financial statements of many U.S. companies. Enron is not alone. For example, Kmart Corporation – which was on the verge of bankruptcy as of January 21, 2002, and clearly was affected by Enron's collapse – held 49 percent interests in several unconsolidated equity affiliates. I believe this Committee should take a hard look at these widespread practices.

In short, derivatives enabled Enron to avoid consolidating these special purpose entities. Enron entered into a derivatives transaction with Chewco similar to the one it entered into with Raptor, effectively guaranteeing repayment to Chewco's outside investor. (The investor's sliver of equity ownership in Chewco was not really equity from an economic perspective, because the investor had nothing – other than Enron's credit – at risk.) In its financial statements, Enron takes the position that although it provides guarantees to unconsolidated subsidiaries, those guarantees do not have a readily determinable fair value, and management does not consider it likely that Enron would be required to perform or otherwise incur losses associated with guarantees. That position enabled Enron to avoid recording its guarantees. Even the guarantees listed in the footnotes are recorded at only 10 percent of their nominal value. (At least this

amount is closer to the truth than the amount listed as debt for unconsolidated subsidiaries: zero.)

Apparently, Arthur Andersen either did not discover this derivatives transaction or decided that the transaction did not require a finding that Enron controlled Chewco. In any event, the Enron derivatives transaction meant that Enron – not the 50 percent “investor” in Chewco – had the real exposure to Chewco’s assets. The ownership daisy chain unraveled once Enron was deemed to own Chewco. JEDI was forced to consolidate Chewco, and Enron was forced to consolidate both limited partnerships – and all of their losses – in its financial statements.

All of this complicated analysis will seem absurd to the average investor. If the assets and liabilities are Enron’s in economic terms, shouldn’t they be reported that way in accounting terms? The answer, of course, is yes. Unfortunately, current rules allow companies to employ derivatives and special purpose entities to make accounting standards diverge from economic reality. Enron used financial engineering as a kind of plastic surgery, to make itself look better than it really was. Many other companies do the same.

Of course, it is possible to detect the flaws in plastic surgery, or financial engineering, if you look hard enough and in the right places. In 2000, Enron disclosed about \$2.1 billion of such derivatives transactions with related entities, and recognized gains of about \$500 million related to those transactions. The disclosure related to these staggering numbers is less than conspicuous, buried at page 48, footnote 16 of Enron’s annual report, deep in the related party disclosures for which Enron was notorious. Still, the disclosure is there. A few sophisticated analysts understood Enron’s finances based

on that disclosure; they bet against Enron's stock. Other securities analysts likely understood the disclosures, but chose not to speak, for fear of losing Enron's banking business. An argument even can be made – although not a good one, in my view – that Enron satisfied its disclosure obligations with its opaque language. In any event, the result of Enron's method of disclosure was that investors did not get a clear picture of the firm's finances.

Enron is not the only example of such abuse; accounting subterfuge using derivatives is widespread. I believe Congress should seriously consider legislation explicitly requiring that financial statements describe the economic reality of a company's transactions. Such a broad standard – backed by rigorous enforcement – would go a long way towards eradicating the schemes companies currently use to dress up their financial statements.

Enron's risk management manual stated the following: "Reported earnings follow the rules and principles of accounting. The results do not always create measures consistent with underlying economics. However, corporate management's performance is generally measured by accounting income, not underlying economics. Risk management strategies are therefore directed at accounting rather than economic performance." This alarming statement is representative of the accounting-driven focus of U.S. managers generally, who all too frequently have little interest in maintaining controls to monitor their firm's economic realities.

C. *Using Derivatives to Inflate the Value of Troubled Businesses*

A third example is even more troubling. It appears that Enron inflated the value of certain assets it held by selling a small portion of those assets to a special purpose entity at an inflated price, and then revaluing the lion's share of those assets it still held at that higher price.

Consider the following sentence disclosed from the infamous footnote 16 of Enron's 2000 annual report, on page 49: "In 2000, Enron sold a portion of its dark fiber inventory to the Related Party in exchange for \$30 million cash and a \$70 million note receivable that was subsequently repaid. Enron recognized gross margin of \$67 million on the sale." What does this sentence mean?

It is possible to understand the sentence today, but only after reading a January 7, 2002, article about the sale by Daniel Fisher of Forbes magazine, together with an August 2001 memorandum describing the transaction (and others) from one Enron employee, Sherron Watkins, to Enron Chairman Kenneth Lay.

Here is my best understanding of what this sentence means:

First, the "Related Party" is LJM2, an Enron partnership run by Enron's Chief Financial Officer, Andrew Fastow. (Fastow reportedly received \$30 million from the LJM1 and LJM2 partnerships pursuant to compensation arrangements Enron's board of directors approved.)

Second, "dark fiber" refers to a type of bandwidth Enron traded as part of its broadband business. In this business, Enron traded the right to transmit data through various fiber-optic cables, more than 40 million miles of which various Internet-related companies had installed in the United States. Only a small percentage of these cables were "lit" – meaning they could transmit the light waves required to carry Internet data;

the vast majority of cables were still awaiting upgrades and were “dark.” The rights associated with those “dark” cables were called “dark fiber.” As one might expect, the rights to transmit over “dark fiber” are very difficult to value.

Third, Enron sold “dark fiber” it apparently valued at only \$33 million for triple that value: \$100 million in all – \$30 million in cash plus \$70 million in a note receivable. It appears that this sale was at an inflated price, thereby enabling Enron to record a \$67 million profit on that trade. LJM2 apparently obtained cash from investors by issuing securities and used some of these proceeds to repay the note receivable issued to Enron.

What the sentence in footnote 16 does not make plain is that the investor in LJM2 was persuaded to pay what appears to be an inflated price, because Enron entered into a “make whole” derivatives contract with LJM2 (of the same type it used with Raptor). Essentially, the investor was buying Enron’s debt. The investor was willing to buy securities in LJM2, because if the “dark fiber” declined in price – as it almost certainly would, from its inflated value – Enron would make the investor whole.

In these transactions, Enron retained the economic risk associated with the “dark fiber.” Yet as the value of “dark fiber” plunged during 2000, Enron nevertheless was able to record a gain on its sale, and avoid recognizing any losses on assets held by LJM2, which was an unconsolidated affiliate of Enron, just like JEDI.

As if all of this were not complicated enough, Enron’s sale of “dark fiber” to LJM2 also magically generated an inflated price, which Enron then could use in valuing any remaining “dark fiber” it held. The third-party investor in LJM2 had, in a sense, “validated” the value of the “dark fiber” at the higher price, and Enron then arguably could use that inflated price in valuing other “dark fiber” assets it held. I do not have any

direct knowledge of this, although public reports and Sherron Watkins's letter indicate that this is precisely what happened.

For example, suppose Enron started with ten units of "dark fiber," worth \$100, and sold one to a special purpose entity for \$20 – double its actual value – using the above scheme. Now, Enron had an argument that each of its remaining nine units of "dark fiber" also were worth \$20 each, for a total of \$180.

Enron then could revalue its remaining nine units of "dark fiber" at a total of \$180. If the assets used in the transaction were difficult to value – as "dark fiber" clearly was – Enron's inflated valuation might not generate much suspicion, at least initially. But ultimately the valuations would be indefensible, and Enron would need to recognize the associated losses.

It is an open question for this Committee and others whether this transaction was unique, or whether Enron engaged in other, similar deals. It seems likely that the "dark fiber" deal was not the only one of its kind. There are many sentences in footnote 16.

D. *The "Gatekeepers"*

These are but three examples of how Enron's derivatives dealings with outside parties resulted in material information not being reflected in market prices. There are others, many within JEDI alone. I have attempted to summarize this information for the Committee. Clearly it is important that investigators question the Enron employees who were directly involved in these transactions to get a sense of whether my summaries are complete.

Moreover, a thorough inquiry into these dealings also should include the major financial market “gatekeepers” involved with Enron: accounting firms, banks, law firms, and credit rating agencies. Employees of these firms are likely to have knowledge of these transactions. Moreover, these firms have a responsibility to come forward with information relevant to these transactions. They benefit directly and indirectly from the existence of U.S. securities regulation, which in many instances both forces companies to use the services of gatekeepers and protects gatekeepers from liability.

Recent cases against accounting firms – including Arthur Andersen – are eroding that protection, but the other gatekeepers remain well insulated. Gatekeepers are kept honest – at least in theory – by the threat of legal liability, which is virtually non-existent for some gatekeepers. The capital markets would be more efficient if companies were not required by law to use particular gatekeepers (which only gives those firms market power), and if gatekeepers were subject to a credible threat of liability for their involvement in fraudulent transactions. Congress should consider expanding the scope of securities fraud liability by making it clear that these gatekeepers will be liable for assisting companies in transactions designed to distort the economic reality of financial statements.

With respect to Enron, all of these gatekeepers have questions to answer about the money they received, the quality of their work, and the extent of their conflicts of interest. It has been reported widely that Enron paid \$52 million in 2000 to its audit firm, Arthur Andersen, the majority of which was for non-audit related consulting services, yet Arthur Andersen failed to spot many of Enron’s losses. It also seems likely that at least

one of the other “Big 5” accounting firms was involved at least one of Enron’s special purpose entities.

Enron also paid several hundred million dollars in fees to investment and commercial banks for work on various financial aspects of its business, including fees for derivatives transactions, and yet none of those firms pointed out to investors any of the derivatives problems at Enron. Instead, as late as October 2001 sixteen of seventeen the securities analysts covering Enron rated it a “strong buy” or “buy.”

Enron paid substantial fees to its outside law firm, which previously had employed Enron’s general counsel, yet that firm failed to correct or disclose the problems related to derivatives and special purpose entities. Other law firms also may have been involved in these transactions; if so, they should be questioned, too.

Finally, and perhaps most importantly, the three major credit rating agencies – Moody’s, Standard & Poor’s, and Fitch/IBCA – received substantial, but as yet undisclosed, fees from Enron. Yet just weeks prior to Enron’s bankruptcy filing – after most of the negative news was out and Enron’s stock was trading at just \$3 per share – all three agencies still gave investment grade ratings to Enron’s debt. The credit rating agencies in particular have benefited greatly from a web of legal rules that essentially require securities issuers to obtain ratings from them (and them only), and at the same time protect those agencies from outside competition and liability under the securities laws. They are at least partially to blame for the Enron mess.

An investment-grade credit rating was necessary to make Enron’s special purpose entities work, and Enron lived on the cusp of investment grade. During 2001, it was rated just above the lowest investment-grade rating by all three agencies: BBB+ by

Standard & Poor's and Fitch IBCA, and Baa1 by Moody's. Just before Enron's bankruptcy, all three rating agencies lowered Enron's rating two notches, to the lowest investment grade rating. Enron noted in its most recent annual report that its "continued investment grade status is critical to the success of its wholesale business as well as its ability to maintain adequate liquidity." Many of Enron's debt obligations were triggered by a credit ratings downgrade; some of those obligations had been scheduled to mature December 2001. The importance of credit ratings at Enron and the timing of Enron's bankruptcy filing are not coincidences; the credit rating agencies have some explaining to do.

Derivatives based on credit ratings – called "credit derivatives" – are a booming business and they raise serious systemic concerns. The rating agencies seem to know this. Even Moody's appears worried, and recently asked several securities firms for more detail about their dealings in these instruments. It is particularly chilling that not even Moody's – the most sophisticated of the three credit rating agencies – knows much about these derivatives deals.

III. Derivatives "Inside" Enron

The derivatives problems at Enron went much deeper than the use of special purpose entities with outside investors. If Enron had been making money in what it represented as its core businesses, and had used derivatives simply to "dress up" its financial statements, this Committee would not be meeting here today. Even after Enron restated its financial statements on November 8, 2001, it could have clarified its

accounting treatment, consolidated its debts, and assured the various analysts that it was a viable entity. But it could not. Why not?

This question leads me to the second explanation of Enron's collapse: most of what Enron represented as its core businesses were not making money. Recall that Enron began as an energy firm. Over time, Enron shifted its focus from the bricks-and-mortar energy business to the trading of derivatives. As this shift occurred, it appears that some of its employees began lying systematically about the profits and losses of Enron's derivatives trading operations. Simply put, Enron's reported earnings from derivatives seem to be more imagined than real. Enron's derivatives trading was profitable, but not in the way an investor might expect based on the firm's financial statements. Instead, some Enron employees seem to have misstated systematically their profits and losses in order to make their trading businesses appear less volatile than they were.

First, a caveat. During the past few weeks, I have been gathering information about Enron's derivatives operations, and I have learned many disturbing things. Obviously, I cannot testify first hand to any of these matters. I have never been on Enron's trading floor, and I have never been involved in Enron's business. I cannot offer fact testimony as to any of these matters.

Nonetheless, I strongly believe the information I have gathered is credible. It is from many sources, including written information, e-mail correspondence, and telephone interviews. Congressional investigators should be able to confirm all of these facts. In any event, even if only a fraction of the information in this section of my testimony proves to be correct, it will be very troubling indeed.

In a nutshell, it appears that some Enron employees used dummy accounts and rigged valuation methodologies to create false profit and loss entries for the derivatives Enron traded. These false entries were systematic and occurred over several years, beginning as early as 1997. They included not only the more esoteric financial instruments Enron began trading recently – such as fiber-optic bandwidth and weather derivatives – but also Enron’s very profitable trading operations in natural gas derivatives.

Enron derivatives traders faced intense pressure to meet quarterly earnings targets imposed directly by management and indirectly by securities analysts who covered Enron. To ensure that Enron met these estimates, some traders apparently hid losses and understated profits. Traders apparently manipulated the reporting of their “real” economic profits and losses in an attempt to fit the “imagined” accounting profits and losses that drove Enron management.

A. *Using “Prudency” Reserves*

Enron’s derivatives trading operations kept records of the traders’ profits and losses. For each trade, a trader would report either a profit or a loss, typically in spreadsheet format. These profit and loss reports were designed to reflect economic reality. Frequently, they did not.

Instead of recording the entire profit for a trade in one column, some traders reportedly split the profit from a trade into two columns. The first column reflected the portion of the actual profits the trader intended to add to Enron’s current financial

statements. The second column, ironically labeled the “prudency” reserve, included the remainder.

To understand this concept of a “prudency” reserve, suppose a derivatives trader earned a profit of \$10 million. Of that \$10 million, the trader might record \$9 million as profit today, and enter \$1 million into “prudency.” An average deal would have “prudency” of up to \$1 million, and all of the “prudency” entries might add up to \$10 to \$15 million.

Enron’s “prudency” reserves did not depict economic reality, nor could they have been intended to do so. Instead, “prudency” was a slush fund that could be used to smooth out profits and losses over time. The portion of profits recorded as “prudency” could be used to offset any future losses.

In essence, the traders were saving for a rainy day. “Prudency” reserves would have been especially effective for long-maturity derivatives contracts, because it was more difficult to determine a precise valuation as of a particular date for those contracts, and any “prudency” cushion would have protected the traders from future losses for several years going forward.

As luck would have it, some of the “prudency” reserves turned out to be quite prudent. In one quarter, some derivatives traders needed so much accounting profit to meet their targets that they wiped out all of their “prudency” accounts.

Saving for a rainy day is not necessarily a bad idea, and it seems possible that derivatives traders at Enron did not believe they were doing anything wrong. But “prudency” accounts are far from an accepted business practice. A trader who used a “prudency” account at a major Wall Street firm would be seriously disciplined, or

perhaps fired. To the extent Enron was smoothing its income using “prudency” entries, it was misstating the volatility and current valuation of its trading businesses, and misleading its investors. Indeed, such fraudulent practices would have thwarted the very purpose of Enron’s financial statements: to give investors an accurate picture of a firm’s risks.

B. *Mismarking Forward Curves*

Not all of the misreporting of derivatives positions at Enron was as brazen as “prudency.” Another way derivatives frequently are used to misstate profits and losses is by mismarking “forward curves.” It appears that Enron traders did this, too.

A forward curve is a list of “forward rates” for a range of maturities. In simple terms, a forward rate is the rate at which a person can buy something in the future.

For example, natural gas forward contracts trade on the New York Mercantile Exchange (NYMEX). A trader can commit to buy a particular type of natural gas to be delivered in a few weeks, months, or even years. The rate at which a trader can buy natural gas in one year is the one-year forward rate. The rate at which a trader can buy natural gas in ten years is the ten-year forward rate. The forward curve for a particular natural gas contract is simply the list of forward rates for all maturities.

Forward curves are crucial to any derivatives trading operation because they determine the value of a derivatives contract today. Like any firm involved in trading derivatives, Enron had risk management and valuation systems that used forward curves to generate profit and loss statements.

It appears that Enron traders selectively mismarked their forward curves, typically in order to hide losses. Traders are compensated based on their profits, so if a trader can hide losses by mismarking forward curves, he or she is likely to receive a larger bonus.

These losses apparently ranged in the tens of millions of dollars for certain markets. At times, a trader would manually input a forward curve that was different from the market. For more complex deals, a trader would use a spreadsheet model of the trade for valuation purposes, and tweak the assumptions in the model to make a transaction appear more or less valuable. Spreadsheet models are especially susceptible to mismarking.

Certain derivatives contracts were more susceptible to mismarking than others. A trader would be unlikely to mismark contracts that were publicly traded – such as the natural gas contracts traded on NYMEX – because quotations of the values of those contracts are publicly available. However, the NYMEX forward curve has a maturity of only six years; accordingly, a trader would be more likely to mismark a ten-year natural gas forward rate.

At Enron, forward curves apparently remained mismarked for as long as three years. In more esoteric areas, where markets were not as liquid, traders apparently were even more aggressive. One trader who already had recorded a substantial profit for the year, and believed any additional profit would not increase his bonus much, reportedly reduced his recorded profits for one year, so he could push them forward into the next year, which he wasn't yet certain would be as profitable. This strategy would have resembled the “prudency” accounts described earlier.

C. *Warning Signs*

Why didn't any of the "gatekeepers" tell investors that Enron was so risky? There were numerous warning signs related to Enron's derivatives trading. Yet the gatekeepers either failed utterly to spot those signs, or spotted those signs and decided not to warn investors about them. Either way, the gatekeepers failed to do their job. This was so even though there have been several recent and high-profile cases involving internal misreporting of derivatives.

Enron disclosed that it used "value at risk" (VAR) methodologies that captured a 95 percent confidence interval for a one-day holding period, and therefore did not disclose worst-case scenarios for Enron's trading operations. Enron said it relied on "the professional judgment of experienced business and risk managers" to assess these worst-case scenarios (which, apparently, Enron ultimately encountered). Enron reported only high and low month-end values for its trading, and therefore had incentives to smooth its profits and losses at month-end. Because Enron did not report its maximum VAR during the year, investors had no way of knowing just how much risk Enron was taking.

Even the reported VAR figures are remarkable. Enron reported VAR for what it called its "commodity price" risk – including natural gas derivatives trading – of \$66 million, more than triple the 1999 value. Enron reported VAR for its equity trading of \$59 million, more than double the 1999 value. A VAR of \$66 million meant that Enron could expect based on historical averages that on five percent of all trading days (on average, twelve business days during the year) its "commodity" derivatives trading operations alone would gain or lose \$66 million, a not trivial sum.

Moreover, because Enron's derivatives frequently had long maturities – maximum terms ranged from 6 to 29 years – there often were not prices from liquid markets to use as benchmarks. For those long-dated derivatives, professional judgment was especially important. For a simple instrument, Enron might calculate the discounted present value of cash flows using Enron's borrowing rates. But more complex instruments required more complex methodologies. For example, Enron completed over 5,000 weather derivatives deals, with a notional value of more than \$4.5 billion, and many of those deals could not be valued without a healthy dose of professional judgment. The same was true of Enron's trading of fiber-optic bandwidth.

And finally there was the following flashing red light in Enron's most recent annual report: "In 2000, the value at risk model utilized for equity trading market risk was refined to more closely correlate with the valuation methodologies used for merchant activities." Enron's financial statements do not describe these refinements, and their effects, but given the failure of the risk and valuation models even at a sophisticated hedge fund such as Long-Term Capital Management – which employed "rocket scientists" and Nobel laureates to design various sophisticated computer models – there should have been reason for concern when Enron spoke of "refining" its own models.

It was Arthur Andersen's responsibility not only to audit Enron's financial statements, but also to assess Enron management's internal controls on derivatives trading. When Arthur Andersen signed Enron's 2000 annual report, it expressed approval in general terms of Enron's system of internal controls during 1998 through 2000.

Yet it does not appear that Arthur Andersen systematically and independently verified Enron's valuations of certain complex trades, or even of its forward curves. Arthur Andersen apparently examined day-to-day changes in these values, as reported by traders, and checked to see if each daily change was recorded accurately. But this Committee – and others investigating Enron – should inquire about whether Arthur Andersen did anything more than sporadically check Enron's forward curves.

To Arthur Andersen's credit as an auditor, much of the relevant risk information is contained in Enron's financial statements. What is unclear is whether Arthur Andersen adequately considered this information in opining that Enron management's internal controls were adequate. To the extent Arthur Andersen alleges – as I understand many accounting firms do – that their control opinion does not cover all types of control failures and necessarily is based on management's "assertions," it is worth noting that the very information Arthur Andersen audited raised substantial questions about potential control problems at Enron. In other words, Arthur Andersen has been hoisted by its own petard.

But Arthur Andersen was not alone in failing to heed these warning signs. Securities analysts and credit rating agencies arguably should have spotted them, too. Why were so many of these firms giving Enron favorable ratings, when publicly available information indicated that there were reasons for worry? Did these firms look the other way because they were subject to conflicts of interest? Individual investors rely on these institutions to interpret the detailed footnote disclosures in Enron's reports, and those institutions have failed utterly. The investigation into Arthur Andersen so far has generated a great deal of detail about that firm's approach to auditing Enron, but the same

questions should be asked of the other gatekeepers, too. Specifically, this Committee should ask for and closely examine all of the analyst reports on Enron from the relevant financial services firms and credit rating agencies.

Finally, to clarify this point, consider how much Enron's businesses had changed during its last years. Consider the change in Enron's assets. Arthur Andersen's most recent audit took place during 2000, when Enron's derivatives-related assets increased from \$2.2 billion to \$12 billion, and Enron's derivatives-related liabilities increased from \$1.8 billion to \$10.5 billion. These numbers are staggering.

Most of this growth was due to increased trading through EnronOnline. But EnronOnline's assets and revenues were qualitatively different from Enron's other derivatives trading. Whereas Enron's derivatives operations included speculative positions in various contracts, EnronOnline's operations simply matched buyers and sellers. The "revenues" associated with EnronOnline arguably do not belong in Enron's financial statements. In any event, the exponential increase in the volume of trading through EnronOnline did not generate substantial profits for Enron.

Enron's aggressive additions to revenues meant that it was the "seventh-largest U.S. company" in title only. In reality, Enron was a much smaller operation, whose primary money-making business – a substantial and speculative derivatives trading operation – covered up poor performance in Enron's other, smaller businesses, including EnronOnline. Enron's public disclosures show that during the past three years the firm was not making money on its non-derivatives businesses. Gross margins from these businesses were essentially zero from 1998 through 2000.

To see this, consider the table below, which sets forth Enron's income statement separated into its non-derivatives and derivatives businesses. I put together this table based on the numbers in Enron's 2000 income statement, after learning from the footnote 1, page 36, that the meaning of the "Other revenues" entry on Enron's income statement is – as far as I can tell – essentially "Gain (loss) from derivatives":

Enron Corp. and Subsidiaries 2000 Consolidated Income Statement (in millions)

	<u>2000</u>	<u>1999</u>	<u>1998</u>
Non-derivatives revenues	93,557	34,774	27,215
Non-derivatives expenses	94,517	34,761	26,381
Non-derivatives gross margin	(960)	13	834
Gain (loss) from derivatives	7,232	5,338	4,045
Other expenses	(4,319)	(4,549)	(3,501)
Operating income	1,953	802	1,378

This chart demonstrates four key facts. First, the recent and dramatic increase in Enron's overall non-derivatives revenues – the statistic that supposedly made Enron the seventh-largest U.S. company – was offset by an increase in non-derivatives expenses. The increase in revenues reflected in the first line of the chart was substantially from EnronOnline, and did not help Enron's bottom line, because it included an increase in expenses reflected in the second line of the chart. Although Enron itself apparently was the counterparty to all of the trades, EnronOnline simply matched buyers ("revenue") with sellers ("expenses"). Indeed, as non-derivatives revenues more than tripled, non-derivatives expenses increased even more.

Second, a related point: Enron's non-derivatives businesses were not performing well in 1998 and were deteriorating through 2000. The third row, "Non-derivatives gross

margin,” is the difference between non-derivatives revenues and non-derivatives expenses. The downward trajectory of Enron’s non-derivatives gross margin shows, in a general sense, that Enron’s non-derivatives businesses made some money in 1998, broke even in 1999, and actually lost money in 2000.

Third, Enron’s positive reported operating income (the last row) was due primarily to gains from derivatives (the fourth row). Enron – like many firms – shied from using the word “derivatives” and substituted the euphemism “Price Risk Management,” but as Enron makes plain in its public filings, the two are the same. Excluding the gains from derivatives, Enron would have reported substantially negative operating income for all three years.

Fourth, Enron’s gains from derivatives were very substantial. Enron gained more than \$16 billion from these activities in three years. To place the numbers in perspective, these gains were roughly comparable to the annual net revenue for all trading activities (including stocks, bonds, and derivatives) at the premier investment firm, Goldman Sachs & Co., during the same periods, a time in which Goldman Sachs first issued shares to the public.

The key difference between Enron and Goldman Sachs is that Goldman Sachs seems to have been upfront with investors about the volatility of its trading operations. In contrast, Enron officials represented that it was not a trading firm, and that derivatives were used for hedging purposes. As a result, Enron’s stock traded at much higher multiples of earnings than more candid trading-oriented firms.

The size and scope of Enron’s derivatives trading operations remain unclear. Enron reported gains from derivatives of \$7.2 billion in 2000, and reported notional

amounts of derivatives contracts as of December 31, 2000, of only \$21.6 billion. Either Enron was generating 33 percent annual returns from derivatives (indicating that the underlying contracts were very risky), or Enron actually had large positions and reduced the notional values of its outstanding derivatives contracts at year-end for cosmetic purposes. Neither conclusion appears in Enron's financial statements.

IV. Conclusion

How did Enron lose so much money? That question has dumbfounded investors and experts in recent months. But the basic answer is now apparent: Enron was a derivatives trading firm; it made billions trading derivatives, but it lost billions on virtually everything else it did, including projects in fiber-optic bandwidth, retail gas and power, water systems, and even technology stocks. Enron used its expertise in derivatives to hide these losses. For most people, the fact that Enron had transformed itself from an energy company into a derivatives trading firm is a surprise.

Enron is to blame for much of this, of course. The temptations associated with derivatives have proved too great for many companies, and Enron is no exception. The conflicts of interest among Enron's officers have been widely reported. Nevertheless, it remains unclear how much top officials knew about the various misdeeds at Enron. They should and will be asked. At least some officers must have been aware of how deeply derivatives penetrated Enron's businesses; Enron even distributed thick multi-volume Derivatives Training Manuals to new employees. (The Committee should ask to see these manuals.)

Enron's directors likely have some regrets. Enron's Audit Committee in particular failed to uncover a range of external and internal financial gimmickry. However, it remains unclear how much of the inner workings at Enron were hidden from the outside directors; some directors may very well have learned a great deal from recent media accounts, or even perhaps from this testimony. Enron's general counsel, on the other hand, will have some questions to answer.

But too much focus on Enron misses the mark. As long as ownership of companies is separated from their control – and in the U.S. securities market it almost always will be – managers of companies will have incentives to be aggressive in reporting financial data. The securities laws recognize this fact of life, and create and subsidize “gatekeeper” institutions to monitor this conflict between managers and shareholders.

The collapse of Enron makes it plain that the key gatekeeper institutions that support our system of market capitalism have failed. The institutions sharing the blame include auditors, law firms, banks, securities analysts, independent directors, and credit rating agencies.

All of the facts I have described in my testimony were available to the gatekeepers. I obtained this information in a matter of weeks by sitting at a computer in my office in San Diego, and by picking up a telephone. The gatekeepers' failure to discover this information, and to communicate it effectively to investors, is simply inexcusable.

The difficult question is what to do about the gatekeepers. They occupy a special place in securities regulation, and receive great benefits as a result. Employees at

gatekeeper firms are among the most highly-paid people in the world. They have access to superior information and supposedly have greater expertise than average investors at deciphering that information. Yet, with respect to Enron, the gatekeepers clearly did not do their job.

One potential answer is to eliminate the legal requirements that companies use particular gatekeepers (especially credit rating agencies), while expanding the scope of securities fraud liability and enforcement to make it clear that all gatekeepers will be liable for assisting companies in transactions designed to distort the economic reality of financial statements. A good starting point before considering such legislation would be to call the key gatekeeper employees to testify.

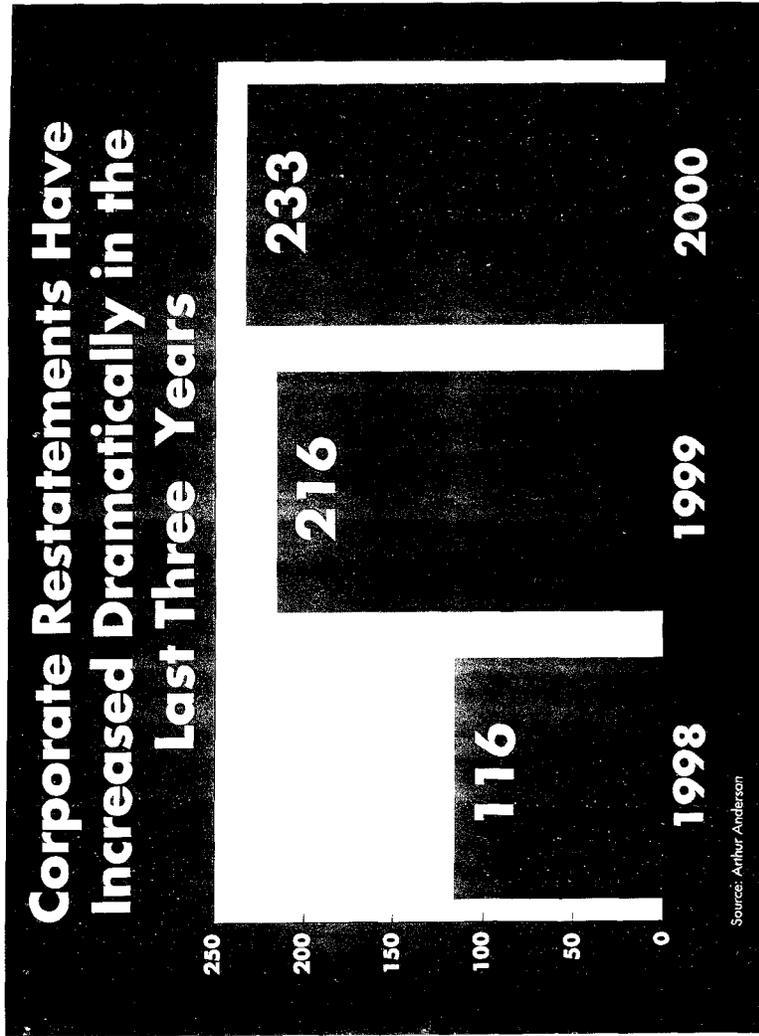
Congress also must decide whether, after ten years of steady deregulation, the post-Enron derivatives markets should remain exempt from the regulation that covers all other investment contracts. In my view, the answer is no.

A headline in Enron's 2000 annual report states, "In Volatile Markets, Everything Changes But Us." Sadly, Enron got it wrong. In volatile markets, everything changes, and the laws should change, too. It is time for Congress to act to ensure that this motto does not apply to U.S. financial market regulation.



Source: Wall Street Journal, June 7, 2001

Forcell: 2023116, 01/23/02, 1st Review



Corporate Overstatements In the Past Decade	
Corporation	Overstatement Amount
Waste Management	\$1.32 billion
Enron	\$591 million
Informix	\$200 million
Sunbeam	\$60 million
Microstrategy	\$66 million
Critical Path	\$19 million

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RESPONSES OF ARTHUR LEVITT
TO QUESTIONS FOR THE OFFICIAL RECORD
SUBMITTED BY SENATORS CLELAND

“The Fall of Enron: How Could It Have Happened?”

January 24, 2002

Question No. 1: While I was Secretary of State and Commissioner of Securities in Georgia, Georgia was “a disclosure state” and we vigorously prosecuted those who failed to disclose material facts and engaged in insider trading. This created an atmosphere that demanded compliance. We need a similar attitude in the federal government of demanding disclosure and enforcing violations of the disclosure rules. How can the SEC effectively create such an environment that would discourage and deter the flagrant market abuses allegedly committed by Enron?

Response: All public company financial statements should be written in plain English and we should work to improve disclosure of critical financial information by companies, audit committees, and auditors. Audit committees should communicate in plain English with the chief financial officer, company executives, the auditor and investors about the quality of financial reporting. Management should issue plain English statements that discuss the three or four most important accounting policies. This is something Chairman Pitt has called for. Auditors should issue audit reports that state whether or not the auditor felt the disclosure included all the material information investors would desire and whether or not the company’s internal controls were working effectively throughout the year. In addition, auditors should include a clearer discussion of how thoroughly the auditor delved into the financial statement and internal controls and address the quality of the company’s audit policies. Are they aggressive or conservative? Are they high or low quality?

Question No. 2: Steve Shepard, editor-in-chief of Business Week magazine, has stated, and I quote: “Enron was really a systemic failure of all the checks and balances we have on corporate governance.” Could you please comment and elaborate on how accurate you believe Mr. Shepard’s statement to be? In an effort to restore the public’s confidence in the auditing profession and corporate financial statements, SEC Chairman Harvey Pitt has proposed the creation of a new self-regulatory board to oversee the accounting industry. According to Mr. Pitt, the private sector would “bear the responsibility for staffing and funding” for the new board. Do you believe a private sector oversight board--with a significant number of its membership coming from the accounting profession--will be effective in monitoring an accounting firms’ performance and practices?

Response: Mr. Shepard’s statement is fair. What was once unthinkable in business has become ordinary. In our highly competitive economy, more and more business leaders are employing financial maneuvers that approach and sometimes cross ethical boundaries. Accounting rules are dealt with in terms of “what can I get away with” or “if it isn’t

expressly forbidden, it's ok." Financial statements, often, are not an accurate reflection of corporate performance, but rather a Potemkin village of deceit. When the motivation to prop up stock prices overtakes the obligation to keep honest books, capital flows to the wrong companies and the very market system from which these executives profit is fundamentally weakened. That is why undertaking reforms that preserve and enhance the independence of the gatekeepers who safeguard the interests of investors is so important.

We need a truly independent oversight body that has the power not only to set the standards by which audits are performed, but also to conduct timely investigations that cannot be deferred for any reason and to discipline accountants. And all of this needs to be done with public accountability – not behind closed doors. To preserve its integrity, this organization cannot be funded, in any way, by the accounting profession or include any current members from the profession on its board.

Question No. 3: Performing an audit often appears to be a stepping stone to more lucrative service relationships with the company. What changes do you believe need to be made in the accounting industry to address allegations of conflict of interest--for example the practice of accounting firms wearing two hats by serving as both auditors of and consultants to the same firm?

Response: I would urge – at a minimum -- that we go back and reconsider some of the limits in the SEC's original rule proposal from 2000. While I commend the firms for voluntarily agreeing not to engage in certain services such as IT work and internal audit outsourcing, I'm disappointed the firms have remained silent about consulting on tax shelters or transactions, such as the kinds of Special Purpose Entities that Enron engaged in. This type of work only serves to help management get around the rules.

I also believe that the audit committee – not company management – should pre-approve all other consulting contracts with the audit firm. Such approval should be granted rarely, and only when the audit committee decides that a consulting contract is in the shareholders' best interests. I also propose that serious consideration be given to requiring companies to change their audit firm – not just the partners -- every 5-7 years to ensure that fresh and skeptical eyes are always looking at the numbers.

Question No. 4: Enron was able to conceal millions of dollars of debt through its use of Special Purpose Entities that kept debt off of Enron's balance sheets. The CEO of Arthur Anderson, has stated that he would like to see accounting rules changed with regard to Special Purpose Entities, so that companies' balance sheets would reflect the true risks at stake. What changes to the accounting rules with regard to Special Purpose Entities do you believe would be appropriate?

Response: I agree with the comments of Chairman Breeden who stated, "Where a company will have cash flow from a financing, it belongs on its balance sheet, and should certainly be disclosed. Where a debt has to be paid directly or indirectly from a company's cash flow (or is diverted from cash flow the company would otherwise receive), that debt

should be on the balance sheet and disclosed. Where a company has contingent liabilities, such as Enron's obligations to deliver stock to some of its partnerships to maintain certain values, the nature of those obligations should be disclosed comprehensively, and the impact of such contingencies under various scenarios should also be disclosed."

Question No. 5: Given the current debate surrounding the investment of Social Security funds in the stock market, first, how can we reassure the American people that what happened to the Enron employees, employees and teachers in the Georgia Teacher Retirement System, among thousands of others, will not happen to them? How can we increase public awareness and education regarding wise investing?

Response: No regulatory agency can have enough resources to completely stamp out fraud and deception. That's why investor education is so vital. There is an unacceptably wide gap between financial knowledge and financial responsibilities. Closing this "knowledge gap" is among the most important problems we face today. We need to remind Americans that they need to know three things before they can make an informed investment decision:

- (1) what are their investment goals;
- (2) when will they need the money; and
- (3) how much risk can they afford.

Only then can they choose investments that match their investing objectives. We should emphasize that planning is key to financial success and show investors how to get started. Even among individuals who earn low incomes, savers who have financial plans report having twice as much in savings and investments as those who do not have a plan. We also need to remind investors that successful investing takes time. Investors need to slow down and read the whole story. They need to get the facts.

In a more specific sense, we should ensure that the SEC's investor education program has the resources to make a difference. The creation of the Office of the Investor Education and Assistance was a vital part of our program to better protect investors.

Question No. 6: The SEC began an informal and then formal, investigation in October, 2001. Given all of the information filed with the SEC, should the SEC have begun their investigation earlier?

Response: The SEC has limited resources. It has been difficult for the Commission's staff to review both new registrations and annual filings. In hindsight, there are a lot of things we could have done differently or sooner.

Question No. 7: I understand that the SEC has a "selective review" program in its Corporation Finance Division which randomly reviews filings for red flags. Should the SEC institute a rotation system by which a majority of companies would undergo this enhanced review on a regular basis?

Response: The SEC's current selective review system essentially is a rotation system coupled with event driven reviews. Anything that can be done to improve the frequency by which company filings are reviewed by SEC staff would be an important endeavor.

**RESPONSES OF ARTHUR LEVITT
TO QUESTIONS FOR THE OFFICIAL RECORD
SUBMITTED BY SENATOR BUNNING**

“The Fall of Enron: How Could It Have Happened?”

January 24, 2002

Question No. 1: In a statement issued January 17, 2002, SEC Chairman Pitt mentioned some needed changes to our disclosure and financial reporting systems, including moving to a system of “current disclosure” and using “plain English financial statements.” What are your thoughts on this?

Response: I support Chairman Pitt’s call to improve disclosures, including moving to a system of “current disclosure” and using “plain English financial statements.” The Chairman’s proposal on new corporate disclosure rules introduced on February 13th was a significant one and it would do much to improve the financial reporting process.

Question No. 2: To the average investor, the Enron collapse must seem very confusing and complex. What advice do you have for the average American?

Response: There is an unacceptably wide gap between financial knowledge and financial responsibilities. Closing this “knowledge gap” is among the most important problems we face today. We need to remind Americans that they need to know three things before they can make an informed investment decision:

- (1) what are their investment goals;
- (2) when will they need the money; and
- (3) how much risk can they afford.

Investors need to understand the relationship between risk and return and the benefits of a diversified portfolio. This is a critical element of making suitable and sound investments at the right time in their lives.

Question No. 3: In your testimony, you said that company boards “often fail to confront management with tough questions” and that the members of a company’s Board of Directors should meet independence requirements. Can you elaborate on this?

Response: Too often, those who manage public companies, audit them, and serve on their boards of directors have forgotten that the opportunity to realize wealth in our capitalist system comes with a responsibility to the public from whose capital they are able to prosper. Corporate boards have a fiduciary duty to the shareholder. But all too often, directors are seduced by economic incentives apart from their director salaries or, for other reasons, fall into the trap of accepting easy answers that ultimately result in lax oversight.

Stock exchanges, as a listing condition, should require at least a majority of the directors on company boards to meet a strict definition of independence. That means no consulting fees, use of corporate aircraft without reimbursement, support of director-connected philanthropies, or other seductions. In Enron’s case, at least three so-called independent board members would have been disqualified under this test of independence.

February 12, 2002

U.S. Senate
Committee on Governmental Affairs
Supplementary Statement of Professor John H. Langbein

This statement responds to questions supplied by Senators Cleland and Bunning, following my testimony to the Committee's January 24, 2002 hearing on the Enron case.

I. Questions from Senator Cleland

QUESTION 1. Georgia's retirement systems suffered a loss of about \$127 million over the three year period preceding the bankruptcy filing by Enron. How can we protect retirement systems like Georgia's from suffering similar losses of investment in the future? On a related note, should this raise some "red flags" about proposals to authorize private investment accounts for Social Security?

ERISA exempts state and local government retirement systems from its coverage. See ERISA § 4(b)(1). The main avenues for remedy to recover the Georgia plan's loss will be under state tort and corporation law and under federal securities law (against the directors, officers, and accountants).

Most state and local plans are defined benefit plans, which are broadly diversified. No single investment in a well diversified plan such as the Georgia system can devastate the retirement prospects of the covered workers. Thus, the Georgia employees in their individual capacities will be barely affected by their plan's investment in Enron. Compare the fate of those Enron employees who, because they had all or most of their retirement funds concentrated in employer stock, lose their pensions as well as their jobs.

I fear that the topic of potential privatization of Social Security accounts would be contentious for a host of reasons not germane to the Enron catastrophe, and thus I would urge that the question be addressed separately. There are ways of privatizing some Social Security investment (that is, investing contributions in something other than government paper) without exposing individual workers to the risks and responsibilities of investment management. See, e.g., Laurence S. Seidman, *Funding Social Security*, 81 *Tax Notes* 241 (1998). I do not endorse this or any other proposal for privatizing the existing Social Security system.

QUESTION 2. Alan Blinder, former vice chairman of the Federal Reserve has stated that "It is a very bad financial package to have a person's pension tied into the company for which they work." Professor Langbein, am I correct in my assumption, from reading your testimony, that you would agree with Mr. Blinder? Do you have any recommendations for statutory or regulatory reforms in this regard?

My testimony of January 24 agrees with the views attributed to Mr. Blinder. The proposal in my testimony to extend ERISA's successful diversification requirement from defined benefit plans to defined contribution plans would prevent such cases from happening in the future.

We must always expect that some companies will fall on hard times and experience severe declines in their equity values, quite apart from any wrongdoing of the sort alleged at Enron. We can never predict in advance which those companies will be. Accordingly, the only way to protect retirement funds from the risk of such large losses is to require pension investment portfolios to diversify broadly. Congress imposed just this solution on defined benefit plans in 1974 when enacting ERISA, and it has been a success story. At that time defined contribution plans were mostly unimportant supplemental plans. Today, defined contribution plans like the 401(k) plan at Enron have become dominant features of the pension landscape. For the future, Congress can prevent Enron-type pension catastrophes by the simple step of extending to defined contribution plans the cure that has worked for defined benefit plans: mandate diversification.

QUESTION 3. What can you tell us about the kinds of communications companies generally have with their workers on the issue of buying shares of the company? In your view, is it general Wall Street practice for companies to play a role in inducing their employees to buy company stock? To your knowledge, is buying company stock made an issue of company loyalty?

We do not know as much as we would wish about how employer stock plans are marketed to employees, but evidence has come to light of significant abuse in some cases. Some companies who sponsor such plans hold pep sessions at which the stock is touted, effectively pressuring employees to elect the company stock option. There is an implication that the employee is disloyal, not a team player, if he or she does not elect to invest in company stock. Descriptive materials (glossy brochures, participant investment direction forms) are slanted, sometimes blatantly, sometimes subtly, toward employer stock. It is very difficult to police against such pressures, which is

another reason why I would solve the problem by mandating diversification.

QUESTION 4. The case of Enron appears to underscore the growing vulnerability of employee retirement savings to the whims of Wall Street. In your testimony you speak forcefully about the need for Congress to mandate diversification in pension plans by setting a cap on employer stock in defined contribution plans. What other kinds of legislative reforms do you believe need to be made to 401 (k) plans?

I am happy to say that I do not think that major reforms are needed on the pension investment front beyond the two that are already being discussed: (1) extending ERISA's diversification requirement to defined contribution plans, and (2) adjusting the fiduciary rules to allow better participant education. I have discussed the latter in other Congressional testimony and return to it below in answer to your Question 9. In the event that Congress does not enact a comprehensive diversification requirement for defined contribution pension plans, I have recommended a Surgeon General's-type warning be required on the annual summary plan description (SPD) that ERISA now requires, advising of the danger of investing retirement funds in employer stock.

The Enron case has revealed one potential flaw in the operation of ERISA's fiduciary rules that Congress ought to clarify, although the courts have been moving toward the right result as a matter of statutory interpretation. The trustees of the Enron 401(k) plan were all Enron employees, as ERISA § 408(c)(3) permits. In the fall of 2001, as it became increasingly clear that Enron common stock was no longer an investment-grade holding for retirement accounts, the Enron plan trustees did not sell the Enron shares, nor close the Enron share account to new purchases. Other plan trustees in such a situation have acted differently. For example, in November 2000, the plan trustees of the USG 401(k) plan, perceiving an increased risk of volatility on account of the emerging potential for asbestos liabilities that had been thought quite remote, immediately suspended employee contributions to the employer stock option in its 401(k) plan. USG entered Chapter 11 many months later.

In my view, the USG and Enron trustees had a fiduciary duty under ERISA's duties of prudence and loyalty to suspend new employee contributions to the employer stock accounts and to notify plan participants of the reasons why. USG appears to have honored this duty, the Enron trustees not. I believe that ERISA's authorization of concentrated holdings in employer stock does not excuse the plan trustees from their overriding duties of loyalty and prudence, to the effect that when the employer stock

in question becomes unsuitably risky for investment of retirement funds, they have an obligation to suspend such investments and to disclose the circumstances to plan participants. Congress should make that limitation on employer-stock plans explicit.

Further, Congress should clarify the ERISA fiduciary rules to make it explicit that an employer who sets up an employer stock plan has abiding fiduciary duties of disclosure to the plan trustees and to the plan participants regarding the investment quality of employer stock. We cannot have one set of Enron executives immune from responsibility for buying watered Enron stock while another set of Enron executives are busy watering the Enron stock.

I would favor one other structural change in 401(k) plan rules, in the event that Congress undertakes a review of 401(k) policy. I believe that Congress should prevent plan participants from accessing 401(k) plan assets by loan or by early withdrawal for purposes other than retirement income. Once again, my model is the defined benefit plan, which 401(k) plans are displacing. 401(k) plans are no longer small supplemental savings plans. The 401(k) has become the only pension plan for most participants. If Congress is going to reward these plans with the pension tax subsidy, Congress has the right to insist that the proceeds be devoted to retirement income. I must emphasize, however, that my views on this matter raise policy concerns quite unconnected to any lessons from the Enron scandal, and I would not wish to see the changes that are needed in the investment arena compromised by widening the agenda in this direction.

QUESTION 5. In your testimony you encourage Congress to insist upon "alerting employees about the risks of holding employer stock" and use the analogy of the Surgeon General's warning on cigarette packages. How do companies currently disclose information to their employees? What changes in investment information do you recommend?

See my answer to Question 3 above. There are two potential remedies: require diversification, or warn employees about the danger of not diversifying. Only the diversification requirement will do the job thoroughly. My suggestion for a Surgeon General's-type warning is contained in my January 24, 2002 testimony to the Committee.

QUESTION 6. There appears to be a factual dispute between Enron and its employees on the issue of the lockdown. According to Enron, the lockdown lasted 10 trading days. Enron employees, on the other hand, contend that access to their 401 (k) plans was restricted much sooner. Under the law, does a company have the ability to call off a lockdown if company

stock prices are falling and there is a strong likelihood that the stock will fall even further? If a company fails to do so, is it, in your opinion, violating its fiduciary duty? In your opinion, should Enron have changed its 401(k) plan administrator at the particular time the company chose to do so?

Congress should not attempt to micromanage the details of plan administration. ERISA imposes two powerful duties on plan fiduciaries, loyalty and prudence. See ERISA § 404(a)(1)(A)-(B). These duties will usually be sufficient to deter or to recompense inappropriate lockdown schemes. ERISA's duty of loyalty requires that plan fiduciaries act "solely in the interest of the participants and beneficiaries and for the exclusive purpose of providing benefits" to them. Thus, the employer or its chosen plan fiduciary has a duty to conduct the details of plan administration such as the change of administrator in the Enron case in a fashion that does not expose the participants to the risk of a lockdown during a period of foreseeable volatility in the share prices. I do not, therefore, think that further legislation is needed on this matter. Imposing a lockdown in circumstances of transparent volatility in the share prices would be a breach of ERISA's duties of loyalty and prudent administration.

Once again, I note that if Congress were to mandate broad diversification, effectively eliminating employer-stock-based pension funds, the entire problem would disappear. We would not have to concern ourselves with the details of how such unwise plans should be managed.

QUESTION 7. A major corporation in Georgia restricts the time line when top executives can sell the company's stock to a relatively narrow window: two weeks every quarter. In addition, the company further stipulates that such selling must be done before the company's Board of Directors. By contrast, we know that there was a major sell-off of Enron shares by Enron executives beginning as early as 2000 and continuing throughout the summer of 2001. What current restrictions either in law or regulation govern the sell-off of company shares by its executives? What reforms would you recommend in this area?

The question deals entirely with securities laws matters that are beyond my expertise.

QUESTION 8. Enron employees were saving for their retirement through their 401(k) plans and many expressed concern about the falling price of Enron stock. Yet, it is alleged that on September 26, less

than a month before Enron reported a \$638 million loss Enron's chairman e-mailed employees and called the company stock an incredible bargain and said the upcoming report for the third quarter is "looking great." Do employees need better access to accurate information about their own company's finances? How do you believe we can best accomplish this objective?

ERISA already makes it a breach of fiduciary duty to mislead employees about the potential investment characteristics of employer stock. In a well-known aphorism that the Supreme Court has quoted, Judge Richard Posner said: "Lying is inconsistent with the duty of loyalty owed by all fiduciaries and codified in section 404(a)(1) of ERISA." *Peoria Union Stock Yards Co. v. Penn Mut. Life Ins. Co.*, 698 F.2d 320, 326 (7th Cir. 1983), quoted in *Varity Corp. v. Howe*, 516 U.S. 489, 506 (1996).

I do, however, believe that ERISA should be amended to make clear that any communication from employer to employees about the merits of company stock as a retirement plan investment is fiduciary in character.

QUESTION 9. Georgia's State Retirement Funds lost \$127 million in Enron stock but fortunately, the plans, due to the savvy decision making by the plan administrator, only lost 2/10 of 1% on their entire portfolio of investments. The message that must be communicated to investors is to know about your plan and diversify, diversify, diversify. Do you believe employers should be required to better educate employees about their 401(k) plans? What recommendations do you have on how to best achieve this education goal?

How can employees who are plan participants be better educated about their choices? This is a question that ranges far beyond the problems of employer stock plans. The challenge would remain even if ERISA were amended as I have recommended to require diversification in such plans. The problem inheres in the structure of the defined contribution plan, which leaves investment responsibility with the plan participant. By contrast, in a defined benefit plan, the employer makes a benefit promise, and the employee has no involvement with how the employer invests to fund the promise.

Under the ERISA § 404(c) regulations, the employer who offers a 401(k) plan containing a reasonably broad choice of diversified investment vehicles (typically mutual funds and certain insurance company products) has discharged the employer's investment duties to the participants. That leaves the employee to make the crucial asset allocations among asset types (equity and debt) as well as among particular funds.

There is widespread agreement among investment professionals that many workers do not handle this task well. Those who are unfamiliar with or frightened of equities often have less equity exposure than they need in order to build adequate retirement funds across the decades. Persons who are nearing retirement need to have larger allocations of debt (bond-type investments), which is less volatile but which also earns less. These allocations should vary with individual circumstances--the availability of other assets, the existence and means of any spouse or dependents, risk preferences, and so forth.

Most employees who are managing their own pension investment programs in defined contribution plans would benefit from some professional guidance on asset allocation and other investment issues. What passes for education today is not adequate to the task. Employers, however, have been quite reluctant to supply such guidance, either directly or through hirelings, for fear that ERISA's expansive definition of "fiduciary" would make the giving of such advice a fiduciary function and expose them to litigation in down markets. The same fear has kept financial intermediaries (such as mutual fund companies, banks, and insurance companies) who offer investment products from providing such advisory services to defined contribution plan participants.

The most likely source of investment advisory services for participants would be the large investment providers, who could offer asset allocation advising as a bundled service along with their funds. I believe that ERISA needs to be modified to facilitate investment providers supplying such bundled investment advisory services. There is a danger of conflict of interest: Would the bank recommend nonbank funds? Would Vanguard recommend only Vanguard funds? But our present practice is to let the drowning person sink in order to prevent the rescuer from being rewarded. I would prefer low grade conflict to the present situation.

II. Questions from Senator Bunning

QUESTION 1. Have there been any blackouts or price spikes that occurred in the energy markets as a result of Enron's Collapse?

QUESTION 2. What have you seen in the energy markets since Enron's collapse. What have electricity and gas prices done?

I have no expertise on energy markets and cannot helpfully respond to these questions.

QUESTION 3. You suggested at the very least that Congress should alert employees to the importance of diversification in their 401(k) accounts and even provided a sample warning in your testimony. Can you explain further how a warning to employees would be implemented and if there are any liability issues we need to be concerned about?

The easiest way for Congress to require a warning about the dangers of employer stock would be to require the warning language to be inserted in the annual summary plan description (SPD) that ERISA now requires to be sent to employees each year. I would amend ERISA § 102 to add the warning requirement. Congress could either specify the language (I have suggested some language in my testimony of January 24), or Congress could direct the Labor Department to draft the language. The warning needs to be imposed through ERISA rather than through the Internal Revenue Code, because it should extend to plans that are not tax qualified.

There could be no liability consequences for employers or other plan sponsors who comply with the duty to supply the warning. The legislation would automatically bestow implicit immunity for compliance. Moreover, even in our litigation-happy legal system, we do not impose liability on people who disclose well-settled truths, and who as a result spare others from harm.

Responses to Additional Questions

Frank Partnoy, Professor of Law, University of San Diego School of Law
United States Senate Committee on Governmental Affairs, February 13, 2002

The following are my responses to additional questions posed by the Committee:

1. Enron is alleged to have concealed millions of dollars of debt through its use of Special Purpose Entities that kept the debt off of Enron's balance sheets. Joseph Berardino, CEO of Arthur Anderson, has stated that he would like to see accounting rules changes with regard to Special Purpose Entities, so that companies' balance sheets would reflect the true risks at stake. Do you believe accounting rules should change with regard to Special Purpose Entities?

Yes, but I believe such rule changes alone would be insufficient. The lesson of Enron and other recent accounting scandals is that specific rules are inferior to broad standards in regulating financial disclosure. In recent years, there has been a proliferation of specific rules – including rules related to Special Purpose Entities – which have enabled companies to report revenues, earnings, and liabilities that do not match economic reality. Changing these specific rules would help, but recent history shows that the more general problem in financial markets is that (1) companies transact to avoid specific rules if the expected benefits of doing so exceed the expected costs, and (2) individuals and institutions rely on specific rules in justifying and defending their conduct. Without greater resources for enforcement, or incentives to encourage private rights of action, market participants will transact around many new rules, and regulators will not be able to keep up with them. At the same time, market participants will rely on such rules in defending their own malfeasance after the fact, just as some participants in the Enron scandal have attempted to justify their conduct with respect to the rules related to Special Purpose Entities.

Therefore, I believe the best approach would be for Congress to pass legislation generally requiring that financial statements reflect economic reality. Such a broad standard, perhaps resembling Section 10(b) of the 1934 Exchange Act, would deter companies from transacting around specific rules while making it clear that financial market participants cannot manipulate transactions to fit such rules when disclosures related to those transactions would not reflect economic reality.

2. As you state in your testimony, the major credit rating agencies received "substantial" fees from Enron and continued to give Enron an investment grade rating just weeks before Enron filed for bankruptcy. What if any, conflicts of interest do you see regarding such practices?

Since the 1970s, companies that issue bonds have directly paid credit rating agencies for ratings. For example, Moody's Corp. reported receiving \$504.5 million of revenue (almost 90 percent of its total revenue) for ratings during the nine months ended September 30, 2001, according to the company's most recent quarterly filing. A typical

ratings fee is in the range of 0.03 percent of the amount of an issue (i.e., tens of thousands of dollars for an individual issue), and ratings fees for complex deals are much higher.

Given these fees, credit rating agencies generally face pressure to issue inflated ratings and – more importantly – to delay downgrades (especially downgrades below the critical investment grade level) when presented with negative information about a company. It is telling that all three major credit rating agencies maintained investment grade ratings for Enron until a few weeks before it filed for bankruptcy, notwithstanding the wave of negative publicly available information about Enron, and the decline in Enron's stock price to \$3 per share. Although credit ratings generally are correlated with default experience, the agencies have been spectacularly wrong in numerous recent instances, including Enron, Pacific Gas & Electric, and Orange County. Moreover, credit rating agencies continue to thrive, notwithstanding their poor performance, because regulatory requirements give the three major agencies a monopoly lock on the ratings business and force issuers to pay for ratings regardless of accuracy.

I understand that credit rating agencies are considering making more frequent ratings evaluations. In your view, will this increase the accuracy of ratings?

My understanding is that efforts to make more frequent ratings evaluations have been largely abandoned, in the face of intense pressure from market participants. In any event, I do not believe more frequent evaluations would substantially increase the accuracy of ratings. For the reasons given in my oral testimony before the Committee, I believe the legal rules that depend substantively on credit ratings must be changed before there is any increase in accuracy.

Do you believe that credit rating agencies should put more focus on off-the-balance sheet transactions?

Yes, I believe they should. However, credit rating agencies have a major business commitment, and earn substantial revenue, from rating structured transactions, including those used in off-balance-sheet transactions. For example, Enron was very active in such transactions, including collateralized debt obligations, which the credit rating agencies earn substantial revenues from rating. (Enron was an active participant in these markets.) Moreover, without improved disclosure requirements, credit rating agencies are unlikely to obtain complete and accurate information about off-balance-sheet transactions from companies.

3. Have there been any blackouts or price spikes that occurred in the energy markets as a result of Enron's collapse?

I am not an expert on energy markets, and was asked by the Committee for testimony in my primary areas of expertise: derivatives and financial market regulation. I know that many experts, including Robert McCullough, have testified about the effect of

Enron's collapse on the energy markets, and I would respectfully defer to those experts on this question.

4. What have you seen in the energy markets since Enron's collapse? What have electricity and gas prices done?

I am not an expert on energy markets, and was asked by the Committee for testimony in my primary areas of expertise: derivatives and financial market regulation. I know that many experts, including Robert McCullough, have testified about the effect of Enron's collapse on the energy markets, and I would respectfully defer to those experts on this question.