107th Congress
2d Session

COMMITTEE PRINT

S. PRT.
107–75

FINANCIAL OVERSIGHT OF ENRON: THE SEC AND PRIVATE-SECTOR WATCHDOGS

REPORT

PREPARED BY THE STAFF

OF THE

COMMITTEE ON GOVERNMENTAL AFFAIRS
UNITED STATES SENATE

OCTOBER 7, 2002

U.S. GOVERNMENT PRINTING OFFICE

82–147 PDF

WASHINGTON : 2002

For sale by the Superintendent of Documents, U.S. Government Printing Office
Internet: bookstore.gpo.gov Phone: toll free (866) 512–1800; DC area (202) 512–1800
Fax: (202) 512–2250 Mail: Stop SSOP, Washington, DC 20402–0001

COMMITTEE ON GOVERNMENTAL AFFAIRS

JOSEPH I. LIEBERMAN, Connecticut, *Chairman*

CARL LEVIN, Michigan	FRED THOMPSON, Tennessee
DANIEL K. AKAKA, Hawaii	TED STEVENS, Alaska
RICHARD J. DURBIN, Illinois	SUSAN M. COLLINS, Maine
ROBERT G. TORRICELLI, New Jersey	GEORGE V. VOINOVICH, Ohio
MAX CLELAND, Georgia	THAD COCHRAN, Mississippi
THOMAS R. CARPER, Delaware	ROBERT F. BENNETT, Utah
JEAN CARNAHAN, Missouri	JIM BUNNING, Kentucky
MARK DAYTON, Minnesota	PETER G. FITZGERALD, Illinois

JOYCE A. RECHTSCHAFFEN, *Staff Director and Counsel*
LAURIE R. RUBENSTEIN, *Chief Counsel*
BETH M. GROSSMAN, *Counsel*
CYNTHIA GOOEN LESSER, *Counsel*
JOHN N. WANAT, *Congressional Fellow*
RICHARD A. HERTLING, *Minority Staff Director*
GARY M. BROWN, *Minority Special Counsel*
DARLA D. CASSELL, *Chief Clerk*

CONTENTS

	Page
INTRODUCTION	1
PART ONE: THE SEC AND OTHER WATCHDOGS WITH LEGAL OBLIGATIONS	6
I. BACKGROUND	7
A. The SEC	7
1. Mission and Organization	7
2. Review of Public Filings	8
3. Enforcement	11
B. Private-Sector Gatekeepers	13
1. Boards of Directors	13
2. Auditors	16
II. EXPERIENCE WITH ENRON	20
A. Private-Sector Gatekeepers	21
1. Enron's Auditor	21
2. Enron's Board of Directors	22
B. The SEC	23
1. Review of Enron's Public Filings	24
2. Enron's Shift to Mark-to-Market Accounting	31
3. Exemptions from the Public Utility Holding Company Act	36
4. Exemption from the Investment Company Act of 1940	43
III. RECOMMENDATIONS	46
PART TWO: MORE WATCHDOGS—WALL STREET SECURITIES ANALYSTS AND CREDIT RATING AGENCIES	52
I. ENRON AND THE WALL STREET ANALYSTS	53
A. Investment Research Analysts	54
B. The Wall Street Analysts' Assessments of Enron	55
C. Factors Affecting the Objectivity of Sell-Side Analyst Recommendations	62
D. Solutions	69
II. ENRON AND THE CREDIT RATING AGENCIES	76
A. History and Uses of Credit Ratings	77
B. Efforts to Regulate Credit Rating Agencies	80
C. Chronology of Enron's Ratings	84
D. Problems With the Agencies' Analyses and Actions	89
E. Conclusions and Recommendations	98
APPENDIX: Note 16 to Financial Statements, Enron Corp. Form 10–K for the Year Ended December 31, 2000	100

FINANCIAL OVERSIGHT OF ENRON: THE SEC AND PRIVATE-SECTOR WATCHDOGS

OCTOBER 7, 2002

INTRODUCTION

On December 2, 2001, Enron Corp. (together with its subsidiaries, collectively referred to in this report as "Enron") filed for bankruptcy protection, making it—at the time—the largest company to declare bankruptcy in the nation's history.[1] Enron's collapse deprived thousands of employees of their jobs, severely diminished their retirement savings, and led to the loss of billions of shareholder dollars. Perhaps most significantly, the company's failure and the months of revelations that followed triggered a crisis in investor confidence in U.S. capital markets. The repercussions of Enron's collapse continue to be felt today.

The misdeeds that led to Enron's demise were, in the first instance and ultimately, the responsibility of Enron and its management. Enron, however, functioned within a larger environment consisting of private and public entities alike that were supposed to monitor or regulate the company's activities and public disclosures. In January 2002, Senate Committee on Governmental Affairs Chairman Joseph I. Lieberman and Ranking Member Fred Thompson initiated a wide-ranging review of the actions of the various governmental and private watchdogs that were supposed to monitor Enron's activities and help protect the public against these sorts of calamities. The Chairman and Ranking Member charged the Committee with examining whether these watchdogs did their jobs correctly and whether different actions by those watchdogs could have prevented—or at least detected earlier—the problems that have come to be associated with Enron.

The Committee took a broad look at a range of entities that play some role in monitoring the financial activities of publicly held companies, from the company's Board of Directors to the accounting firm that audited Enron's books to stock analysts and credit rating agencies that purported to give the public accurate and objective information about Enron's financial health.[2] The Committee

---

[1] Since that time, WorldCom has superseded Enron as the largest corporate bankruptcy. *See* Simon Romero and Riva D. Atlas, "WorldCom's Collapse: The Overview; WorldCom Files for Bankruptcy; Largest U.S. Case," *The New York Times,* July 22, 2002.

[2] The Committee's Permanent Subcommittee on Investigations ("PSI") also has been investigating aspects of Enron's collapse, and has held a series of hearings on the role of Enron's Board of Directors and the role of financial institutions in Enron's collapse. *See* The Role of the Board of Directors in Enron's Collapse, Hearing Before the Permanent Subcommittee on Investigations, Senate Governmental Affairs Committee, 107th Cong., S. Hrg. 107–511 (May 7, 2002); The Role of Financial Institutions in Enron's Collapse, Hearing Before the Permanent Subcommittee on Investigations, Senate Governmental Affairs Committee, 107th Cong., S. Hrg. 107–618 (July 23 and 30, 2002) (Printed Hearing Record Pending). PSI also has issued a report on the role of the Board of Directors in its collapse. *See* Report of the Senate Permanent Sub-

Continued

placed a particular focus on the most important watchdog of all, the Securities and Exchange Commission (the "SEC" or the "Commission"). Each of these entities plays a particular role in monitoring our capital markets. Together, they are supposed to ensure that the markets operate fairly, with complete, accurate and comprehensible information available to all investors.

In looking at the array of purported checks on financial misbehavior, what Committee staff discovered was deeply disturbing—not so much because they uncovered malfeasance or intentional wrongdoing on anyone's part (although that seems to have been present in some cases as well), but because what emerged was a story of systemic and arguably catastrophic failure, a failure of all the watchdogs to properly discharge their appointed roles. Despite the magnitude of Enron's implosion and the apparent pervasiveness of its fraudulent conduct, virtually no one in the multilayered system of controls devised to protect the public detected Enron's problems, or, if they did, they did nothing to correct them or alert investors. Not one of the watchdogs was there to prevent or warn of the impending disaster: Not Enron's Board of Directors, which asked few, if any, probing questions of Enron's management and which authorized various related-party transactions that facilitated many of Enron's fraudulent practices; not Enron's auditor, Arthur Andersen, which certified the apparently fraudulent financial statements; not the investment banking firms, which structured and sold securities and other financial products that appear to have allowed Enron to obfuscate its financial position; not the attorneys, whose opinions and work were critical to certain transactions that may have been central to Enron's collapse; not the Wall Street securities analysts, many of whom continued to recommend Enron as a "buy" up until the bitter end; not the credit rating agencies, who rated Enron's debt as investment grade up until 4 days before the company filed for bankruptcy; and not the SEC, which did not begin to seriously investigate Enron's practices until after the company's demise became all but inevitable.

These failings call into question the basic assumptions on which our financial regulatory framework is built. The SEC, with its relatively small staff, does not, and is not set up to, directly perform many of the tasks necessary to root out corporate fraud. Instead, we have a system in which the public relies on a partnership of both the SEC and private gatekeepers in order to keep tabs on the enormous U.S. markets. But this foundational assumption—that the SEC can depend on private entities as the first and primary restraint against massive corporate wrongdoing—proved terribly wrong in the case of Enron. And the failure of this premise, along with the insufficiency of the SEC's adjustment for it, raises questions about whether the SEC is effectively functioning as the lead market watchdog that it is meant to be.

That the Enron collapse, moreover, has been followed by a seeming flood of allegations about large-scale financial fraud at other prominent companies, including WorldCom, Global Crossing, Tyco, Adelphia, and Rite Aid, precludes any easy characterization of

committee on Investigations on "The Role of the Board of Directors in Enron's Collapse," S. Prt. 107–70 (July 8, 2002).

Enron as simply a "bad apple" or the lapses of the gatekeepers and regulators as isolated breakdowns in an otherwise sound system. Indeed, even if the malfeasants are viewed as but rogue corporations, it is precisely the role of the gatekeepers to spot and protect against such rogues. That none of them did so suggests that there have been some basic flaws in our system of market regulation, ones that well warrant the re-examination that the system is currently undergoing.

Furthermore, while Enron is now the poster company for all of the failures of due diligence and objectivity on the part of the watchdogs, portents of such problems should have been seen for some time. The SEC, for example, had reason for years to question the validity of financial statements; restatements of filings with the SEC skyrocketed from just 3 in 1981 to 270 in 2001.[3] Former SEC Chairman Arthur Levitt, moreover, in a now famous speech called the "Numbers Game," was talking about gaps in the system of gatekeepers more than 3 years before Enron imploded. In that speech, then-Chairman Levitt expressed deep concern about "earnings management"—the manipulation of accounting in order to meet Wall Street's earnings expectation. "Too many corporate managers, auditors and analysts are participating in a game of nods and winks," he warned. "I fear that we are witnessing an erosion in the quality of earnings, and therefore, the quality of financial reporting. Managing may be giving way to manipulation; Integrity may be losing out to illusion." In the conclusion to the speech Levitt asked this ominous question: "Today, American markets enjoy the confidence of the world. How many half-truths, and how much accounting sleight-of-hand, will it take to tarnish that faith?"[4]

Sadly, the Enron debacle and those that have followed may have provided the answer to Levitt's question. The size and number of these corporate frauds, coupled with the failure of all of those charged with protecting against such fraud to do so, appear to have left many investors with doubts about whether they can rely on any of the financial information in the marketplace.[5] And because

[3] *See* Ianthe Jeanne Dugan, "Depreciated: Did You Hear the One About the Accountant? It's Not Very Funny," *The Wall Street Journal*, March 14, 2002; Financial Executives International, "Quantitative Measures of the Quality of Financial Reporting," June 7, 2001, available at http://www.fei.org/download/QualFinRep-6-7-2k1.ppt; Huron Consulting Group, "A Study of Restatement Matters," June 11, 2002, available at http://www.huronconsultinggroup.com/files/tbl—s6News/PDF134/50/restatement—study.pdf.

[4] Arthur Levitt, "The Numbers Game," Remarks at the NYU Center for Law and Business, September 28, 1998, available at http://www.sec.gov/news/speech/speecharchive/1998/spch220.txt. *See also* The Fall of Enron: How Could It Have Happened, Hearing Before the Senate Governmental Affairs Committee, 107th Cong., S. Hrg. 107–376 (January 24, 2002) at 26–27 (Statement of the Honorable Arthur Levitt, Jr., former SEC Chairman) ("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 okay 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 potentially 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.").

[5] In one recent survey, for example, 57 percent of respondents indicated that they do not trust corporate executives or brokerage firms to give them honest information, and one third indicated that they believed that what happened at Enron is typical of what goes on at most or many companies. John Harwood, "Americans Distrust Institutions in Poll," *The Wall Street Journal*, June 13, 2002 (reporting the results of a Wall Street Journal/NBC News Poll). In another poll,

Continued

the proper functioning of U.S. financial markets rests on the cornerstone principle that all individuals have access to accurate basic information about the companies in which they invest, this crisis in investor confidence is widely seen as contributing significantly to the current downturn in the stock market and as being a drag on any economic recovery.[6]

Fortunately, with the recent enactment of the Sarbanes-Oxley Act of 2002[7]—which, among other things, strengthens the oversight of accountants, takes steps to reduce the conflicts of interests faced by auditors and stock analysts, and enhances the SEC's enforcement tools—things seem to be moving in the right direction. There are additional actions, however, that can and should be taken by the various actors in our system of market oversight themselves to improve the information and protection they provide to the public. No one watchdog—governmental or nongovernmental—alone can restore the investor confidence that is vital to the continued robust operation of our markets; all of those entrusted as gatekeepers will need to take action to ensure the public that fraud will be uncovered and that financial chicanery will not be tolerated.

This report documents the results of the Committee's review of the financial oversight of Enron. It is divided into two parts. Part One discusses Committee staff's findings with respect to the SEC's oversight of Enron. As discussed below, the SEC staff failed to review any of Enron's post-1997 financial filings even though the company was undergoing significant growth and substantially changing the nature of its business and the SEC itself was aware that other gatekeepers, such as boards of directors and auditors, were proving increasingly unreliable. Had SEC staff reviewed these filings, they would have had an opportunity to uncover some of the problems with the company's financial practices that appear to have been signaled in those documents. In addition, the SEC staff made administrative determinations that allowed Enron to engage in certain accounting practices and exempted the company from certain regulatory requirements. Whether or not these decisions were reasonable at the time, what is particularly troubling is that the SEC lacked any procedures by which to monitor the effects of these determinations to see whether they were being applied appropriately by the company and/or whether the circumstances that underlay them had changed. The leeway afforded Enron by these

---

72 percent of respondents said they thought stockbrokers acting in their own interest rather than that of their clients was a somewhat or very widespread practice; 73 percent said they thought financial audits hiding damaging information about a company was somewhat or very widespread; and 77 percent said they thought improper, self-serving actions by top executives were somewhat or very widespread. Gary Strauss, "Bush's Call for Reform Draws Mixed Reviews," *USA Today*, July 10, 2002 (reporting the results of a USA Today/CNN/Gallup Poll; complete survey results available at http://www.usatoday.com/news/2002-07-09-poll.htm).

[6] *See, e.g.,* Steven Pearlstein, "Corporate Scandals Taking Toll on Markets," *The Washington Post,* June 26, 2002; Joseph Nocera et al., "System Failure," *Fortune,* June 24, 2002. *See also* David W. Moore, "Corporate Abuses, 9/11 Attacks Seen as Most Important Causes of Economic Downturn," *Gallup News Service,* August 5, 2002, available at http://www.gallup.com/poll/releases/pr020805.asp?Version=p (poll found that 77 percent of respondents said that greed and corruption among corporate executives was "the major reason" or "one of the most important reasons' for the current state of the economy). The lack of confidence resulting from these scandals has also reportedly led to a decline in foreign investment in U.S. markets. *See* Louis Uchitelle, "Foreign Investors Turning Cautious on Spending in U.S.," *The New York Times,* August 4, 2002; Philip Coggan, "Losing Faith," *Financial Times (London)*, June 27, 2002; Pearlstein, above.

[7] Pub. L. No. 107–204.

determinations in certain cases appears in fact to have been abused by the company in ways that ultimately played a role in Enron's collapse. In short, the SEC's interactions with Enron reveal the downside to the Commission's largely reactive approach to market regulation and should provide an impetus for the Commission to reorient some of its activities toward more proactive anti-fraud measures. Unfortunately, although the Commission has stepped up its enforcement activities post-Enron, it has been less than proactive in attempting to address fraud at an earlier stage, before it becomes a corporate calamity.

The report's second part describes the roles of two additional groups of private sector watchdogs—Wall Street securities analysts and credit rating agencies—and how each group failed the market by not ringing the alarm bells about Enron until it was too late.[8] Along with other investigations into securities analysts, Enron exposed a dirty little secret—apparently known widely among market insiders, but unfortunately kept from average investors—that Wall Street analyst recommendations were of questionable reliability. Of 15 analysts at major Wall Street firms who covered Enron, all 15 were recommending that investors buy Enron stock when the news about the company's financial misdeeds was first revealed. Three weeks later, after the company had announced an SEC investigation, its Chief Financial Officer had resigned and it had announced that it was restating its financial results for the past 4½ years due to accounting irregularities, 10 of those 15 analysts continued to encourage the public to buy Enron stock. Why, after so much bad news, would these experts hold to their rosy assessment of this company? It turns out that Enron, which tapped the capital markets for funds on a regular basis, had a great deal of investment banking business, and the Wall Street firms that wanted that business also had research departments with analysts assessing Enron stock. This kind of conflict of interest is rife in the industry, and only now, with the historic passage of the Sarbanes-Oxley Act, is there a chance that investors may obtain the unvarnished stock advice that they had thought they were receiving all along.

The credit rating agencies, though unhampered by the kind of conflicts faced by securities analysts at major Wall Street firms, similarly failed to warn the public of Enron's precarious situation until a mere 4 days before Enron declared bankruptcy. Until that time, the rating agencies gave Enron an "investment grade" rating, which indicated that Enron was creditworthy and its bonds were a safe investment. How could the creditworthiness experts consider a company less than a week away from bankruptcy to be a solid investment? This is particularly troubling given that numerous Federal and State statutes and regulations rely on credit ratings

[8] This report focuses on groups about which the Committee has already conducted hearings. Committee staff, however, is mindful that there are other groups that can, and in fact, do function as gatekeepers, particularly in the public securities markets. One of these groups, securities underwriters, has been the subject of an extensive investigation and hearings by PSI. It is also Committee staff's understanding that some firms are being investigated by other governmental bodies. A second group is attorneys. The role of lawyers and law firms as gatekeepers should not be overlooked. *See* Soderquist, *Understanding the Securities Laws,* § 1:7 (Practising Law Institute 2002) (discussing the special position of securities lawyers); "SEC Enforcement Actions Against Securities Lawyers: New Remedies vs. Old Policies," 22 *Del. J. Corp. L.* 537 (1997) (same). The Sarbanes-Oxley Act requires the SEC, within 180 days from the law's enactment, to promulgate rules regarding lawyers' conduct. Pub. L. No. 107–204 § 307.

to set the standard for the kind of investments that funds of public importance, such as money market funds, State pension funds or insurance companies, may make. Based on interviews with the credit rating agencies about their coverage of Enron, Committee staff concluded that, at least with respect to Enron, the rating agencies failed to detect Enron's problems—or take sufficiently seriously the problems they were aware of—until it was too late because they did not exercise the proper diligence. They did not ask sufficiently probing questions and, despite their mission to make long-term credit assessments, did not sufficiently consider factors affecting the long-term health of the company, particularly accounting irregularities and overly complex financing structures. Committee staff recommends increased oversight for these rating agencies in order to ensure that the public's trust in these firms is well-placed.

PART ONE: THE SEC AND OTHER WATCHDOGS WITH LEGAL OBLIGATIONS

Of those entities that participate in our public-private system of market oversight, a number have legally required responsibilities to serve an interest broader than their own. Corporate boards of directors, for example, are responsible to the corporation's shareholders, while auditors owe duties to the company's shareholders and creditors and, indeed, to the investing public. The SEC occupies a unique position in this system as the public institution responsible for overseeing the financial markets, and, accordingly, has the most comprehensive mandate to act in the public interest and protect the interests of investors.

This Part looks at this set of mandated watchdogs, focusing in particular on the actions of the SEC.[9] It starts with an overview of the role each entity plays in our system of market oversight. Looking first at the SEC, this Part reviews the Commission's operations and describes its role in preventing and combating financial fraud. It then turns to the roles and responsibilities of the private-sector gatekeepers and describes the integral part boards of directors and auditors are supposed to play in protecting against fraud.

This Part next examines the actions of each of these players in the case of Enron. It begins with a brief discussion of what Enron's Board of Directors and its auditor did—or, more importantly, failed to do—to head off the company's fraudulent practices. Against this backdrop of failings by the private-sector gatekeepers, the report turns to the SEC, describing the Commission's review of Enron's

[9] This Part of the report is based on a Committee investigation that began with letters from the Committee to the SEC on February 15, 2002 and March 27, 2002, seeking information concerning the Commission's dealings with Enron from 1992 to the present, as well as certain additional information about the operations of the agency. The SEC provided the Committee with written responses to the Committee's letter request, and over the course of the months that followed, Committee staff held numerous meetings and telephone calls with staff from various offices in the SEC and received supplementary documents as requested. (The SEC staff has been consistently responsive and helpful to Committee staff throughout this process). The telephone calls, of various lengths and range, are cited in this report as "Committee staff interview with SEC staff"; face-to-face meetings are cited as "Committee staff meeting with SEC staff." In addition, Committee staff has consulted with numerous outside individuals with relevant knowledge, including former SEC employees, experts in securities law, accounting, and public management, consumer and investor advocates, independent stock analysts and others, and has reviewed documents produced by Enron in response to the Committee's subpoenas to the company on February 15, 2002 and March 22, 2002.

public filings over the past decade, including its failure to review Enron's filings in recent years. It then examines some of the SEC's other regulatory actions with respect to Enron and their implications, including the SEC's determination in 1992 to allow an Enron subsidiary to use so-called "mark-to-market" accounting to record certain of its transactions, and exemptions the SEC granted Enron and its affiliates from the requirements of the Public Utility Holding Company Act of 1935 ("PUHCA") and the Investment Company Act of 1940 (the "Investment Company Act").

Part One of the report concludes by offering recommendations about how, within our overall system of oversight, the SEC can improve its ability to protect investors against future cases of financial fraud and thereby help restore confidence to the financial marketplace.

I. BACKGROUND

A. *The SEC*

1. Mission and Organization

In the wake of the 1929 stock market crash, Congress created the SEC in an effort to restore stability and confidence to the U.S. capital markets. Then and now, the SEC's mission has been to protect investors and ensure the integrity of the securities market. The core principle of the fundamental Federal securities statutes, the Securities Act of 1933 [10] (the "Securities Act") and the Securities Exchange Act of 1934 [11] (the "Exchange Act") is one of disclosure: That all investors should have access to basic information about a stock or other security before investing in it.[12]

The SEC is divided into four "divisions" and 18 "offices." The four divisions, reflecting the scope of the Commission's responsibilities, are: (1) the Division of Corporation Finance, which oversees corporate disclosures through review of companies' public filings; (2) the Division of Market Regulation, which regulates major market participants, including broker-dealers and self-regulatory organizations, such as NASD (formerly known as the National Association of Securities Dealers) and the eight stock exchanges; (3) the Division of Investment Management, which oversees investment companies, including mutual funds, and investment advisers, and which administers PUHCA; and (4) the Division of Enforcement, which investigates possible violations of U.S. securities laws and brings legal action where appropriate.[13] Altogether, the Commission employs approximately 3,000 people.

With respect to fighting financial fraud, the SEC plays perhaps its most essential roles within the broader public-private scheme in two areas. First, the SEC establishes requirements that companies

---

[10] 15 U.S.C. § 77a *et seq.*

[11] 15 U.S.C. § 78 *et seq.* The Exchange Act established the SEC.

[12] *See* Louis Loss and Joel Seligman, *Fundamentals of Securities Regulation* (4th ed. 2001) at 29–31; Joel Seligman, *The Transformation of Wall Street: A History of the Securities and Exchange Commission and Modern Corporate Finance* (Rev. ed. 1995) at 39–40, 561–62.

[13] The SEC's 18 "offices" include the Office of the General Counsel, the Office of the Chief Accountant, the Office of Compliance Inspections and Examinations (which administers the SEC's examination and inspection program for broker-dealers, self-regulatory agencies, investment companies and others), the Office of Investor Education and Assistance, the Administrative Law Judges, and assorted other administrative and policy offices. Also, in addition to its headquarters in Washington, D.C., the SEC has 11 regional offices.

disclose certain information to investors and works to ensure compliance with those disclosure requirements by reviewing the public filings companies submit. In doing so, the SEC both directly discourages shady accounting practices and, by ensuring that material, comprehensible information is publicly available, empowers the entire marketplace—stock analysts and credit raters, individual shareholders and institutional investors—to evaluate the information provided. This is particularly true after the SEC implemented electronic filing and on-line availability of company filings through its EDGAR (Electronic Data Gathering And Retrieval) System. Second, when preventive measures fail, the SEC has the authority to enforce the law and bring legal action against those who have committed fraud.

2. Review of Public Filings

The SEC's Division of Corporation Finance employs approximately 330 people, of whom approximately 144 are lawyers and 107 are accountants; [14] together, they are charged with reviewing the public filings of more than 17,000 public companies in the United States.[15] The Division's staff is organized into 11 groups, with each group responsible for reviewing the filings of a different industry category.[16]

The public filings required to be submitted to the Commission fall largely into two general categories: Transactional filings and periodic reports. Transactional filings are those associated with a particular transaction—e.g., the sale of securities (including initial public offerings) or a merger. They contain information about the transactions as well as about the company's financial condition. Transactional filings are prospective (that is, they address events that have not yet happened) and often call for action by Commission staff. A sale of securities, for example, requires the Division to declare the registration statement submitted by the company to be effective before the sale can go forward. Periodic filings include annual reports (Forms 10–K) and quarterly reports (Forms 10–Q) that set forth a company's financial condition.[17] They are historical in nature, describing the last period's events, and do not require further Commission action. Transactional filings typically contain or incorporate the historical information available in periodic filings.

[14] Correspondence from SEC staff to Committee staff (August 9, 2002).

[15] *See* Letter from Harvey L. Pitt, Chairman, Securities and Exchange Commission, to Joseph I. Lieberman, Chairman, and Fred Thompson, Ranking Member, Senate Committee on Governmental Affairs, dated March 4, 2002 ("SEC Response") at 4.

[16] One of these groups is not industry-specific but instead devoted to the review of small businesses. Until recently, Enron's filings were reviewed by the natural resources and food companies group. In February 2001, representatives from Enron's investor relations department, arguing that Enron was no longer primarily a natural gas pipelines company, asked that the Corporation Finance Division reassign Enron to the group that reviews filings from companies that deal with commodities pools. Corporation Finance declined to do this, but did reassign Enron to the financial services group (which reviews filings made by securities and commodities brokers and dealers), based on the fact that Enron's revenues were at that time primarily derived from its wholesale trading business. No reviews of Enron's filings have been conducted since the reassignment was made. SEC Response at 20–21; Committee staff interview with SEC staff, Division of Corporation Finance (April 24, 2002).

[17] In addition to annual reports and quarterly reports, companies are required to file so-called "current reports" on Form 8–K to report certain specified events which are material to shareholders so that this information is made available sooner than the next quarterly or annual filing.

The Corporation Finance Division does not have the resources to review every filing submitted; accordingly, it employs a screening process to select the filings to be reviewed fully. This "screening" process is distinct from an actual "review" of the filings. Although it involves an initial examination of the filings, the screening process is intended only to determine whether a filing merits a further "review." Unlike a "review," it does not involve a substantive evaluation of the disclosures made in the filing. The screening process employs a variety of criteria, both financial and otherwise (including the length of time from last review), to determine which filings warrant further scrutiny. These criteria can vary by industry group. The criteria are kept confidential by the SEC, but are intended to target those filings that "most warrant[ ] staff review"—presumably those most likely to pose the greatest risk to investors.[18] The screening process relies heavily on initial, direct staff examination of the filings, although it incorporates computer-based financial data as well. As a result of the screening process, a filing may be selected for one of four levels of review: A full review (that is to say, a review of the entire filing), a financial statement review (a review only of the company's financial statements and Management Discussion and Analysis ("MD&A")),[19] a limited review or "monitor" (a review of a specific item or items in the filing), or no review at all.

All transactional filings go through the screening process because the Division must take action on them. The Corporation Finance Division, furthermore, has given priority to initial public offerings (IPOs) because of the risks to investors inherent in a company's first sale of stock.[20] Accordingly, all IPO filings are reviewed by Corporation Finance Division staff. Although this may reflect a reasonable risk assessment, it nonetheless leaves fewer resources to devote to other types of filings. This became a particular problem in the mid-to-late 1990's, when the number of initial public offerings increased substantially.[21] According to SEC staff, the focus on IPO reviews has meant that even those non-IPO transactional filings that meet the screening criteria are not necessarily reviewed.

As for periodic reports, screening of these is uncertain and is subject to the time and resources available after screening and re-

[18] SEC Response at 2.

[19] These financial statements—including balance sheet, income statement, and statement of cash flows—are accompanied by explanatory footnotes, which are also reviewed. MD&A (formally, "Management Discussion and Analysis of Financial Condition and Results of Operations") is a required supplementary analysis of the financial statements in which the company is required to provide other information necessary to understand its financial condition. *See generally* SEC Regulation S–X, 17 C.F.R. Part 210 (detailing the requirements for financial statements); SEC Regulation S–K, 17 C.F.R. Part 229 (detailing other requirements for information contained in SEC filings, including Form 10–K; MD&A is discussed at 17 C.F.R. § 229.303).

[20] According to SEC staff, IPOs, which constitute a company's first filing with the Commission, often raise a greater number of disclosure and securities law concerns than other filings; they also provide an opportunity for staff to correct improper disclosures early, before they appear in later periodic reports. Correspondence from SEC staff to Committee staff (August 9, 2002). One former SEC official, agreeing that the greatest risk of misrepresentations lies with companies attempting to raise capital, opined that many company officials had adopted more brazen attitudes in the late 1990's with respect to IPO filings, deliberately testing the limits of what the SEC would allow them to do. Interview with Lynn Turner, Director, Center for Quality Financial Reporting, Colorado State University College of Business and former SEC Chief Accountant (June 24, 2002).

[21] The number of IPO filings examined by the SEC peaked at 1,350 in 2000; as recently as 1995, the number was 805. By 2001, the number decreased to 745. Correspondence from SEC staff to Committee staff (August 9, 2002); *see also* U.S. General Accounting Office, "SEC Operations: Increased Workload Creates Challenges," GAO–02–302, March 2002, at 17.

view of transactional filings. In other words, many periodic reports are not screened at all, even to determine whether they should be examined further.[22] The SEC's stated goal has been to review every company's annual report at least once every 3 years, but in recent years, it has fallen far short of this mark. In fiscal year 2001, for example, the Division completed a full or financial statement review of only 2,280 of 14,600 Forms 10–K filed, or approximately 16 percent. Of more than 17,300 public companies, approximately 9,200, or 53 percent, have not had their Forms 10–K reviewed in the past three years.[23]

For those annual reports actually reviewed by the Corporation Finance Division, the review generally is limited to the four corners of the document. One SEC staff member referred to this process as a "desk audit—" that is, information one can get while sitting at one's desk. The review may thus incorporate information gleaned from news stories and analyst and industry reports, but the focus is on the filings themselves.[24] The primary goal is to ensure that required disclosures are set forth in the report and that the disclosures themselves are facially accurate and comprehensible.[25] If the staff has questions or concerns about disclosures that do not comply with the requirements, are incomplete or are inconsistent with other information in the filings or that is otherwise available, the company will receive a comment letter listing the staff's concerns. In some cases after the initial reply by the company, another round or rounds of comments may follow. These formal exchanges may be supplemented by informal conversations between the SEC staff and the company, its counsel, or its auditor. When a resolution is reached about the changes to be made, the company may, at the staff's discretion, be required either to amend an existing filing or to incorporate the changes in the future filings submitted by the company.[26]

The review of a company's periodic filings, however, is *not* intended to serve as a second audit of the financial statements or otherwise validate the numbers set forth.[27] Thus, SEC reviewers may look at whether a company has clearly explained its accounting policies (*e.g.,* how it calculates certain revenue or how it determines in what period it records that revenue), but they generally will not look at whether those policies have been applied appropriately in a particularly instance. Should a company simply lie about the amount of revenue it got from a particular source or record that revenue in an earlier period than would be permitted

[22] The SEC does not track the number of periodic reports that go through the screening process. Committee staff interview with SEC staff, Division of Corporation Finance (June 25, 2002); Correspondence from SEC staff to Committee staff (August 9, 2002).

[23] SEC Response at 4. Following the Enron collapse, the SEC announced that it will "monitor" the Forms 10–K of each of the country's 500 largest companies (by revenue) each year for selected disclosure issues and, where problems are identified, will select these filings for expedited review. "Program to Monitor Annual Reports of Fortune 500 Companies," *SEC News Digest,* Issue 2001–245, December 21, 2001. The SEC staff hopes to conduct reviews of approximately half these filings. As of August 2002, they had screened over 400 of these filings and issued comments on approximately 100. Committee staff meeting with SEC staff (June 10, 2002); Committee staff interview with SEC staff (August 22, 2002). The Sarbanes-Oxley Act now requires the SEC to review a company's filings at least once every 3 years. Pub. L. 107–204 § 408.

[24] Committee staff interview with SEC staff, Division of Corporation Finance (April 24, 2002).

[25] *Id.*

[26] *Id.*

[27] Committee staff interview with SEC staff, Division of Corporation Finance (April 24, 2002); Committee staff meeting with SEC staff (June 10, 2002).

under its stated policies, a routine SEC review of the company's filings may well not detect this—and is not designed to.[28] To look behind the numbers of all the filings SEC staff reviews is too resource-intensive; as further explained below, the SEC relies on auditors to perform this function.[29] Nonetheless, when the Corporation Finance Division staff's review of a company's filings does reveal a troubling item or some indicia of fraud that the company is unable to explain adequately, Corporation Finance Division staff may refer it to the Division of Enforcement for further investigation.[30]

3. Enforcement

Another important way in which the SEC combats financial fraud is through its Division of Enforcement. The Enforcement Division's role—investigating and prosecuting fraud under the securities laws—is essential not only to punish wrongdoers but also to deter those who might be considering committing similar misdeeds. Although the Commission cannot on its own bring criminal prosecutions, it may nonetheless obtain significant civil sanctions against those found to have violated the securities laws—and may (and frequently does) refer to the Department of Justice matters that it believes warrant criminal charges.[31]

Potential financial fraud cases, like other cases brought by the Enforcement Division, are identified for investigation by a variety of means. Often, Commission staff receives a tip from an insider at the company warning of a potential fraud. Other times, there may be something anomalous about a company's performance or something reported in the news that causes staff to take a closer look. Sometimes, Corporation Finance staff will make a referral of a disclosure matter they deem suspicious (although, by the accounts of staff of both divisions, these referrals account for a small portion of the Enforcement Division's cases).[32] Once there is some reason to believe that a company has misreported financial information,

[28] SEC staff explained that, among other things, no single transaction is likely to be material in and of itself to a company's overall financial condition.

[29] In the case of a large corporation, even auditors typically do not look behind each transaction that contributes to the numbers on the company's financial statements; rather, they review a sample of notable or representative ones. *See* American Institute of Certified Public Accountants Professional Standards, AU Section 350 (Audit Sampling). Full-scale forensic accounting is generally done only when there is already evidence that fraud has occurred. *See* Michael R. Young, *Accounting Irregularities and Financial Fraud* (2d ed. 2002) at 102–105 (describing the difference between ordinary audits and forensic investigations).

[30] Committee staff interview with SEC staff, Division of Corporation Finance (April 24, 2002).

[31] *See* Securities Act § 20(b), 15 U.S.C. § 77t(b); Exchange Act § 21(d)(1), 15 U.S.C. § 78u(d)(1). For a general discussion of the relationship between civil and criminal enforcement of the securities laws, *see* Thomas C. Newkirk and Ira L. Brandriss, SEC Division of Enforcement, "The Advantages of a Dual System: Parallel Streams of Civil and Criminal Enforcement of the U.S. Securities Laws," Remarks at the 16th International Symposium on Economic Crime, Jesus College, Cambridge, England, September 19, 1998, available at http://www.sec.gov/news/speech/speecharchive/1998/spch222.htm.

Many of the securities laws that are civilly enforced by the SEC also provide that willful violations may be prosecuted criminally. *See, e.g.,* Securities Act § 24, 77x; Exchange Act § 32, 15 U.S.C. § 78ff. In addition, the recently enacted Sarbanes-Oxley Act of 2002 establishes the new Federal crime of "securities fraud" for the knowing execution of a scheme to defraud any person in connection with any security, or to obtain money or property by means of false or fraudulent pretenses in connection with the purchase or sale of any security. Pub. L. No. 107–204 § 807 (to be codified at 18 U.S.C. § 1348). The Sarbanes-Oxley Act also increases the criminal penalties for violations of the Exchange Act, and for other associated white-collar crimes, such as mail and wire fraud. *See* Pub. L. No. 107–204 §§ 901–904, 1106.

[32] Committee staff interviews with SEC staff, Division of Enforcement (May 7, 2002), and Division of Corporation Finance (April 24, 2002).

the Enforcement Division can conduct an in-depth investigation of that company's accounting and reporting practices to determine whether and to what extent there has been financial fraud. The Commission has the power, and may authorize its staff, to subpoena documents and witnesses.[33]

If the Enforcement Division staff's investigation uncovers violations of the securities laws, the Commission may bring an enforcement action either in Federal court or through an administrative proceeding (with a trial before an administrative law judge, with a right of appeal to the Commission itself). Depending on whether it is a court or the Commission imposing the sanctions, the available remedies differ somewhat, but can include injunctions,[34] monetary penalties,[35] disgorgement of ill-gotten gains,[36] and bans on a person serving as an officer or director of a publicly held company.[37]

In recent years, the Commission has brought approximately 500 enforcement cases annually and, of these, approximately 100 have involved financial fraud.[38] Though financial fraud matters make up only about 20 percent of the cases, Division of Enforcement staff estimate that these matters consume half of the Division's resources, because of their complex and document-intensive nature.[39] Not surprisingly, Commission staff expects the number of financial fraud cases brought to increase substantially this year.[40]

Essential as it is, the Enforcement Division's method of operation has two important (and inherent) limitations. First, though it may punish wrongdoers and deter others, it generally comes after the damage has been done and so can do little to make whole those shareholders and employees who have seen the value of their holdings substantially diminished as a result of others' financial fraud.[41] Second, by its nature, it can only be undertaken where there is already some reason to believe that fraud has been com-

---

[33] Securities Act § 19(b), 15 U.S.C. § 77s(b); Exchange Act § 21(b), 15 U.S.C. § 78u(b). SEC staff may begin its investigation by conducting an informal inquiry—that is, opening a so-called "matter under inquiry." If and when staff seeks to use compulsory process, it will seek a formal order of investigation from the Commission. Committee staff interview with SEC staff (July 24, 2002).

[34] Securities Act § 20(b), 15 U.S.C. § 77t(b); Exchange Act § 21(d)(1), 15 U.S.C. § 78u(d)(1) (providing for injunctive relief in Federal court). The equivalent remedy in an administrative proceeding is a cease-and-desist order. *See* Securities Act § 8A, 15 U.S.C. § 77h–1; Exchange Act § 21C, 15 U.S.C. § 78u–3.

[35] Securities Act § 20(d)(1), 15 U.S.C. § 77t(d)(1); Exchange Act § 21(d)(3), 15 U.S.C. § 78u(d)(3) (providing for monetary penalties in a Federal court action). In some, more limited circumstances, the Commission is also able to impose monetary penalties in administrative cases. *See* Exchange Act § 21B, 15 U.S.C. § 78u–2.

[36] Disgorgement can be imposed by Federal courts as part of their inherent equitable powers. *See, e.g., SEC v. Materia,* 745 F.2d 197, 200–01 (2d. Cir. 1984); *SEC v. Texas Gulf Sulphur Co.,* 446 F.2d 1301, 1307–08 (2d. Cir. 1971). In 1990, Congress gave the Commission the power to require disgorgement in an administrative proceeding as well. *See* Securities Act, § 8A(e), 15 U.S.C. § 77h–1(e); Exchange Act § 21C(e), 15 U.S.C. § 78u–3(e)

[37] Securities Act § 20(e), 15 U.S.C. § 77t(e); Exchange Act § 21(d)(2), 15 U.S.C. § 78u(d)(2) (providing for such bans by a Federal court). The Sarbanes-Oxley Act now gives the Commission the power to impose such bans in an administrative proceeding as well. Pub. L. No. 107–204 § 1105 (to be codified at 15 U.S.C. §§ 77h–1(f) and 78u–3(f)).

[38] Committee staff interview with Commission staff, Division of Enforcement (May 7, 2002; *see also* Securities and Exchange Commission, 2001 Annual Report, at 1, 134, available at http://www.sec.gov/about/annrep01.shtml.

[39] Committee staff interview with SEC staff, Division of Enforcement (May 7, 2002).

[40] *Id.*

[41] When feasible, disgorgement proceeds may be used to compensate victims, *see, e.g., SEC v. Levine,* 881 F.2d 1165 (2d Cir. 1989); *SEC v. Certain Unknown Purchasers,* 817 F.2d 1018 (2d Cir. 1987), and, under the Sarbanes-Oxley Act, civil penalty amounts now may be added to disgorgement funds to be used for this purpose, *see* Pub. L. No. 107–204 § 308. Although such procedures provide important potential remedies to investors, payments received thereby are highly unlikely to fully compensate shareholders for their losses.

mitted. Thus, it is impossible to know how many cases of fraud—cases where no tip has been received or the fraud has not yet snowballed to the point of inevitable discovery—are not being found and therefore not being brought and the wrongdoers not being punished.

B. *Private-Sector Gatekeepers*

As the discussion above suggests, the SEC plays a key but nonetheless circumscribed role in addressing financial fraud. The Commission's reviews of corporate filings, limited as they are in number and nature, are not (and have not been intended to be) a reliable mechanism for identifying fraud, and enforcement actions can only be brought when fraud has already been identified. The system contemplates that much of the front-line work for prevention and discovery of financial misconduct will be done by private-sector gatekeepers—most importantly, corporations' boards of directors and auditors—a role implicitly recognized in the legal obligations that govern the conduct of these groups.[42]

1. Boards of Directors

One of the first lines of defense against management wrongdoing is the company's board of directors. Boards are not supposed to run a corporation's day-to-day operations—that is the job of the full-time management—and they are not supposed to work full-time in their capacity as board members. Nevertheless, as the elected representatives of the shareholders, directors are charged with protecting their interests by setting the direction for the corporation and by watching over management.[43] The board should provide leadership and oversight with an eye toward maximizing shareholder value. Unfortunately, this is a difficult job for the board on a part-time basis, as corporations, their businesses and the transactions they enter into become ever larger and increasingly complex.

The duties and responsibilities of corporate directors are set mostly by State law, which governs the general structure and function of corporations. State law is fairly consistent with respect to the duties of directors. Directors are fiduciaries owing the two basic duties to the company and its shareholders: A duty of care and a duty of loyalty.[44] As the Delaware Supreme Court, which many courts and commentators view as a leading authority on corporate

[42] There are other private actors that can serve as gatekeepers as well, such as securities lawyers and investment bankers. *See* note 8 above.

[43] Boards of directors typically are composed of both outside directors, who are elected by the company's shareholders, and management directors who sit on the Board by virtue of their position in the company (such as CEO). Notably, outside directors are not necessarily "independent" directors as that term is generally understood. For example, the New York Stock Exchange's new rules, which await SEC approval, define an independent director as one with no "material" relationship with the company. *See* New York Stock Exchange Listed Company Manual § 303A(2) (proposed). Thus, a director who has had extensive business dealings with the company but is elected by the shareholders would be an outside director, but not an independent one.

[44] Most States, when confronted with a lack of precedent on a particular matter, follow the corporate law of Delaware, a State in which many companies have incorporated, and whose law generally is recognized as the most developed in this area. Enron originally was incorporated in Delaware; in 1993, it reincorporated in Oregon. Oregon law, like Delaware law, requires directors to fulfill fiduciary duties of both care and loyalty. Oregon Revised Statutes § 60.357; *Klinicki v. Lundren,* 298 Ore. 662, 667; 695 P.2d 906, 910 (1985). In any event, Oregon will often look to Delaware precedent on corporations law issues. *See, e.g., Stringer v. Car Data Systems, Inc.,* 314 Ore. 576, 841 P.2d 1183 (1992).

law, has stated: "Duty of care and duty of loyalty are the traditional hallmarks of a fiduciary who endeavors to act in the service of a corporation and its stockholders."[45] The duty of loyalty requires a director to be independent and objective, and to put the interests of the corporation before others, including his own.[46] The duty of care requires a director to act in good faith with the diligence that an ordinary prudent person in a similar position would exercise under similar circumstances.[47] Beyond these general duties, the law generally provides few specific requirements or prohibitions for directors; they are merely to oversee the corporation consistent with their fiduciary duties. The SEC, however, has placed certain specific requirements on directors. One of the most significant is the directors' responsibility to sign the company's annual report. This is supposed to signal to investors that the directors have reviewed and approve of its contents.

Despite their weighty responsibilities, directors in reality have little personal accountability or oversight. The SEC can sue directors for violations of the Federal securities laws (as it can with any person), and if it proves a violation, can among other things request a Federal court to issue an injunction barring that person from serving on the board of any other public company in the future. In addition, the Sarbanes-Oxley Act permits the SEC to prohibit an individual who has committed securities fraud from serving as a director on the boards of public companies without the need to go to Federal court.[48] The SEC, however, has no jurisdiction over State law violations by corporate directors; such violations, generally breaches of their fiduciary duties, are enforced by private shareholder lawsuits in State court. Holding directors personally accountable is not easy. After the Delaware Supreme Court held directors responsible for grossly negligent conduct in *Smith v. Van Gorkom,* 488 A.2d 858 (Del. 1985), some States reacted by enacting "exculpation statutes."[49] These laws allow corporations to provide in their charters that directors are not liable for breaches of the duty of care involving simple negligence. Furthermore, even when a director might be held liable for such a breach, or for a breach of the duty of loyalty, a director may be entitled to indemnification from the corporation or covered by directors and officers liability insurance, except in cases of fraud on the corporation by the director.

In addition, decisions of the board are presumptively protected from liability by the doctrine known as the "business judgment rule," unless it can be shown that the directors breached one or both of their duties.[50] The initial burden is on shareholders to prove that the directors did something wrong in order to convince a court to second-guess the board's decisionmaking, and to determine that the board did something that hurt the company. Thus

---

[45] *Cede & Co. v. Technicolor,* 634 A.2d 345, 367 (Del. 1993).

[46] *Guth v. Loft,* 23 Del. Ch. 255, 273; 5 A.2d 503, 511 (1939), aff'd, 19 A.2d 721 (Del. 1941).

[47] *Aronson v. Lewis,* 473 A.2d 805, 812 (Del. 1984).

[48] Pub. L. No. 107–204 § 1105. *See also* Pub. L. No. 107–204 § 305 (easing the standard for obtaining a Federal court order barring an individual from serving on a board of directors).

[49] *See, e.g.,* 8 Del. C. § 102(b)(7) (permitting corporate charters to excuse directors from liability for any breach of fiduciary duty except a breach of the duty of loyalty, intentional misconduct or knowing violations of law, or any transaction from which the director improperly derived a personal benefit).

[50] *See In Re Unitrin, Inc.,* 651 A.2d 1361, 1373 (Del. 1995).

directors, in general, have little at stake personally if they do not properly discharge their duties, at least with respect to the duty of care.

Because of the part-time and big-picture nature of their work, directors by law are entitled to rely on experts in discharging their duties.[51] This reliance, however, may not be blind: The statutes require that the reliance be reasonable under the circumstances. In addition, directors may delegate certain functions or responsibilities to a committee of the board, although such delegation does not relieve the full board of its fiduciary obligations. One of the most common committees formed by a board of directors is the audit committee. Typically, an audit committee focuses on the corporation's retention of auditors, financial reporting and internal financial controls.[52] Audit committees are not required by SEC regulations,[53] but they are mandated by listing requirements for both the New York Stock Exchange ("NYSE") and the NASDAQ.[54] NYSE requires that all the members of the audit committee be independent of the corporation (that is, not affiliated with management or a large shareholder), and NASDAQ requires a majority of the audit committee members to be independent. By maximizing use of committees and the full board, directors are supposed to maintain a strong foothold on what is going on in the company and ensure management's efforts are serving the needs of the shareholders.

The series of corporate collapses that began with Enron has caused concern about the independence and vigilance of corporate boards, and has led to calls for board reform. There has been some response. On June 6, 2002, the New York Stock Exchange Corporate Accountability and Listing Standards Committee published a list of recommendations for changes in the Exchange's listing requirements to enhance corporate governance. Many of these address directors in an effort to tighten their sense of accountability and diligence. Among them: A majority of directors on boards of listed companies must be independent directors; boards must convene regular sessions without management in attendance; the chair of the audit committee must have financial or accounting expertise; and audit committees must have sole responsibility for hiring or firing independent auditors and for approving all non-audit work by the auditors. The recommendations also attempt to enhance the independence of independent directors by requiring that the board affirmatively determine, with respect to each inde-

[51] *See* 8 Del. C. § 141(e); Oregon Revised Statutes § 60.357.

[52] "The primary functions of the audit committee generally are to recommend the appointment of the public accountants and review with them their report on the financial reports of the corporation; to review the adequacy of the system of internal controls and of compliance with material policies and laws, including the corporation's code of ethics and conduct; and to provide a direct channel of communication to the board for the public accountants and internal auditors and, when needed, finance officers, compliance officers, and general counsel." *Statement on Corporate Governance,* The Business Roundtable, September 1997.

[53] Nevertheless, the SEC does require each company, in its annual proxy statement, to disclose the existence, composition, functions, and number of annual meetings of its audit committee. 17 C.F.R. § 14a–101, Item 7, Paragraph (e)(3).

[54] Subject to SEC approval of their rules, stock exchanges (of which there are currently eight) are self-regulatory organizations, allowed to govern the conduct of their members—broker-dealers that trade or make markets in equities—and the companies that list securities on those exchanges. Exchange Act § 19(b), 15 U.S.C. § 78s(b). To those who prefer market solutions, listing requirements generally are viewed with more favor than SEC regulation because they come from market participants rather then government. Stock exchanges can fine, penalize or delist listed companies that do not comply with their rules; they can fine, penalize or suspend the membership of members that fail to comply.

pendent director, that he or she has no material relationship with the company and that directors fees constitute the sole compensation received from the company by any audit committee member. These recommendations were adopted by the NYSE Board of Directors on August 1, 2002, following a 2-month public comment period. On August 16, 2002, the proposal and summary of comments was submitted by the NYSE Board to the SEC for review and approval, which involves an additional public comment period.[55] Similar changes have been proposed for NASDAQ's listing requirements.[56]

2. Auditors

Beyond the watchdog role boards of directors are supposed to play, the securities laws add a second layer of oversight: The independent auditor. As discussed above, our market regulatory system rests upon the supposition that companies offering their securities to the public provide broad and accurate disclosure to investors. In order for the information to have meaning—and for investors to be able to compare apples to apples—it must be presented according to a set of uniform standards. For financial information, those standards are accounting standards. The accounting standards now applicable in the U.S. markets are known as Generally Accepted Accounting Principles (GAAP). In addition, to assure investors that each company is preparing its financial statements in accordance with applicable accounting standards, which should result in statements that provide a fair depiction of the company's financial position,[57] companies must have their books audited by independent certified or public accountants. This requirement, so basic to the scheme of securities regulation, was incorporated into the securities laws in the Securities Act, even before the SEC was created the following year in the Exchange Act.[58] During the hearings on the bill that was to become the Securities Act, several senators suggested that auditors working for the government, rather than the private sector, should inspect public company financial statements. Representatives of the accounting profession and others, however, urged rejection of that proposal due to the size and the complexity of the market.[59] With an ever-expanding and ever-changing set of industries, this remains the approach. The SEC relies entirely on private-sector auditors to ensure that the financial statements of public companies comply with GAAP; as discussed above, the SEC does not do audits.

[55] *See* "NYSE Files Changes to Listing Standards with SEC, NYSE-Approved Measures Aim To Strengthen Corporate Accountability," NYSE Press Release August 16, 2002, available at http://www.nyse.com/pdfs/corp—gov—pro—b.pdf. The proposed standards filed with the SEC are available at http://www.nyse.com/report.

[56] *See* "Nasdaq Takes New Actions on Corporate Governance Reform," NASDAQ Press Release, July 25, 2002, available at http://www.nasdaqnews.com/news/pr2002/ne—section02—141.html; "Summary of NASDAQ Corporate Governance Proposals," September 13, 2002, available at http://www.nasdaq.com/about/Corp—Gov—Summary091302.pdf.

[57] Although compliance with GAAP is expected to result in a fair presentation of a company's financial statements, this is not always the case. *See United States v. Simon,* 425 F.2d 796 (2nd Cir. 1969) (despite technical compliance with GAAP, conviction of defendant for preparing false and misleading financial statements was proper where the statements did not fairly present financial position of company). *But see SEC v. Arthur Young,* 590 F.2d 794 (9th Cir. 1979) and *Escott v. Barchris Construction Corp.,* 283 F. Supp. 643 (S.D.N.Y. 1968) (compliance with GAAP is a defense to auditor liability for false financial statements).

[58] Exchange Act § 4, 15 U.S.C. § 78d.

[59] Hearings on S. 875 Before the Senate Committee on Banking and Currency, 73rd Cong., 1st Sess., at 57–62 (1933).

Although the SEC has the power to promulgate accounting and auditing standards,[60] since its inception the SEC has chosen to delegate the primary responsibility for these matters to private bodies. Until 1973, the American Institute of Certified Public Accountants (AICPA) or its predecessor organization—the trade association for accountants—set both accounting and auditing standards. In the late sixties and early seventies, widespread dissatisfaction developed with AICPA's process for setting accounting standards; not only was the process slow, it was handled by professionals from corporations and the accounting industry only on a part-time basis. This led to the creation in 1973 of the Financial Accounting Standards Board (FASB), an independent organization, which was charged by the SEC to set GAAP. The AICPA and its member firms, however, continue to have influence in the standard-setting process. Most of the funding for the FASB comes from the accounting industry, and members of accounting firms and representatives from AICPA and other trade groups sit on the board of FASB's parent organization, which chooses the members of the FASB. FASB, like its predecessor, has been subject to criticism for its lack of speed in promulgating standards and for being too close to the accounting industry.

The SEC also has allowed the AICPA to set auditing standards for the industry. This raised doubts almost from inception. In 1940, the SEC investigated McKesson & Robbins, a reputable accounting firm that failed to prevent senior officers of one of its audit clients from embezzling millions, while overstating inventory and accounts receivable and reporting profits from a non-existent business. Based on the findings of that investigation, the AICPA adopted a number of changes to auditing practices. The reforms essentially persuaded the SEC to continue allowing the industry to set its own standards.[61] Doubts arose again, in the wake of the collapse of the Penn Central Company, the massive Equity Funding Corporation fraud, foreign bribery scandals, and other corporate abuses revealed in the early to mid-1970's.[62] Senate and House subcommittees initiated investigations into the perceived failure of accounting firms serving as independent auditors to detect and to disclose business reversals or fraudulent conduct of managements of publicly held corporations. The leaders of this Congressional effort, Senator Metcalf and Representative Moss, tried to convince the SEC to take direct control of audit standards.[63] When the SEC did not, Moss introduced a bill to establish a self-regulatory organization in the style of NASD, called the "National Organization of SEC Accountancy" to oversee the accounting industry.[64] The legislation was never adopted, and the AICPA, through the Auditing Standards Board, continues to set audit standards today. The Board, which has 15 members, promulgates Statements on Auditing

---

[60] Securities Act § 19(a), 15 U.S.C. § 77s(a); Exchange Act § 13(b), 15 U.S.C. § 78m(b).

[61] *See* Louis Loss and Joel Seligman, *Fundamentals of Securities Regulation* (4th ed. 2001) at 178.

[62] *Id.*

[63] Michael S. Luehlfing, "The Politics of Self-Imposed Regulations—Has a New Day Dawned?" *Accounting Horizons,* June 1995.

[64] *Id.*

Standards.[65] In addition, for 25 years, the Auditing Standards Board was overseen by the Public Oversight Board, a private entity of five members funded by AICPA, which provided guidance with respect to the audit process.[66]

In addition to setting its own standards for auditing, the accounting industry until recently also, for the most part, disciplined itself. The SEC may bar or suspend from practice before the Commission any professional—including an accountant—who has engaged in "unethical or improper professional conduct."[67] Beyond that, however, until the recent passage of the Sarbanes-Oxley Act, accountants were subject to direct professional discipline only from two places. First, to the extent accountants are licensed (Certified Public Accountants—the only accountants who may serve as external auditors in satisfaction of the securities laws—must be licensed), they receive their licenses from the State in which they practice; the applicable State board of accountancy may fine, suspend or bar a CPA from practice. Second, the AICPA, through its Professional Ethics Division, investigates allegations of unethical or wrongful conduct and, if appropriate, expels or suspends accountants from AICPA membership. These avenues of professional discipline for accountants have been criticized—particularly in the wake of the Enron scandal—as fairly ineffective.[68] State boards of accountancy vary in their approaches and do not have sufficient resources to monitor the professionals in their States. Meanwhile, the AICPA, as the industry trade association, tends not to act aggressively, particularly against accountants in the most established firms. The Sarbanes-Oxley Act, however, has changed this system by providing for a centralized, independent disciplinary body for accountants.[69] The Public Company Accounting Oversight Board will issue rules establishing standards for accountants with respect to auditing practice, ethics, and independence.[70] The Board will also monitor accounting firms for compliance with these and other applicable rules and may investigate and punish violations with fines, censures or suspensions from the practice of auditing public companies.[71]

One specific issue regarding auditors that has been the subject of attention in recent years concerns auditors' responsibility for independence and objectivity in carrying out audits. In auditing companies, accountants are supposed to approach the books with a skeptical eye and with allegiance only to the company and its investors.[72] For example, auditors are required to make efforts to de-

---

[65] *See* "The Enron Crisis: The AICPA, The Profession & The Public Interest," available at http://www.aicpa.org/info/regulation02.htm.

[66] The Public Oversight Board disbanded in March 2002 after SEC Chairman Pitt announced his intention to form a new body to oversee the accounting industry.

[67] SEC Rule of Practice 102(e).

[68] David S. Hilzenrath, "Auditors Face Scant Discipline; Review Process Lacks Resources, Coordination, Will," *The Washington Post,* December 6, 2001.

[69] Pub. L. No. 107–204 §§ 101–109.

[70] Pub. L. No. 107–204 § 103(a).

[71] Pub. L. No. 107–204 § 105.

[72] "By certifying the public reports that collectively depict a corporation's financial status, the independent auditor assumes a *public* responsibility transcending any employment relationship with the client. The independent public accountant performing this special function owes ultimate allegiance to the corporation's creditors and stockholders, as well as to the investing public. This 'public watchdog' function demands that the accountant maintain total independence from the client at all times and requires complete fidelity to the public trust." *United States v. Arthur Young & Co.,* 465 U.S. 805, 817–818 (1984) (emphasis in original).

tect fraud in their audits and report what they find to the Board, and if not appropriately dealt with at that level, to the SEC.[73] Management and its decisions are supposed to be questioned and scrutinized. Consulting services, on the other hand, are provided at the pleasure and direction of management. Consulting services, which can be anything non-audit related, such as advice on tax issues, information technology design, internal audits, or assisting in accounting aspects of structured finance, are seen by clients as value-added services (unlike audits, which are just an expensive necessity), and therefore, they are more lucrative for accounting firms than auditing. Accordingly, allowing the same firm to audit a company and provide consulting services for that company might tempt the firm to work with and please management in the audit function in order to assure itself further consulting work. Moreover, to the extent that some of the consulting work may involve setting up internal audit systems or even helping to structure transactions, the firm might end up auditing its own work, perhaps leading it to be either less critical or more trusting than it should be.

In June 2000, the SEC proposed new rules to enhance auditor independence, which would have prohibited a firm auditing a public company from providing much of the consulting work it was then permitted to provide. The rule was controversial, however, and faced strong objections from the accounting profession as well as from Congress. The rule that the SEC eventually promulgated in November 2000, in addition to setting new guidelines, required mainly that companies disclose the amounts they paid the firms that audited them for audit work and consulting work.[74] The Sarbanes-Oxley Act, however, passed in the wake of the Enron scandal, includes auditor independence provisions that borrow in significant part from the initial SEC proposal, particularly with respect to the consulting services that are considered a conflict for auditors to provide. Under the Act, accounting firms are barred from providing companies they audit with many non-audit services, including bookkeeping, financial information systems design and implementation, appraisals, and investment adviser and investment banking services. The Sarbanes-Oxley Act also requires lead audit partners at accounting firms to rotate every 5 years.[75]

In sum, the Federal securities and State corporate laws place at least three tiers of oversight over public companies—the board of directors, who are supposed to keep tabs on management inside the company; the independent auditors, who are supposed to make sure the company is keeping—and disclosing—its books honestly; and the SEC, which is supposed to watch over and keep tabs on the whole system and make sure the other watchdogs are doing their jobs. As the next section discusses, they all failed—to one degree or another—in the Enron case.

---

[73] Exchange Act § 10A, 15 U.S.C. § 78j–1. Nevertheless, according to a recent study, only 41 percent of auditors—as opposed to 71 percent of investors—believe auditors serve as "public watchdogs." John McEnroe and Stanley Martens, "Auditors' and Investors' Perception of the 'Expectation Gap,'" *Accounting Horizons,* December 2001. This is the case despite the Supreme Court's clear pronouncement in the *Arthur Young* case (see note above).

[74] Securities Act Release No. 7919, Exchange Act Release No. 43602 (November 21, 2000); 65 Fed. Reg. 76008 (December 5, 2000). In addition, the rule specifies a limited number of non-audit services that firms conducting audits may not provide. 17 C.F.R. § 210.2–01(c)(4).

[75] Pub. L. No. 107–204 §§ 201–209.

II. EXPERIENCE WITH ENRON

Before addressing how the watchdogs reacted to Enron's financial practices, it is worth noting what Enron is alleged to have done wrong—and therefore what more effective watchdogs might have discovered. Beginning at least as early as 1997 and gaining momentum in 1999 and 2000, Enron is alleged to have engaged in complex and ultimately pervasive accounting fraud designed to make it look like the company had more revenue and earnings, less debt, greater operating cash flow, and generally healthier financial statements than it in fact had.

The various investigations into Enron—including those of the SEC, Justice Department, and Congress—are still ongoing, but a number of allegations about Enron's specific practices have come to light which, if true, are likely to have involved violations of Federal securities laws. The alleged practices include: Not fully disclosing the extent and nature of transactions the company engaged in with so-called "related parties"—primarily partnerships operated by Enron's Chief Financial Officer, Andrew Fastow, and those who worked for him;[76] improperly excluding the debt of certain so-called "special purpose entities" (SPEs)[77] from the company's balance sheet;[78] treating certain transactions as asset sales (in order to get poorly performing assets off the company's books and/or to realize immediate revenue) without actually transferring the risks of ownership;[79] executing transactions that, in reality, were loans disguised as commodity trades and treating them as trading liabilities rather than debt and treating the cash received as cash flow from operations rather than cash flow from financing;[80] failing to disclose the full extent of contingent liabilities—*i.e.,* debt that would come due if Enron's stock price and/or credit rating dropped below a specified level;[81] misaccounting for a note received in exchange for the company's stock so that it was considered an asset and increased shareholder equity instead of (properly) reducing shareholder equity;[82] and engaging in transactions that purportedly hedged the company's risk in certain investments but, not

---

[76] *See* "Report of Investigation by the Special Investigative Committee of the Board of Directors of Enron Corp.," February 1, 2002, ("Powers Report") at 178–203.

[77] Special purpose entities are entities created by a sponsoring company for a limited purpose, such as to hold a particular asset. Enron used a number of these entities in the transactions that have come under scrutiny since its collapse. In some cases, SPEs can be treated as unconsolidated entities for financial reporting purposes: That is, their assets and liabilities need not be included (*i.e.,* "consolidated") on the sponsoring company's balance sheet. In order to qualify for nonconsolidation, an SPE must meet two requirements: (1) at least 3 percent of the total capital in the SPE must come from an independent outside equity investor; and (2) the SPE must be under the control of the outside investor—that is to say, the outside investor must hold a majority of the SPE's stock. *See* Powers Report at 36–40.

[78] *See* Powers Report at 49–54, 66–67.

[79] *See* Powers Report at 134–147; The Role of Financial Institutions in Enron's Collapse, Hearing Before the Permanent Subcommittee on Investigations, Senate Governmental Affairs Committee, 107th Cong., S. Hrg. 107–618 (July 30, 2002) at— (Printed Hearing Record Pending) (evidence of Enron's purported sale of interest in three power barges located in Nigeria to Merrill Lynch).

[80] The Role of Financial Institutions in Enron's Collapse, Hearing Before the Permanent Subcommittee on Investigations, Senate Governmental Affairs Committee, 107th Cong., S. Hrg. 107-618 (July 23, 2002) at— (Printed Hearing Record Pending) (evidence that Enron used questionable structured finance transactions to disguise loans as trading liabilities in order to avoid reporting such financing as debt).

[81] *See* William W. Bratton, "Enron and the Dark Side of Shareholder Value," *76 Tulane L. Rev.* — (forthcoming May 2002) (Draft), available at http://papers.ssrn.com/sol3/papers.cfm?abstract—id=301475, at 43–47, 65–67.

[82] *See* Powers Report at 125–26; Bratton, at note 81 above, at 37–38.

being true hedges, were designed instead to keep losses from these investments off Enron's books and left Enron open to significant financial risk.[83]

Not only do these fraudulent practices appear to have been many and varied, but they also involved substantial—in some cases staggering—amounts of money. The loans-cum-commodity trades, for example, alone accounted for an estimated $7–8 billion in allegedly improperly recorded liabilities and cash flow;[84] not disclosing contingent liabilities kept the potential for almost $4 billion in losses out of Enron's financial statements;[85] the disclosure of the failure to consolidate two Enron SPEs (and a related partnership) led to an approximately $500 million restatement of net income over 4 years;[86] the improper hedging transactions led to a charge against earnings of $710 million ($544 million after taxes);[87] and the improper accounting of the note-for-stock exchange resulted in a $1 billion reduction in shareholder equity.[88]

A. *Private-Sector Gatekeepers*

The private-sector gatekeepers—such as Enron's Board of Directors and its auditor, Arthur Andersen—were the first lines of defense against the apparent fraud described above.[89] The failure of these parties to discharge their duties have been delved into more deeply and reported on more thoroughly elsewhere.[90] They are recounted here in brief to give context to the SEC's actions with respect to Enron.

1. Enron's Auditor

Audit failures have increasingly occurred over the last decade—restatements have reached record numbers, at over 270 in 2001—and every major accounting firm has been involved in at least one significant financial fraud case in the last few years.[91] Nevertheless, Enron appears to be the straw that broke the camel's back in instigating a climate for change in auditor regulation. Even beyond

[83] *See* Powers Report at 97–118; Bratton, at note 81 above, at 38–40.

[84] The Role of Financial Institutions in Enron's Collapse, Hearing Before the Permanent Subcommittee on Investigations, Senate Governmental Affairs Committee, 107th Cong., S. Hrg. 107-618 (July 23, 2002) at— (Printed Hearing Record Pending).

[85] Enron Corp. Form 10–Q for the quarter ended September 30, 2001 (filed November 19, 2001), Part I, Item 2, at 66.

[86] Enron Corp. Form 8–K (filed November 8, 2001), Section 2, at 3–5. In addition to recording a reduction in net income, the restatement also resulted in a significant reduction in shareholders' equity and a significant increase in reported debt. *See also* Powers Report at 3.

[87] Enron Corp. Form 10–Q for the quarter ended September 30, 2001 (filed November 19, 2001), Part I, Item 1, Note 4, at 23; *see also* Powers Report at 128.

[88] Enron Corp. Form 8–K (filed November 8, 2001), Section 3, at 6–7.

[89] Indeed, other private sector gatekeepers, such as some of the investment banks with which Enron worked, appear to have actively participated in some of the transactions described above. In recent hearings held by PSI, e-mails, memoranda and presentation materials revealed that financial institutions structured and marketed transactions apparently used by Enron to disguise loans as energy trades, characterize loan proceeds as cash flow from operations rather than cash flow from financing, and generate proceeds from asset sales that, in fact, were not true asset sales. *See* The Role of Financial Institutions in Enron's Collapse, Hearing Before the Permanent Subcommittee on Investigations, Senate Governmental Affairs Committee, 107th Cong., S. Hrg. 107–618 (July 23 and 30, 2002) at— (Printed Hearing Record Pending) (Hearing Exhibits 102, 158, 201 and 203.)

[90] *See, e.g.,* Report of the Senate Permanent Subcommittee on Investigations on "The Role of the Board of Directors in Enron's Collapse," S. Prt. 107–70 (July 8, 2002).

[91] Though Andersen has surely had its share of audit failures with Sunbeam, Waste Management, Enron, and now WorldCom, the other big four accounting firms can hardly boast spotless records: PricewaterhouseCoopers audited Microstrategy, Ernst & Young audited Cendant, KPMG audited Rite-Aid and Xerox, and Deloitte & Touche audited Adelphia, all of which resulted in significant audit failures.

its conviction for obstruction of justice in connection with its shredding of documents related to Enron, Andersen appears to have failed miserably in its responsibility as Enron's auditor. In its report about failures at Enron with respect to the related-party transactions, the special committee of Enron's Board of Directors concluded that "Andersen did not fulfill its professional responsibilities in connection with its audits of Enron's financial statements, or its obligation to bring to the attention of Enron's Board (or the Audit and Compliance Committee) concerns about Enron's internal controls over the related-party transactions."[92] In addition, Andersen helped structure many of the transactions Enron used to improve the appearance of its financial statements but which had no economic purpose, such as the so-called "Raptor" transactions.[93] Indeed, the Committee's Permanent Subcommittee on Investigations ("PSI") concluded as part of its investigation into Enron's collapse that Andersen was aware of how problematic these transactions were and warned the Board of Directors that they represented "high-risk accounting."[94] Among themselves, Andersen partners involved on the Enron engagement were even more frank. In its yearly client risk analysis on Enron, Andersen expressed concern about some of Enron's business as "form over substance transactions"; in an e-mail describing the content of one annual client retention meeting regarding Enron on February 6, 2001, Andersen acknowledged "Enron's dependence on transaction execution to meet financial objectives," and how "aggressive" Enron was in its accounting.[95]

One of the major concerns about Andersen as the auditor of Enron has been that it did not exhibit sufficient independence and objectivity in discharging its responsibilities. In 2000, Andersen earned $52 million in fees from Enron. Less than half of that amount, $25 million, was for audit work; $27 million related to consulting services. As discussed above, it is difficult to comprehend how such large consulting fees could not have created a serious conflict of interest for Andersen. But regardless of the cause, the result is clear: Enron's auditor failed to discharge its role of verifying the accuracy of Enron's books.

2. Enron's Board of Directors

After the Enron scandal broke, the company's Board of Directors appointed a special committee of the Board to investigate the company's transactions with partnerships controlled by Enron's Chief Financial Officer, Andrew Fastow, and others who worked with Fastow.[96] The special committee concluded that the Board did not act with sufficient diligence in approving these transactions. Moreover, the special committee further faulted the board for failing to carefully monitor the precarious situation once they allowed it to go forward.[97] PSI went further, and concluded that the board of the

[92] Powers Report at 24.

[93] Powers Report at 24–25. The Raptors were SPEs purportedly set up to hedge certain of Enron's investments but which were in fact used to avoid reflecting losses in those investments on Enron's income statement. *Id.* at 97.

[94] Report of the Senate Permanent Subcommittee on Investigations on "The Role of the Board of Directors in Enron's Collapse," S. Prt. 107–70 (July 8, 2002) at 15–20.

[95] *Id.* at 18–19.

[96] Powers Report at 1.

[97] Powers Report at 10.

directors did not take appropriate care to protect shareholder value from management overreaching in a number of respects. PSI, based on an extensive investigation involving over one million documents and numerous interviews, including interviews of 13 former Enron board members, found that although the directors argued that management misled and concealed key facts about the company's activities from them, the board in fact had substantial amounts of information about the high-risk accounting and structured finance vehicles used by Enron. And instead of responding with probing questions to what corporate governance and accounting experts at a May 7, 2002 hearing before PSI characterized as obvious red flags, the board simply and unreasonably (in light of the warning signs) relied on management. Indeed, the board and its committees met only about five times annually,[98] and spent under an hour reviewing even the most complicated transactions.[99]

Despite their apparent lack of diligence, Enron board members enjoyed compensation that was among the highest offered to any corporate directors in the country. Their compensation, which was paid in cash, stock and stock options, was valued in 2000 at approximately $350,000 per director—more than twice the national average for a U.S. publicly traded corporation.[100] In addition, some of the directors received other forms of compensation or had other financial ties with Enron. The expert witnesses at the May 7, 2002 PSI hearing not surprisingly opined that all of this remuneration may have compromised the directors' objectivity with respect to management.[101]

B. *The SEC*

Since Enron's auditors and Board of Directors failed to ensure the accuracy of the company's public reports, the SEC was left as the watchdog of last resort for Enron. The Committee set out to review the SEC's interactions with Enron and determine what, if anything, the SEC could have done differently to prevent, or at least detect sooner, the problems that led to Enron's collapse. Most of Enron's dealings with the SEC, staff learned, were in connection with the public filings the company was required to submit to the Commission—its periodic reports, proxy statements, securities registration statements, and the like. In fact, before it undertook its current investigation of Enron's accounting practices, the SEC, in the past decade, had opened only one other investigation involving Enron: An informal probe of an affiliated entity on a relatively minor matter that was subsequently closed without further action.[102] The Commission similarly received few substantive com-

[98] Report of the Senate Permanent Subcommittee on Investigations on "The Role of the Board of Directors in Enron's Collapse," S. Prt. 107–70 (July 8, 2002) at 9.

[99] *Id.* at 32.

[100] *Id.* at 11, 56.

[101] *Id.* at 56–57.

[102] This was a "matter under inquiry"—that is to say, an informal investigation that had not yet risen to the level that the SEC staff had requested the authority to issue subpoenas—involving the Enron affiliate Zond Panaero Windsystems concerning its disclosure regarding the potential for year 2000 problems. The matter was opened in April 1999 and closed in September 1999, after the company revised the disclosure. SEC Response at 90; Committee staff interview with SEC staff (September 6, 2002).

The general partner of Zond Panaero Wind Systems is a subsidiary of Enron Wind Systems (formerly Zond Systems), which is (through at least one further layer of ownership) a subsidiary

Continued

plaints about Enron, none of which appear relevant to the allegations that later surfaced.[103] Furthermore, in contrast to its aggressive lobbying of other agencies and in other forums, Enron appears to have presented its views to the SEC on a major policy matter only once: In September 2000, CEO Kenneth Lay sent a letter to then-SEC Chairman Levitt opposing the Commission's proposed auditor independence rules.[104] Enron did, however, on a number of occasions, successfully seek exemptions from applicable statutes or other favorable determinations. In at least two instances, Enron was the first company to present the issue to the SEC.

Committee staff's investigation points to a number of problems that need to be addressed. As discussed more fully below, Enron's case suggests that the SEC's largely passive interaction with companies (particularly large companies) likely led it to miss warning signs of corporate misconduct. Moreover, the Commission's failure to follow up on a change in Enron's accounting deprived the Commission of an important opportunity to better scrutinize and therefore sooner discover Enron's questionable activities. More broadly, the Enron case suggests that the SEC needs to re-examine the way it operates: In particular, its assumption that it can rely as fully as it does on private gatekeepers to play a significant role in ensuring the flow of honest and accurate information. Without the ability to rely as extensively on these private watchdogs, the SEC must find ways to more proactively detect and root out financial fraud.

1. Review of Enron's Public Filings

In the decade preceding its collapse, Enron submitted numerous filings to the SEC.[105] These included annual and quarterly reports

---

of Enron Corp. In 1997, Enron Wind Systems sold part of its interests in various wind farms to an entity called RADR, which was allegedly controlled by former Enron executives Andrew Fastow and Michael Kopper. These transactions formed part of the basis for the civil and criminal charges recently brought against Fastow and Kopper. *See* Complaint, *SEC v. Kopper,* Civ. Action No. H–02–3127 (S.D. Tex. August 21, 2002); Information, *United States v. Kopper,* Cr. No. H–02–0560 (S.D. Tex. August 20, 2002); Complaint, *SEC v. Fastow,* Civ. Action No. H–02–3666 (S.D. Tex. Oct. 2, 2002); Criminal Complaint, *United States v. Fastow,* Cr. No. H–02–889–M (S.D. Tex. Oct. 1, 2002). No interest in Zond Panaero, however, was ever transferred to RADR and the 1999 investigation of Zond Panaero Windsystems is, from all indications, unrelated to the subsequent charges. For further discussion of Enron's transfer of its interests in various windfarms, see note below and the accompanying text.

[103] *See* SEC Response at 86–89.

[104] The letter was treated as a public comment and placed on the public record. It has subsequently been revealed that the letter was sent at the urging, and with the assistance, of Enron's auditor, Arthur Andersen. *See, e.g.,* Alexei Barrionuevo and Jonathan Weil, "Duncan Knew Enron Papers Would Be Lost," *The Wall Street Journal*, May 14, 2002 (reporting on testimony by David Duncan, a former Andersen partner, at the Arthur Andersen obstruction of justice trial that he and an Andersen lobbyist had enlisted Lay to write such a letter to the SEC Chairman).

In addition, Enron's lobbying disclosure forms indicate that it had at least one lobbying contact with the SEC during the first half of 2001. Enron Corp. 2001 Amended Mid-Year Lobbying Report (March 1, 2002). The SEC has no record of such a contact. SEC staff speculated, however, that Enron's disclosure might refer to an interview with Enron that was conducted for a Joint Report on Retails Swaps issued in December 2001 pursuant to the Commodity Futures Modernization Act of 2000 by the SEC, the Board of Governors of the Federal Reserve System, the Department of the Treasury and the Commodity Futures Trading Commission. Committee staff interview with SEC staff, Office of General Counsel (June 7, 2002).

[105] According to the SEC's electronic database of public filings, EDGAR, Enron submitted in excess of 300 filings to the SEC from January 1994 to the date of its bankruptcy. This total, however, includes a number of routine filings that would not have ordinarily been subject to review. In addition, Enron had an ownership interest in 50 other companies that were required to file separately with the SEC; in half of these, Enron's interest was 20 percent or greater. Memorandum from Alan Beller, Director, Division of Corporation Finance to Office of General Counsel, dated September 12, 2002, under cover of letter from Peter Kiernan, Deputy Director, Office of Legislative Affairs, Securities and Exchange Commission to Beth Grossman, Counsel, Committee on Governmental Affairs, dated September 18, 2002.

each year, as well as 29 registration statements for the sale of securities, [106] and two filings in connection with proposed mergers.[107]

During this period, the SEC's Corporation Finance Division reviewed four of Enron's annual reports on Form 10–K—those for the years 1991, 1995, 1996 and 1997.[108] The latter three annual reports were reviewed as part of the SEC's consideration of other transactions pending with the Commission at that time. This fact—and, according to SEC staff, not any concerns raised about the filings themselves—accounts for the uneven intervals between reviews and the fact that reviews were conducted of the company's 10–Ks 3 years in a row.[109]

There appears to be little remarkable about the SEC's reviews of these filings. SEC staff conducted a full review of Enron's 1991 annual report—that is, a review of the entire filing. The staff issued an initial comment letter and two follow-up letters in the fall of 1992 that raised a number of concerns about the report, ranging from a request for additional information about potential liability for pollution clean-up to concerns about its discussion of net cash flows. Enron responded to each of the comment letters and ultimately amended its 10–K to conform to the SEC's comments.[110]

The reviews of the 1995 and 1996 annual reports, both also described by SEC staff as full reviews, were undertaken in conjunction with the Commission's review of transactional filings associated with Enron's acquisition of Portland General Corp.[111] Although the filing concerning the acquisition—a so-called "merger proxy"—received 44 separate comments from SEC staff (all of which appear to have been ultimately resolved), [112] the annual reports led to fewer questions. In response to its review of the 1995 annual report, the SEC staff issued a letter to Enron with two comments, both relating to details of Enron's defined benefit plan; [113]

[106] This excludes registration statements that becomes effective without SEC action, such as registration statements for employee benefit plans filed on Form S–8.

[107] SEC Response at 23–66.

[108] In addition, SEC staff reviewed Enron's 10–Q for the second quarter of 1997 in conjunction with its review of the S–4 registration statement that Enron filed in connection with the merger between Enron Global Power and Pipelines (a 54 percent owned subsidiary of Enron) and another, wholly-owned subsidiary of Enron. SEC Response at 11, 31.

[109] Committee staff interview with SEC, Division of Corporation Finance (April 24, 2002). In addition to the annual reports, since 1992, the SEC conducted full reviews of two of Enron's proxy statements (in 1993 and 1994), and the Forms S–4 submitted in connection with two mergers—Enron's acquisition of Portland General Electric (filed in 1996) and the merger of two of its subsidiaries (filed in 1997). Only two of Enron's registration statements for the sale of securities were subject to a full review; both of these reviews took place in 1992 (in addition, the registration statement for an Enron subsidiary's proposed—and ultimately abandoned—IPO was reviewed in 1998). None of Enron's registration statements after 1992—the last of which was filed on June 1, 2001—has received a full or financial statement review, although seven have been monitored for specific issues. *See* SEC Response at 23–66.

[110] SEC staff had agreed to permit Enron to forego amending its 10–K and instead to conform its future filings to certain of the comments. After the issuance of comment letters, however, Enron decided to spin-off one of its subsidiaries, Enron Oil Trading and Transportation Company, and amended its 10–K to reflect the spin-off as well as "substantially all" of the SEC's comments. SEC Response at 13–14.

[111] SEC Response at 35. In connection with the acquisition, Enron filed a registration statement on Form S–4 confidentially with the Commission on August 14, 1996. The registration statement was declared effective on October 10, 1996. Subsequently, on May 16, 1997, Enron filed an amendment to the Form S–4. Enron's 1995 10–K was reviewed in connection with the review of the original registration statement. Its 1996 10–K was reviewed in connection with the review of the post-effective amendment. *See* Correspondence from SEC staff to Committee staff (August 9, 2002).

[112] SEC Response at 35–38.

[113] SEC Response at 12–33.

the review of the 1996 10–K, which took only 3 days, resulted in no comments at all.[114]

SEC staff's review of Enron's 1997 Form 10–K was a financial review—that is, it looked only at the financial statements, notes and MD&A—and it was undertaken in connection with the SEC's consideration of a proposed initial public offering by two Enron affiliates.[115] SEC staff also reviewed Enron's two Forms 10–Q that were filed during the pendency of this review. The review of the 1997 Form 10–K raised 15 comments, covering an array of subjects. Two of the comments focused on Enron's description of market risk for its trading business, a particular focus of SEC's reviews at the time, as the Commission had recently changed its rules to require greater disclosure on this topic.[116] Another addressed whether certain oil and gas exploration costs were properly classified as a cost associated with investing cash flows rather than operating cash flows.[117] Even in hindsight, however, these comments address little that is directly relevant to the fraudulent practices that have since been revealed.[118] After further communications between Commission staff and Enron, the company eventually agreed to address the SEC's concerns in its future filings; the review was completed in February 1999.[119]

None of Enron's subsequently filed Forms 10–K (*i.e.,* those from 1998, 1999 and 2000) were reviewed by SEC staff. The SEC has indicated that, in response to concerns raised in the press about Enron's accounting for derivatives and Enron's general lack of clarity in its reporting, it flagged Enron's next scheduled annual re-

[114] SEC Response at 11–12. The post-effective amendment to the merger proxy that was reviewed at the same time also generated no comments. Correspondence from SEC staff to Committee staff (August 9, 2002).

[115] SEC Response at 5, 10. The affiliates were Enron International Corp. CPO LP and its wholly owned subsidiary Enron International Corp. CPO, Inc. (collectively, ECPO). The proposed IPO was ultimately abandoned by Enron in a decision the company attributed to changed market circumstances. SEC Response at 60–61.

[116] *See* Regulation S–K, Item 305, 17 C.F.R § 229.305.

[117] Letter from H. Roger Schwall, Assistant Director, Division of Corporation Finance, SEC, to Robert G. Gay, Enron International CPO, L.P., dated September 16, 1998; *see also* Letter from H. Roger Schwall to Rex R. Rogers, Vice President and Associate General Counsel, Enron Corp., dated January 26, 1999 (following up on cash flow issue).

[118] As noted, the review of the 1997 10–K was done in connection with a review of the proposed IPO by the Enron affiliate ECPO; the 1997 10–K of another Enron subsidiary, Enron Oil & Gas Company, was also reviewed as part of this process. SEC Response at 60. Commission staff responded to the ECPO filing with 103 comments and the Enron Oil & Gas filing with 20 comments (Enron never addressed the former because, as noted above, the IPO was ultimately abandoned). *See* Letter from H. Roger Schwall, Assistant Director, Division of Corporation Finance, SEC, to Robert G. Gay, Enron International CPO, L.P., dated September 16, 1998. Although a handful of the SEC staff's comments on the ECPO registration statement relate broadly to themes that would later appear with Enron's collapse—including nonconsolidation of affiliated entities and conflicts of interest—those themes manifested themselves in the ECPO filing in ways largely unrelated to their later appearance in Enron's dubious accounting. Thus, for example, the conflicts of interest that are the subject of SEC staff comments in the ECPO filing have to do with the possibility that, in offering certain business opportunities, Enron might be required to give preference to a certain other Enron affiliate over ECPO—troubling, perhaps, but not the sort of related-party transactions involving the enrichment of Enron insiders that have been the focus of much of the subsequent Enron revelations about conflicts of interest.

[119] SEC staff issued its comment letter to Enron on September 16, 1998. Enron had not responded to this letter by January 12, 1999, when it filed a registration statement for the sale of securities on Form S–3. SEC staff indicated that the Form S–3 would not become effective until the comments raised were satisfactorily resolved. Enron then responded by letter dated January 14, 1999. After a subsequent exchange of correspondence, SEC staff concluded its review. SEC Response at 10.

port—its 2001 Form 10–K—for review.[120] This annual report was due to be filed April 1, 2002; because of Enron's collapse, it was never submitted.

As discussed in the earlier section on the SEC's methods of operations, the SEC's lack of scrutiny of Enron's financial statements was not in and of itself unusual. Nevertheless, the Commission's experience in reviewing (or not reviewing) Enron's periodic filings raises four distinct sets of concerns, each of which calls into question the wisdom of the SEC's previously existing practice of not regularly examining large companies' annual reports.

First, the fact that the SEC did not review Enron's post-1997 financial statements—and indeed reviewed relatively few companies' annual reports at all during this time period—is troubling in part because of the backdrop against which these cutbacks in reviews took place. By the late 1990's, the vulnerabilities in the private portion of the public-private system of checks on financial malfeasance were becoming quite apparent. In fact, as noted above, the SEC was well aware of the burgeoning breakdown, signaled by such trends as the increasing number of financial restatements filed with the Commission. Indeed, in 1998, the SEC's Chairman had warned of the declining quality of financial reporting and voiced his belief that "almost everyone in the financial community"—management, analysts, boards of directors, auditors—"shares responsibility for fostering a climate" in which this was so.[121] Specific concerns about the potential conflicts faced by auditors, moreover, had led the SEC to propose significantly tightening the rules on auditor independence. Faced with increasing indications of the inadequacy of the private watchdogs, the SEC took some modest measures, such as the creation of an "earnings management task force" that was set up to pull out and review those companies' public filings that had certain indicia of active "earnings management."[122] For the most part, however, the Commission's processes remained unchanged just when additional efforts from government regulators—the other half of the public-private system of oversight—were most needed.

Second, even within the existing review system, better screening perhaps should have led SEC staff to select Enron's later Forms 10–K for further review. Securities law experts with whom Committee staff spoke suggested a couple of factors that should have at least triggered the SEC's interest in these reports, including Enron's astonishingly rapid growth, among the fastest of U.S. companies, and the significant change in the nature of its business (from energy to trading)—facts available from both press reports and the filings themselves.[123] The sheer number of Enron-related entities—Enron's 2000 Form 10–K lists over 50 pages of affiliates, many of which were not consolidated onto Enron's balance sheets—perhaps also should have raised suspicions, if only because it sug-

[120] SEC Response at 18. The 2001 10–K, the SEC notes, would have been the first annual filing to reflect a new accounting pronouncement on audited derivative disclosures (FASB Statement No. 133, Accounting for Derivative Instruments and Hedging Activities).
[121] Levitt, "The Numbers Game," at note 4 above.
[122] Committee staff interview with SEC staff, Division of Corporation Finance (June 25, 2002).
[123] Committee staff interview with James D. Cox, Brainerd Currie Professor of Law, Duke University (June 13, 2002); Committee staff interview with Joel Seligman, Dean and Ethan A. H. Shepley University Professor, Washington University School of Law (June 3, 2001).

gests the possibility that the information in the company's public filings and consolidated on its financial statements did not reflect the full scope of its business dealings.[124] Notwithstanding these facts, the SEC's selective review process did not identify Enron's later annual reports, including its 2000 report, as worthy of review. One reason for this was that, under the Commission's priority system, Enron was not "due" to have its annual report reviewed until 2002. As noted, the SEC's goal was to review a company's 10–K once every 3 years. The SEC staff calculates this 3-year period from the time the last review was completed. Thus, the SEC's review of Enron's 1997 Form 10–K having been finished in February 1999 (along with a review of the intervening 10–Qs), no further review was called for before Enron's bankruptcy in December 2001. Even apart from this timing, however, the SEC staff confirmed that Enron's 2000 Form 10–K would not have been flagged for review under their remaining screening criteria.[125]

Third, the fact that the SEC did not review Enron's later filings, particularly its 2000 Form 10–K, is of concern because, had it done so, there are a number of items that are likely to have led to questions by Commission staff and, perhaps, to the discovery of at least some of Enron's wrongful practices. The most notable of these, of course, is the now notorious footnote 16, which appeared in Enron's 2000 Form 10–K—and, in somewhat different form in its 1999 Form 10–K as well.[126] Footnote 16, which addresses "related party transactions" and runs for seven paragraphs in Enron's 2000 Form 10–K, raises several issues.[127] There was the inherent potential for

---

[124] *See* Enron 2000 Form 10–K, Exhibit 21. Notably, the extent of Enron's off-balance sheet entities (and the concomitant complexity of Enron's filings) led at least one large institutional investor to eschew investments in Enron in its actively managed portfolio as early as 1998. Committee staff interview with Scott Budde, Director, Equity Portfolio Analytics, TIAA–CREF (July 26, 2002).

[125] This is confirmed by the handling of Enron's transactional filings. Over the last few years, Enron submitted several registration statements for the sale of securities to the Commission, none of which were selected for full or financial reviews, despite the fact that all necessarily went through the screening process. Because the screening criteria for transactional filings are similar to (in fact, more inclusive than) those for periodic filings but do not include any time-from-last review factor, it follows (as SEC staff explained to Committee staff) that if these transactional filings were not selected for review, it is likely that neither would the Forms 10–K that were filed close in time to them. Committee staff interview with SEC staff, Division of Corporation Finance (June 25, 2002).

Late in the process, Commission staff did identify Enron as a company warranting further scrutiny, with the Corporation Finance Division determining in August 2001 that press reports about Enron's accounting merited checking out Enron's filings the *following* year. SEC Response at 18. At approximately the same time, staff in the SEC's Fort Worth office opened an informal investigation (a so-called "matter under inquiry") into Enron in the wake of these press reports as well as the sudden resignation of Enron's CEO, Jeffrey Skilling; as part of that investigation, Fort Worth staff took an initial look at Enron's filings, including its most recently filed annual report, the 2000 Form 10–K. Committee staff interview with SEC staff, Division of Enforcement (May 7, 2002), and Office of Legislative Affairs (July 24, 2002). *See also* Alexei Barrionuevo and Jonathan Weil, "Partner Warned Arthur Andersen on Enron Audit," *The Wall Street Journal*, May 9, 2002 (reporting on the testimony of Spencer Barasch, Associate District Administrator of the SEC's Forth Worth office, concerning the initiation of the SEC's Enron investigation, at the obstruction of justice trial of Arthur Andersen); Tom Fowler, "Enron's Woes Become Focus of Andersen Trial," *Houston Chronicle,* May 9, 2002 (same).

[126] *See* Enron Corp. Annual Report on Form 10–K for fiscal year ended December 31, 2000 (filed April 2, 2001), Item 14, Note 16 ("Enron 2000 Form 10–K"); Enron Corp. Form 10–K for fiscal year ended December 31, 1999 (filed March 30, 2000), Item 14, Note 16. In the 2000 10–K, footnote 16 references a long list of transactions with an unidentified "related party" (apparently LJM2, controlled by Enron CFO Andrew Fastow). Footnote 16 in the 1999 10–K discusses a more limited set of transactions, but identifies the related party entities involved (although not the individuals who control them): LJM and LJM2 (both controlled by Fastow, identified only as "a senior officer of Enron"), JEDI (whose limited partner, Chewco, was controlled by Michael Kopper, who reported to Fastow, and who is identified as an "officer of Enron"), and Whitewing, one of Enron's unconsolidated equity affiliates.

[127] *See* Appendix for the full text of footnote 16 as it appeared in Enron's 2000 Form 10–K.

conflicts of interests in such transactions; for this reason, every person whom Committee staff consulted (including SEC staff) agreed that such transactions are often a sign of trouble and generally merit further inquiry. In addition, footnote 16 makes oblique reference to a number of transactions that are themselves troubling—or would be if their details could be understood.[128] Among these are the use of SPEs for purported hedging activities (which, as noted above, turned out not to be legitimate hedges at all)[129] and the funding of these SPEs with Enron stock in exchange for a note receivable (the misaccounting for which led, as noted, to a $1 billion reduction in shareholder equity). There is also a particularly inscrutable reference to the sale of "dark fiber," which, read with the benefit of subsequently disclosed information, turns out to involve the sale of an asset related to Enron's broadband business to a Fastow-controlled SPE at an inflated price.[130]

Beyond footnote 16, experts whom Committee staff consulted identified several other items in Enron's 2000 Form 10–K that might cause a reviewer to take a closer look. These include, in footnote 9, a list of unconsolidated equity affiliates in which Enron's interest was at or near 50 percent—just below the threshold for having to consolidate these entities on Enron's balance sheet.[131] This fact, coupled with indications that Enron was providing substantial amounts of money to these entities, raises questions about the independence of these entities and, by extension, the purposes for which they were being used.[132] Also noted was a reference in

[128] Footnote 16 is so lacking in significant information that it does not even name the related party involved in these transactions. One needs to closely read Enron's 2000 proxy statement to learn that the Enron "senior officer" referred to is its former CFO, Andrew Fastow. *See* Enron Corp. Definitive Proxy Statement (Schedule 14A) (filed March 27, 2001), at 29 ("Certain Transactions").

[129] Among other things, footnote 16 states that, in connection with the hedging activity, Enron owed the SPEs "premiums" of $36 million (no reason is given, but it turns out, as explained in the Powers Report, to be essentially a payment to Fastow). It goes on to say that "Enron recognized revenues of approximately $500 million related to the subsequent change in the market value of these derivatives, which offset market value changes in certain merchant investments and price risk management activities," although it does not specify how the SPE would cover the $500 million loss exposure (with Enron's own stock, as it turns out). *See* Bratton, at note above, at 40.

[130] The relevant passage reads in full: "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." Enron apparently was able to sell the "related party" an asset worth $33 million for $100 million—a deal, it turns out, the related party was willing to enter into because Enron had promised to make the investors in the SPE whole if the asset declined in value. ("Dark fiber" refers to the right to transmit data over fiber-optic cables that are not yet ready to transmit internet data, but would possibly be so in the future—an asset difficult to value). *See* The Fall of Enron: How Could It Have Happened, Hearing Before the Senate Governmental Affairs Committee, 107th Cong., S. Hrg. 107–376 (January 24, 2002) at 115 (Statement of Frank Partnoy, Professor, University of San Diego School of Law).

[131] Enron 2000 Form 10–K, Item 14, Note 9. "Unconsolidated equity affiliates" refers to companies in which Enron owned at least some, but not more than 50 percent, of the company's stock. If Enron had over a 50 percent interest in a company, the assets and liabilities of the company would have to be included on Enron's own balance sheet—*i.e.,* "consolidated." By maintaining an interest at 50 percent or below, Enron (though perhaps owning a sufficient share to effectively control these companies), was able to avoid including such information on its financial statements. According to at least one expert, having a large number of such entities, with little disclosure about them in Enron's public filings, at least raises the possibility that Enron was deliberately structuring them so as to keep certain information off its own financial statements. Committee staff interview with April Klein, Associate Professor of Accounting, New York University Leonard N. Stern School of Business (June 26, 2002).

[132] *See* Bratton, note 81 above, at 46 (noting, for example, that of Enron's $23.4 billion of assets reported on its balance sheet, $5.3 billion, or 22.6 percent, represented investments in these unconsolidated equity affiliates); Committee staff interview with April Klein (June 26, 2002) (observing that Enron appeared to be loaning a substantial portion of its income to these entities

Continued

the MD&A to the contingent liabilities that ultimately were disclosed more fully by Enron in November 2001.[133] The relevant passage states "Enron is a party to certain financial contracts which contain provisions for early settlement in the event of a significant market price decline in which Enron's common stock falls below certain levels (prices ranging from $28.20 to $55.00 per share) or if the credit ratings for Enron's unsecured, senior long-term debt obligations fall below investment grade,"[134] but offers no indication of the magnitude of these liabilities—a whopping $4 billion. Finally, as one of the Committee's witnesses testified, there was another "flashing red light" in the 2000 Form 10–K, a notation by Enron in its discussion of risk management, that it had recently "refined" its value at risk model (a sophisticated and complex way of estimating its exposure in its trading operations) "to more closely correlate with the valuation methodologies used for merchant activities"[135]—a "refinement" that raises troubling concerns that the previous model may have come up with unacceptable high risk values.[136] None of these items (and this list is not intended to be exhaustive), in and of itself, is necessarily an indication of fraud, but each might well lead a reviewer to probe further into Enron's complexities. By not reviewing Enron's last three Forms 10–K—or any of its recent registration statements, which incorporated much of this information—the SEC missed potential opportunities to identify serious problems before the house of cards fell.[137]

The final concern highlighted by the SEC's review of Enron's public filings is the constrained nature of those reviews and their limited power to detect serious wrongdoing. For example, we now know from Enron's announced restatements and the Powers Report that although the most egregious practices appear to have occurred from 1999 on, Enron's financial statements back to at least 1997 contained inaccurate, and likely fraudulent, information.[138] Yet the SEC's review of the 1997 Form 10–K did not—indeed, given that such reviews are not intended to re-audit the company's numbers, could not be expected to—identify such problems, which included the initial, improper structuring of certain unconsolidated SPEs. One accounting expert with whom Committee staff spoke described

and that it had recognized significant revenues from its transactions with these entities); Enron 2000 Form 10–K, Item 14, Note 9.

[133] *See* Enron Corp. Form 10–Q for quarter ended September 30, 2001 (filed November 19, 2001), Part I, Item 2, at 66; Committee staff interview with William W. Bratton, Samuel Tyler Research Professor of Law, George Washington University Law School (June 19, 2002).

[134] Enron 2000 Form 10–K, Item 7, Capitalization.

[135] Enron 2000 Form 10–K, Item 7A, Value at Risk, note (c) to table. A value at risk model is one of three ways by which the SEC permits companies to disclose their market risk. Committee staff interview with SEC staff, Division of Corporation Finance (April 24, 2002); *see* SEC Regulation S–K, Item 305, 17 C.F.R. § 229.305.

[136] The Fall of Enron: How Could It Have Happened, Hearing Before the Senate Governmental Affairs Committee, 107th Cong., S. Hrg. 107–376 (January 24, 2002) at 127. (Statement of Frank Partnoy, Professor, University of San Diego School of Law).

[137] This is not to suggest that merely by reviewing Enron's 2000 10–K, the SEC might have averted Enron's collapse. Enron's 2000 10–K was filed on April 2, 2001. Allowing the SEC staff time to initiate and conduct a review in accordance with its ordinary timetables, it is unlikely that any revelations its review brought about would have come early enough to do more than hasten Enron's demise. Nonetheless, more routine reviews of Enron's filings over a course of years would likely have put the SEC in a better position to identify and address budding problems.

[138] One recent report suggests that Enron's use of SPEs to improperly keep debt off the company's balance sheet may have begun as far back as the early 1990's. *See* John R. Emshwiller, "Enron May Have Started Earlier On Its Off-Balance-Sheet Deals," *The Wall Street Journal*, September 30, 2002.

Enron's 1997 Form 10–K as "murky" but found no facial indicia of fraud in the filing, which mentioned neither related-party transactions nor SPEs.[139] Even in Enron's 2000 Form 10–K, which contained some warning signs about some of the wrongful practices, much of the fraud was hidden—in off-balance sheet entities or inflated valuations—in ways that could not be detected by a mere review of the filing. To uncover such fraud requires a considerably more in-depth audit than the SEC has thus far been equipped or oriented to do.

2. Enron's Shift to Mark-to-Market Accounting

By letter dated June 11, 1991, Enron notified the SEC's Office of Chief Accountant of its intent to use "mark-to-market" accounting to record the natural gas trades of its newly formed subsidiary, Enron Gas Services (EGS).[140] Using mark-to-market accounting meant that when EGS entered into a natural gas contract,[141] it would book the present value of all future profits from that contract at the time the contract was signed, in contrast to traditional accounting methods that would have required that the company spread out the recognition of revenue over the life of the contract. Any changes in the value of the contract once it had been recorded on EGS's books—and the contracts were required to be revalued quarterly—would, under mark-to-market principles, be reflected as subsequent increases or decreases in revenue on the company's income statement.[142] EGS's accounting, moreover, would carry over onto Enron's consolidated balance sheet.

Enron sought a so-called "no-objection" letter from SEC staff. Such a letter would tell Enron that SEC staff would not object to Enron's proposed change in accounting. At the time Enron requested the no-objection letter, it was unusual for pipeline companies or others outside the financial industry to use mark-to-market accounting. Enron, however, argued that EGS was essentially a commodity trading business and that mark-to-market accounting was common in such businesses. In its request to the SEC, moreover, Enron included a letter from Arthur Andersen to the effect

---

[139] Committee staff interview with April Klein, Associate Professor of Accounting, New York University Leonard N. Stern School of Business (June 26, 2002). It is possible that if the SEC had diligently insisted on the clarification of all instances of murkiness in Enron's disclosures, it may have affected Enron's future practices, even if it did not uncover fraud. It can be argued that, if Enron and its auditor had believed that the SEC would insist on full, clear disclosures in its financial statement, it would have been deterred from engaging in the worst of its practices, the details of which it would have been loath to disclose. Moreover, the murkiness of Enron's filings itself—which only became worse with time—should likely have been a signal to the SEC that further inquiry was necessary.

[140] Enron Gas Services, which engaged primarily in gas trading activities (including gas derivatives), later became Enron Capital and Trade Resources Corp., which in turn became Enron North America. At the time this request was made, EGS's CEO was Jeffrey Skilling.

[141] Only some of EGS's contracts involved the actual, physical delivery of natural gas; the rest involved derivatives and other financial instruments sold as a means of purported price risk management.

[142] Alternatively, gains and losses may be recorded in a separate account on the balance sheet rather than reported on the income statement, thus having no immediate effect on reported revenue or profits. This is a more conservative treatment, and according to experts with whom Committee staff spoke, a more appropriate one when a contract's value is not easily susceptible to objective measure. Committee staff interview with April Klein, Associate Professor of Accounting, New York University Leonard N. Stern School of Business (June 26, 2002); Committee staff interview with Bala G. Dharan, J. Howard Creekmore Professor of Management, Graduate School of Management, Rice University (August 1, 2002); *see also* Lessons Learned From Enron's Collapse: Auditing the Accounting Industry, Hearing Before the House of Representatives Energy and Commerce Committee, 107th Cong., Hrg. No. 107–83 (February 6, 2002) at 95 (Statement of Bala G. Dharan).

that such accounting was the preferable method to use in these circumstances. Enron also included a letter from Ernst & Young indicating that the treatment was consistent with GAAP.[143]

Over the course of the next several months, at least eight letters, as well as additional phone calls, were exchanged between SEC staff and Enron, and Enron representatives (including Jeffrey Skilling) met with SEC staff twice. Staff in the Office of Chief Accountant posed a number of questions, including how comparable businesses did their accounting, how mark-to-market results would be calculated, and how such accounting would interact with the accounting of Enron's non-trading subsidiaries.[144] In addition, at one point, SEC staff apparently suggested that Enron consider supplemental disclosure of mark-to-market results (that is, in addition to its traditional accounting) until it got a better sense of the reliability of the supporting measurements. Enron resisted, asserting that the mark-to-market earnings would be calculated based on "known spreads and balanced positions" and that the reliability of the measurements would not be "significantly dependent on subjective elements." [145]

Ultimately, the Office of Chief Accountant sent the requested no-objection letter to Enron on January 30, 1992, indicating that it would not object to the proposed change in accounting method beginning in the first quarter of fiscal year 1992.[146] By letter dated February 11, 1992, Enron replied that "upon further review," it had decided that the "most appropriate period for adoption of mark-to-market accounting" was the beginning of 1991—a year earlier than the SEC had approved—and represented that the impact on 1991 earnings was not material.[147] Apparently, the SEC did not respond further to this correspondence and Enron went ahead and reported EGS's 1991 financial information using the mark-to-market method.[148]

At the time EGS changed its accounting methods, the switch to mark-to-market accounting was unusual and was seen by many as

[143] Letter from Jack I. Tompkins, Senior Vice President and Chief Financial Officer, Enron Corp. and George W. Posey, Vice President Finance and Accounting, Enron Gas Services to George H. Diacont, Acting Chief Accountant, Office of the Chief Accountant, Securities and Exchange Commission, and Robert Bayless, Associate Director (Chief Accountant), Division of Corporation Finance, Securities and Exchange Commission, dated June 11, 1991 (letters from Arthur Andersen and Ernst & Young attached as Exhibits I and II, respectively).

[144] *See* SEC Response at 76–81.

[145] Letter from Jack I. Tompkins, Senior Vice President and Chief Financial Officer, Enron Corp. and George W. Posey, Vice President Finance and Accounting, Enron Gas Services, to John W. Albert, Associate Chief Accountant, Office of the Chief Accountant, Securities and Exchange Commission, dated July 29, 1991.

[146] Letter from Walter P. Schuetze, Chief Accountant, Securities and Exchange Commission, to Jack I. Tompkins, Senior Vice President and Chief Financial Officer, Enron Corp., dated January 30, 1992.

[147] Letter from Jack I. Tompkins, Senior Vice President and Chief Financial Officer, Enron Corp., to Walter P. Schuetze, Chief Accountant, Securities and Exchange Commission, dated February 11, 1992.

[148] According to one press account, Enron's representation that its use of mark-to-market accounting for its 1991 financial statements would not have a material impact on earnings was false. The account quotes unnamed former Enron employees as saying that Enron signed two large natural gas supply contracts in the latter half of 1991 and used mark-to-market accounting for those contracts to significantly boost Enron's revenues for the last two quarters of the year. This enabled Enron to show increased earnings over the same periods in the previous year. Barbara Shook, "Enron Missteps Began In 1991; Aggressive Accounting Blamed," *Natural Gas Week,* January 28, 2002. *See also* "Origin of Questionable Enron Accounts," *World Gas Intelligence,* January 18, 2002.

an aggressive move.[149] Mark-to-market accounting has since become common in the energy trading industry.[150] In fact, the experts with whom Committee staff spoke did not raise any general objections to the use of mark-to-market accounting and suggested that, at least as a theoretical matter, mark-to-market accounting was often a preferable method of accounting, because, applied correctly, it can enable investors to see more accurately the current value of a company's assets.[151]

Mark-to-market accounting, however, is not without its problems—some significant. Most importantly, it was questionable whether Enron could accurately value these contracts at the time of signing. For short-term, standard form contracts, there is often a public market, such as the New York Mercantile Exchange, that can provide the necessary values. For longer-term or more complex trading contracts, there would likely not be market quotes available on which to base the values. Instead, Enron would use complex models to estimate the value of these contracts, making assumptions about an assortment of variables that could range from future gas prices to the pace of energy deregulation to trends in interest rates.[152] The assumptions underlying these models were, in the best case, necessarily subjective and, in the worst, subject to deliberate manipulation.

The evidence suggests that Enron, at a minimum, overestimated and very possibly manipulated the values of the energy contracts it marked to market. Enron's misuse of mark-to-market accounting has been most widely reported in connection with the activities of Enron Energy Services (EES), the company's retail energy subsidiary (Enron ultimately used mark-to-market accounting at subsidiaries beyond EGS). One former employee with whom Committee staff spoke described the arcane models and aggressive assumptions—often, according to this employee, different even from those employed by Enron's own Wholesale Services division—that were used to value the highly complex, long-term energy contracts

---

[149] *See, e.g.,* Toni Mack, "Hidden Risks," *Forbes,* May 24, 1993 (warning that if something major happened to impair the value of the contracts that Enron was marking to market, the company could be forced to book losses, and that by accelerating income, Enron would have to keep doing more and more deals to show the same or rising income); Harry Hurt III, "Power Players," *Fortune,* August 5, 1996 (citing former employees as suggesting that mark-to-market accounting "simultaneously inflates current earnings and creates a 'feeding frenzy' as executives scramble to make new deals to prop up future profits.").

[150] Committee staff interview with Bala G. Dharan (August 1, 2002); *see* FASB Statement No. 133, *Accounting for Derivative Instruments and Hedging Activities* (June 1998).

[151] *See, e.g.,* Committee staff interview with Lynn Turner (June 24, 2002); Committee staff interview with Bala G. Dharan (August 1, 2002); *see also* Lessons Learned From Enron's Collapse: Auditing the Accounting Industry, Hearing Before the House of Representatives Energy and Commerce Committee, 107th Cong., Hrg. No. 107–83 (February 6, 2002) at 95 (Statement of Bala G. Dharan). This contrasts with historical cost accounting, a more traditional accounting method in which assets are recorded at their original cost without subsequent adjustments. SEC staff explained to Committee staff that awareness of the problems that arose from historical cost accounting in the Savings and Loan crisis of the late 1980's had, in fact, contributed to their decision to permit Enron to use mark-to-market accounting. The savings and loans, pursuant to historical cost accounting principles, had kept on their books at their original cost investments that thereafter declined substantially in value, thereby effectively shielding from the public the true state of their finances (under mark-to market accounting, these investments would have had to be revalued quarterly and the changes in value recorded on the company's financial statements). This practice had resulted in substantial criticism. Committee staff interview with SEC staff, Office of Chief Accountant (April 22, 2002).

[152] *See* Floyd Norris and Kurt Eichenwald, "Fuzzy Rules of Accounting and Enron," *The New York Times*, January 30, 2002; Committee staff interview with Bala G. Dharan (August 1, 2002).

that EES was marketing to major commercial customers.[153] The incentives to be optimistic about the assumptions underlying the model, moreover, were present not only for Enron's executives, concerned about the next quarter's revenue numbers, but also for lower level employees whose bonuses were based on the full marked-to-market value of the deals they completed.[154] As the deals came to maturity, however, the assumptions underlying the valuations in many cases proved incorrect and the contracts had to be revalued. By Spring 2001, Enron apparently would have had to report significant losses from these deals, had it not merged the commodity risk activities of EES with those of Enron's Wholesale Services group, effectively hiding these losses amid that group's substantially larger revenues and allowing the remaining part of EES to appear profitable.[155]

In permitting Enron to switch to mark-to-market accounting, SEC staff appeared to anticipate some of the problems that could arise when a company was allowed to estimate the present value of a long-term contract. Indeed, in its no-objection letter, the Office of the Chief Accountant explicitly conditioned its acceptance of Enron's change in accounting methods on the company's representations that it would value such contracts objectively.[156] Once the

---

[153] Committee staff interview with Margaret Ceconi (February 1, 2002). One press account lists a number of specific practices cited by former EES employees that were used to inflate the present value of EES contracts, including routinely underestimating commodities prices in the later years of a contract, quoting prices from highly illiquid markets that Enron dominated, and projecting unjustifiably high efficiency savings. Joshua Chafin, Stephen Fidler and Andrew Hill, "Enron: Virtual Company, Virtual Profits," *Financial Times (London)*, February 4, 2002. Another press account describes similar practices at Enron North America, a subsidiary that engaged in wholesale energy trading, where a former manager on the trade desk alleged that the price curves (the expected direction of prices in the future) on which the deals were valued were set unreasonably high and then were moved even higher, often at the end of a quarter, in order to generate reported income. Michael Brick, "What Was the Heart of Enron Keeps Shrinking," *The New York Times*, April 6, 2002. Enron Vice President of Corporate Development Sherron Watkins' now famous letter to Ken Lay warning of various improper accounting practices (primarily transactions related to the so-called Raptor SPEs) also mentions possible "valuation issues" in connection with EES's mark-to-market positions. Letter from Sherron Watkins to Kenneth Lay (August 2001), reprinted in The Financial Collapse of Enron, Hearing before the Subcommittee on Oversight and Investigations, House of Representatives Committee on Energy and Commerce, 107th Cong., Hrg. No. 107–89 (February 14, 2002) at 119.

[154] Committee staff interview with Margaret Ceconi (February 1, 2002); *see also* Laura Goldberg and Tom Fowler, "The Myth of Enron," *Houston Chronicle,* January 27, 2002.

[155] *Id.* Notably, after filing for bankruptcy, Enron sought and received permission to abandon 700 EES contracts as "burdensome to the estate." Motion of Enron Energy Services Operations, Inc., Enron Energy Services, Inc. and Enron Energy Marketing Corp. Pursuant to Section 365(a) of the Bankruptcy Code for Order Authorizing Debtors to Reject Certain Executory Contracts, *In re Enron Corp.,* Case No. 01–16034 (AJG) (Bankr. S.D.N.Y., December 21, 2001); Order Authorizing Rejection of Certain Executory Contracts, *In re Enron Corp.,* Case No. 01–16034 (AJG) (Bankr. S.D.N.Y., January 4, 2002); *see* "Business Folly As Well As Financial Fraud," *Gas Processors Report,* February 11, 2002.

Ceconi was sufficiently concerned about the transfer of EES losses to another subsidiary that she contacted the SEC to inquire if the accounting was permissible, e-mailing her question to the SEC's Office of Investor Education and Assistance in July 2001. In response, she received a phone call from a Commission employee. In neither her e-mail nor her telephone conversation, however, did Ceconi reveal the company at issue. Only after the SEC's current investigation was underway and had been publicly announced, did Ceconi sent another e-mail which expressly referred to Enron. Committee staff interview with Margaret Ceconi (February 1, 2002); SEC Response at 86.

[156] Specifically, the Office of the Chief Accountant noted, among other things, Enron's representations that:

> Market values will be based on market prices to the extent such prices are available. Where derived values are used because market prices are not available, those values will be derived using a valuation model that uses objective data, such as actual bid and asked prices from transactions in the marketplace, to develop a value;

and that

> Allocation of the physical risk and price risk components (price risk being the element of the contract subject to mark-to-market measurement) is objectively verifiable by the independent auditors.

conditions were set forth, however, the SEC itself had no procedures to ensure that the company complied with these conditions. The Division of Corporation Finance staff would have seen the Chief Accountant's no-objection determination if and when they reviewed Enron's filings, but the complex and detailed work of determining whether Enron was employing appropriate valuation models and that trading contracts were marked to market fairly would have been left to Enron's auditors. The SEC, by all indications, did not seek to ascertain whether the auditors in fact had validated the models used by the company.[157]

Even without any investigation into particular contracts or computer models, however, Enron's public filings suggest both the magnitude and the subjectivity of the company's mark-to-market valuations—something the SEC staff might well have noticed had they reviewed the filings and done so with an eye toward this issue. For the year 2000, Enron's unrealized trading gains—that is, the profits it expected to earn in future years—constituted over half the company's $1.41 billion originally reported pre-tax profit.[158] Of the basis for the company's mark-to-market valuations, the Forms 10–K that Enron filed with the SEC for the years 1997 onward state that "[t]he market prices used to value these transactions reflect management's best estimate considering various factors including closing exchange and over-the-counter quotations, time value and volatility factors underlying the commitments."[159] Despite the opacity of this explanation as well as the relative size of the valuations at issue, and despite its initial concerns, the SEC did not attempt to look more closely at Enron's mark-to-market accounting methods, or at any point even seek to require Enron to amend this disclosure to go beyond the unhelpful information that this was management's "best estimate" and clarify for investors any of the key assumptions it was relying on in valuing the transactions for its financial statements.[160] The SEC's failure to follow up on its

---

Letter from Walter P. Schuetze, Chief Accountant, Securities and Exchange Commission, to Jack I. Tompkins, Senior Vice President and Chief Financial Officer, Enron Corp., dated January 30, 1992.

[157] The actual validation of the models used by Enron does appear to be a task that is best left in the first instance to the auditors; the large accounting firms typically have the expertise to design and evaluate such models. *See* Committee staff interview with Lynn Turner (June 24, 2002). Nonetheless, the SEC has an important role to play in assuring that such validation is taking place and, where appropriate, requiring documentation of how the models work. *See* Committee staff interview with Bala G. Dharan (August 1, 2002).

[158] Jonathan Weil, "After Enron 'Mark to Market' Accounting Gets Scrutiny," *The Wall Street Journal*, December 4, 2001. Enron's public financial statements do not separate out the precise amount of these unrealized gains, but a line item in its cash flow statement—"additions and unrealized gains" equal to almost $1.3 billion (though it may also include unrealized gains from other activities as well)—suggests the magnitude. *See* Enron Corp. 2000 Form 10–K, Item 14, Consolidated Statement of Cash Flows; Committee staff interview with Bala G. Dharan (August 2000). Weil had first pointed out this issue a year earlier, noting that, without the inclusions of these unrealized, noncash gains, Enron would have in fact lost money in the second quarter of 2000. *See* Jonathan Weil, "Energy Traders Cite Gains, But Some Math is Missing," *The Wall Street Journal* (Texas ed.), September 20, 2000.

[159] Enron 2000 Form 10–K, Item 14, Note 1, Accounting for Price Risk Management; Enron 1999 Form 10–K, Item 14, Note 1, Accounting for Price Risk Management; Enron 1998 Form 10–K, Item 14, Note 1, Accounting for Price Risk Management; Enron 1997 Form 10–K, Item 14, Note 1, Accounting for Price Risk Management. Equally unhelpful is Enron's caveat that "Judgment is necessarily required in interpreting market data and the use of different market assumptions or estimation methodologies may affect the fair value amounts." Enron 2000 Form 10–K, Item 14, Note 3.

[160] Subsequently, the SEC has issued a statement urging companies to consider including additional disclosures in its financial statements concerning commodity contracts accounted for at fair value, but for which there is a lack of market price quotations. Commission Statement

Continued

initial accounting determination (and the concerns accompanying it) meant another lost opportunity to identify (and potentially mitigate) some of the accounting abuses perpetrated by Enron.

3. Exemptions from the Public Utility Holding Company Act

The Public Utility Holding Company Act of 1935 [161] was passed to protect consumers and investors against abuses by the holding companies that then controlled a substantial portion of the country's gas and electric utilities. In the 1920's, many of these companies had developed complex, multistate pyramid structures that masked unsound financial practices, adversely affected the underlying utilities and their ratepayers, and made the companies less susceptible to State regulation.[162] In response, PUHCA imposes a number of restrictions on public utility holding companies, defined as companies which directly or indirectly own 10 percent or more of a gas or electric public utility.[163] These provisions require, among other things, that each registered holding company be limited to a single "integrated public utility system" that is geographically confined and physically interconnected; [164] prohibit the ownership of nonutility businesses unless those businesses are "reasonably incidental, or economically necessary or appropriate" to the operations of the integrated public utility system; [165] restrict transactions between holding company affiliates; [166] and require SEC review of a holding company's issuance of securities [167] or acquisition of securities or utility assets of another holding or public utility company.[168] The SEC is charged with administering PUHCA, [169] and companies that come within the definition of a public utility holding company must register with the SEC or apply for an exemption under the Act. As of March 4, 2002, there were 29 registered holding companies in the United States and 124 exempt holding companies.[170]

Enron appears to have been aggressive in its efforts to ensure that the company would not be brought within the strictures of PUHCA. In the last 10 years, Enron and/or its subsidiaries on six occasions successfully either asserted that they were entitled to an

---

About Management's Discussion and Analysis of Financial Condition and Results of Operations, Release Nos. 33–8056, 34–45321, 67 Fed. Reg. 3746 (January 25, 2002).

[161] 15 U.S.C. § 79a *et seq.*

[162] *See* 15 U.S.C. § 79a(b) (setting out factual basis for legislation).

[163] 15 U.S.C. § 79b(a)(7).

[164] 15 U.S.C. § 79k(b)(1).

[165] *Id.*

[166] 15 U.S.C. §§ 79l and 79m.

[167] 15 U.S.C. §§ 79f and 79g.

[168] 15 U.S.C. § 79i and 79j.

[169] For the last 20 years, the SEC has advocated the repeal of PUHCA and the transfer of related responsibilities to the Federal Energy Regulatory Commission. *See, e.g.,* Effects of Subtitle B of S. 1766 to the Public Utility Holding Company Act, Hearing Before the Subcommittee on Securities, Senate Committee on Banking, Housing, and Urban Affairs 107th Cong., S. Hrg. 107–521 (February 6, 2002) at 7–16 (Statement of the Honorable Isaac C. Hunt, Jr., SEC Commissioner); Public Utility Holding Company Act Amendments, Hearing Before the Subcommittee on Securities, Senate Committee on Banking, Housing, and Urban Affairs, 97th Cong., S. Hrg. 97–62 (June 8, 1982) at 359–421 (Statement of SEC).

[170] SEC Response at 95 and n. 2. Of those companies that are public utility holdings companies but are exempt from registration, the majority have claimed an exemption because they are intrastate holding companies or because they are predominantly utility companies themselves and operate in a single State or States contiguous to that State. SEC Response at 95–96. In numerous other instances, companies have successfully sought determinations from the Commission or its staff that they did not come within the definition of a public utility holding company. SEC Response at 97, 108–16.

exemption under the Act or sought determinations from SEC staff that the activities they intended to engage in would not bring them within the definition of a "public utility holding company." [171] In addition, on five other occasions, Enron sought exemptions from the Commission or no-action letters from SEC staff, but no Commission or staff determination was reached because either Enron withdrew the request, the issue became moot, or the request is still pending.[172] Questions have been raised publicly about two of these PUHCA determinations, [173] and a third matter that is still pending poses some additional concerns. We will address each of these three matters in turn.[174]

The first of these involved a request, in 1993, by Enron Power Marketing, Inc. (EPMI), a wholly owned subsidiary of Enron Gas Services, which was, in turn, a wholly owned subsidiary of Enron Corp. EPMI asked the SEC for a "no-action letter"—that is, staff assurances that it would not recommend enforcement action—in connection with EPMI's power marketing activities. Although EPMI did not itself generate or transmit electricity, it proposed to engage in transactions such as purchasing and then reselling electricity. At issue was whether these activities made EPMI an "electric utility company" under Section 2(a)(3) of PUHCA. If so, Enron, as the parent of EPMI, would be considered a public utility holding company and subject to the restrictions of the Act.

Enron first contacted the SEC about this issue on October 19, 1993.[175] At the time, Enron was one of a number of companies inquiring whether power marketing would subject them to the reg-

---

[171] None of these required action by the Commission itself. On five of these occasions, Enron was issued a no-action letter by SEC staff. In the remaining case (involving Enron's Portland General Electric subsidiary, discussed below), the exemption was self-executing—that is, Enron was able to claim the exemption by filing a form; in the absence of an objection by SEC staff, the exemption was effective.

[172] SEC Response at 131, 133–34. In a further PUHCA matter, Enron sought and received permission to include consolidating balance sheets for only its first-tier subsidiaries on the exemption form (Form U–3A–2) it filed in connection with its claim for an intrastate exemption related to its Portland General Electric subsidiary. *Id.* at 131.

[173] *See, e.g.,* Michael Schroeder, "Accounting for Enron: SEC Feels Heat Over Exemptions to Enron," *The Wall Street Journal*, January 21, 2002.

[174] The remaining four no-action requests that were granted were as follows:

(1) a 1992 request concerning the sale and distribution of compressed natural gas for use in compressed natural gas vehicles. A no-action letter was sought on the grounds that this was not the type of activity contemplated by PUHCA and also that the cars constituted "portable containers" equivalent to the portable cylinders of compressed natural gas that the SEC had exempted from PUHCA in other cases.

(2) a 1993 request concerning an Enron affiliate that provided certain operation and maintenance services to an electric power plant in the Philippines. Enron sought a no-action letter based on PUHCA's exemption for foreign utility companies under section 33(a)(1) of PUHCA, 15 U.S.C. § 79z–5b(a)(1).

(3) a 1997 request by Enron Capital & Trade (the successor to Enron Gas Services) for a no-action letter in connection with retail energy activities (including hooking up individual consumers to the power grid and supplying electricity meters) that they believed might be beyond the scope of an earlier no-action letter given to EGS for Enron Power Marketing, Inc.'s power marketing activities, discussed below.

(4) a 1999 request by Enron Federal Solutions for a no-action letter related to its proposal to own and operate electric, gas, water, and wastewater distribution systems at Fort Hamilton Military Base in Brooklyn. Enron asserted that an entity dedicated exclusively to provide services to the Federal Government was not the type of company PUHCA was intended to regulate.

SEC staff characterized all but the last of these as routine.

[175] Enron contacted the SEC through its attorney, who sought advice from SEC staff at that point without revealing the client's name. Memorandum to Files from T.C. Havens, Reid & Priest, dated October 19, 1993 (Enron document numbers EC2 000032904–EC2 000032907).

istration and other requirements of PUHCA.[176] After speaking informally with the SEC staff and soliciting their advice as to how to proceed, Enron submitted for staff review a draft application for a declaratory order from the Commission that power marketers were not "utilities" under the Act.[177] For reasons that remain unclear, Enron did not proceed with this application. Instead, it chose to request a no-action letter from the SEC staff on this issue and subsequently submitted draft and then final versions of such a no-action request in December 1993.[178] Enron was the first power marketer to request an exemption from PUHCA on these grounds. Without commenting on the issues raised, the SEC issued the no-action letter on January 5, 1994;[179] since that time, 20 other companies have received similar no-action letters.[180]

Section 2(a)(3) of PUHCA defines an "electric utility company" as "any company which owns or operates facilities used for the generation, transmission, or distribution of electric energy for sale."[181] As EPMI represented that it did not own generating plants, transmission lines or electric distribution systems, the resolution of this issue turned on whether the contracts, books, and records associated with the proposed power marketing activity constituted "facilities" for the generation, transmission, or distribution of electricity under the statute.[182]

Interestingly, some years before, the Federal Energy Regulatory Commission (FERC) had been faced with a similar question about the definition of "facilities' under the Federal Power Act (FPA),[183] a companion statute to PUHCA that is administered by FERC. In that case, FERC held that a power marketer's contracts, books, etc. were facilities under the FPA and that those who bought and resold electricity were subject to FERC's jurisdiction under the Act as utilities, even if they did not own traditional transmission facilities.[184]

---

[176] Committee staff interview with SEC staff, Division of Investment Management (July 2, 2002).

[177] Application Pursuant to Section 2(a)(3)(A) of the Public Utility Holding Company Act of 1935, as Amended, for an Order Declaring Enron Power Marketing, Inc. Not to be an Electric Utility, dated November 30, 1993 (Draft) (Enron document numbers EC2 000032908–EC2 000032928).

[178] Letter from William T. Baker, Jr., Reid & Priest, to Kevin An, Office of Public Utility Regulation, Securities and Exchange Commission, dated December 22, 1993 (Enron document numbers EC2 000032929–EC2 000032952) (enclosing draft no-action request); Letter from William T. Baker, Jr., Counsel for Enron Power Marketing, Inc., Reid & Priest, to William C. Weeden, Associate Director, Office of Public Utility Regulation, Division of Investment Management, Securities and Exchange Commission, dated December 28, 1993, available at 1994 SEC No-Act. LEXIS 42 (request for no-action determination).

[179] Enron Power Marketing, Inc., Ref. No. 94–1–OPUR, Response of the Office of Public Utility Regulation, Division of Investment Management, from S. Kevin An, Staff Attorney, dated January 5, 1994, available at 1994 SEC No-Act. LEXIS 42.

[180] SEC Response at 94. Subsequently, the Commission promulgated a rule permitting *registered* holding companies to engage in power marketing activities that implicitly recognizes that power marketing is a nonutility activity. *See* 17 C.F.R. § 250.58.

[181] 15 U.S.C. § 79b(a)(3).

[182] As is their practice, SEC staff noted in their no-action letter that it did not purport to express any legal conclusion on the questions presented. Nonetheless, SEC staff now notes that "it would be logical to conclude" that the staff did not regard Enron's contracts and associated books and records to be "facilities" as defined in the Act and consequently concluded that power marketers were not "electric utilities" within the meaning of the Act. SEC Response at 94.

[183] 16 U.S.C. § 791a *et seq.*

[184] Citizens Energy Corporation, 35 F.E.R.C. 61,198 (1986) (reasoning that, among other things, a contrary decision would have left FERC "without any other party over whom to assert authority with respect to what are clearly wholesale sales . . . in interstate commerce"); *see* 16 U.S.C. § 824(b) (providing that FERC "shall have jurisdiction over all facilities for such transmission or sale of electric energy").

At the time of its no-action request, Enron argued, and the SEC has since explained in its response to the Committee, that a contrary ruling would have effectively prohibited companies from creating power marketing subsidiaries as it would be virtually impossible for such companies to then comply with PUHCA's requirement for an integrated system operating in a single geographic area, because "power marketing by its nature tends to be a nationwide activity that does not rely on specific, in-place assets." [185] Power marketers could thus presumably exist only as free-standing companies, not as subsidiaries of holding companies. In addition, both Enron and the SEC have pointed to the different statutory purposes underlying PUHCA and the FPA and have further argued that precisely because FERC had asserted jurisdiction over power marketers, there was no danger that excluding such activities from PUHCA's requirements would leave them unregulated.[186] Although it is possible to disagree with the SEC staff's reasoning, it does not appear to Committee staff that the conclusion they reached was insupportable.

The second issue that has received a fair amount of public attention is Enron's claim under PUHCA Rule 2 of an exemption from PUHCA as an intrastate holding company when it acquired Portland General Electric (PGE) in 1997. Rule 2 implements Section 3(a)(1) of PUHCA, which provides that the SEC is to exempt a holding company if it and each of its subsidiary public utility companies "are predominantly intrastate in character and carry on their business substantially in a single State in which such holding company and every such subsidiary company thereof are organized." [187] The SEC has interpreted this provision to mean that when a holding company and each of its public utilities (as that term is defined in the statute) are located in one State, the holding company is exempt from PUHCA. A company that meets this requirement is not required to formally apply for an exemption or request a no-action letter. Rather, it need only file a form claiming the exemption; the exemption is effective unless the Commission notifies the company that it has questions.

When Enron acquired PGE, it re-incorporated in Oregon (it had previously been a Delaware corporation). As PGE, too, was incorporated in Oregon and was the only Enron subsidiary that was considered a "public utility," Enron was clearly eligible for this exemption under governing SEC interpretation. Although some have raised questions about the SEC's interpretation of the intrastate provisions of Section 3(a)(1) [188]—and other interpretations are clearly possible and perhaps more intuitive—the Commission's ap-

---

[185] SEC Response at 94; *see also* Enron request for no-action determination, note 178 above.

[186] Committee staff interview with SEC staff, Division of Investment Management (July 2, 2002); Enron request for no-action determination, note 178 above.

[187] 15 U.S.C. § 79c(a)(1).

[188] *See, e.g.,* Effects of Subtitle B of S. 1766 to the Public Utility Holding Company Act, Hearing Before the Senate Committee on Energy and Natural Resources, 107th Cong., S. Hrg. 107–521 (February 6, 2002) at 41–62 (Statement of Scott Hempling, Attorney at Law). Hempling argues that Enron does not meet the literal requirements of the section 3(a)(1) exemption because its business operations are not "predominantly intrastate in character" and its worldwide business is not carried on "substantially in a single State." Alternatively, he suggests that SEC should have found Enron's exemption to be "detrimental to the public interest" under section (3)(a) of the Act, 15 U.S.C. § 79c(a).

proach, first set forth in 1937,[189] is well-established and the Commission's response to Enron's application was consistent with this precedent.

Had the SEC in these cases not found Enron exempt from PUHCA, and the stringent requirements of PUHCA in fact been applied to Enron, it would theoretically have had a substantial effect on Enron's operations. Enron, for example, presumably would not have been able to own and operate a power marketing company, or to own other businesses that were not "reasonably incidental, or economically necessary or appropriate to the operations" of its public utility company, and it may have been subject to greater restrictions in issuing securities or engage in transactions among its affiliates. Indeed, had Enron otherwise failed to take action to remove itself from PUHCA jurisdiction, it could potentially have been subject to SEC efforts to simplify its structure. For this reason, however, it is also reasonable to expect that Enron, had the SEC made different determinations, would have gone to some lengths to restructure its business to avoid coming within PUHCA's restrictions.

In the remaining PUHCA matter, Enron filed an application with the SEC on April 14, 2000, for an exemption under section 3(a)(3) or, in the alternative, section 3(a)(5) of PUHCA. These provisions specify that the Commission may exempt from the requirements of PUHCA a company that is only "incidentally" a public utility holding company and is primarily engaged in other businesses[190] or a company that "derives no material part of its income" from companies the principal business of which is that of a public utility company.[191] From an SEC perspective, this request was unnecessary—as described above, Enron was already exempt from PUHCA under section 3(a)(1), the intrastate exemption provision. Nonetheless, Enron sought this exemption because doing so provided it with certain benefits before FERC.

Specifically, at about the same time that it was applying for this PUHCA exemption, Enron was in the process of repurchasing its interest in certain windfarms from, among others, an entity (RADR) allegedly controlled by Enron executives Andrew Fastow and Michael Kopper, to which Enron had sold a 50 percent interest in these windfarms in 1997. Under the Public Utilities Regulatory Policies Act of 1978 (PURPA), administered by FERC, and its associated implementing regulations, the windfarms were potentially "qualifying facilities" (QFs) that were eligible for certain economic benefits—but only if they were no more than 50 percent owned by a public utility or its holding company.[192] Because Enron owned a public utility (PGE), if it owned more than a 50 percent interest in the windfarms—which it proposed to do by buying out RADR's and others' interests—they would ordinarily not be eligible for QF status.[193]

[189] *See In the Matter of Southeastern Indiana Corp.,* 2 SEC 156 (1937) (holding that as long as the public utility business of a holding company's subsidiaries was confined to one State, the company could engage in non-utility activities in other States without losing its PUHCA exemption).

[190] 15 U.S.C. § 79c(a)(3).

[191] 15 U.S.C. § 79c(a)(5).

[192] *See* 16 U.S.C. § 796(18)(b); 18 C.F.R. § 292.206(b).

[193] The desire to preserve the projects' QF status is apparently what led Enron initially to sell a 50 percent interest in the windfarms to RADR when it acquired PGE in 1997. The sale and

What guaranteed these projects QF status, however, were FERC regulations that provided for an exception to the QF ownership rules when a company is exempt "by rule or order" under section 3(a)(3) or 3(a)(5) of PUHCA.[194] FERC's practice, moreover, was to treat a company's "good faith" application to the SEC for an exemption under these sections of PUHCA—unless and until it was denied by the SEC—to be sufficient to qualify for this PURPA exception.[195] Thus, merely by having an application pending with the SEC for a 3(a)(3) or 3(a)(5) exemption under PUHCA, Enron was able to preserve its windfarms' beneficial QF status.[196]

In its application to the SEC for the 3(a)(3) or 3(a)(5) PUHCA exemption and in its related communications with SEC staff, Enron made clear that its purpose was to get out from under FERC's QF ownership rules.[197] Enron noted that it had contracted to sell PGE and, if it did so, it would no longer be a "public utility holding company," and, accordingly, this would render the FERC QF issue moot. Enron strongly suggested that it had no interest in the SEC ruling on the exemption application before the sale of PGE was either completed or abandoned.[198] If the PGE sale went through, Enron, no longer in need of the PUHCA exemption, would withdraw its application; if not, it could pursue its request for an exemption at that time. In the interim, the pending application served to maintain the QF status of the windfarms and to enable Enron to acquire or develop new QFs.[199]

To this date, the SEC has not ruled on Enron's request for this exemption. Since Enron's initial application—which was amended in response to SEC staff's comments in August 2000—a number of relevant events, however, have transpired. To begin with, on April

---

repurchase of these interests and certain associated financial transactions (which is alleged to have resulted in significant payments to Fastow, Kopper, and others) formed part of the basis for the civil and criminal charges recently brought against Fastow and Kopper. *See* Complaint, *SEC v. Kopper,* Civ. Action No. H–02–3127 (S.D. Tex. August. 21, 2002); Information, *United States v. Kopper,* Cr. No. H–02–0560 (S.D. Tex. August 20, 2002); Complaint, *SEC v. Fastow,* Civ. Action No. H–02–3666 (S.D. Tex. Oct. 2, 2002); Criminal Complaint, *United States v. Fastow,* Cr. No. H–02–889–M (S.D. Tex. Oct. 1, 2002).

[194] 18 C.F.R. § 292.206(c)(1).

[195] *See Doswell Limited Partnership and Diamond Energy, Inc.,* 56 F.E.R.C. 61,170 (1997).

[196] *See, e.g.,* Notice of Self-Recertification of Qualifying Facility Status for Small Power Production Facility, August 3, 2000, *Zond Windsystems Holding Co.,* FERC Docket No. QF87–365 (notifying FERC that Enron, through its Zond subsidiary, had repurchased a 100 percent interest in a wind energy facility and that it had made a good faith application to the SEC for a PUHCA exemption). When no affected utility company raises objection, FERC accepts such self-recertifications without review. Committee staff meeting with FERC staff (September 6, 2002).

[197] Enron Corp. Form U–1, Application under the Public Utility Holding Company Act, SEC File No. 70–9661 (April 14, 2000); Letter from Joanne C. Rutkowski, LeBoeuf, Lamb, Greene & MacRae to Catherine A. Fisher, Assistant Director, Office of Public Utility Regulation, Division of Investment Management, Securities and Exchange Commission, dated April 13, 2000; *see also* Committee staff interview with SEC staff, Division of Investment Management (September 3, 2002).

[198] *Id.* In a 2001 presentation to SEC staff, Enron asserted that "the SEC and Enron agreed to delay pursuing a formal order on the Application pending the PGE sale." Enron Corp., "Alternative PUHCA Exemption for QF Relief–SEC Staff Presentation," July 27, 2001. SEC staff denied that there was such an agreement, but stated that it was nonetheless their priority to complete the regulatory review of the PGE sale before turning their attention to Enron's exemption application. Committee staff interview with SEC staff, Division of Investment Management (September 3, 2002).

[199] In its application to the SEC, Enron emphasizes its desire to bid to acquire additional QF assets and asserts that, without the exemption, it had been unable to do so. Enron Corp. Form U–1, Application under the Public Utility Holding Company Act, SEC File No. 70–9661 (April 14, 2000), at 8–9. FERC records evidence at least one case in which Enron has relied on its exemption application to the SEC in order to first obtain QF status for a wind power facility, rather than simply maintaining the existing QF status of such a facility. *See Green Power Partners I LLC,* FERC Docket No. QF00–96–000 (Notice of Self-Certification of Qualifying Facility Status for Small Power Production Facility, filed September 29, 2000).

26, 2001, Enron and Sierra Pacific terminated their agreement for the sale of PGE. Thereafter, on July 24, 2001, Enron submitted a further amended draft application, along with a letter setting forth Enron's request that the Commission now act on the application and issue an exemption order. A few days later, Enron met with SEC staff to discuss its revised application. After submitting this revised application, Enron then entered into another agreement to sell PGE, this time to Northwest Natural Gas Co. Announced on October 8, 2001, this agreement also eventually was terminated, on May 16, 2002. Finally, on March 26, 2002, Southern California Edison Co., which has long-term contracts with several Enron QF projects (and which is therefore paying higher rates than would be required if the projects were not considered QFs), filed a motion to intervene and opposition to Enron's application for an exemption. Southern California Edison argues, among other things, that Enron's collapse and resulting precipitous decline in revenue means that (whatever was the case previously) the income the company receives from PGE now constitutes a highly substantial portion of Enron's total income and so cannot be said to be nonmaterial or merely incidental as required by sections 3(a)(3) and 3(a)(5) of PUHCA.[200] Enron filed a response to Southern California Edison's motion on April 30, 2002, asserting that its exemption request was, and continues to be, in good faith and asking that any hearing on the exemption be deferred further until after the company's bankruptcy reorganization plan is adopted.[201]

Throughout the substantial changes that have occurred at Enron since the company's request for this PUHCA exemption was filed in April 2000—the collapse of one proposed deal to sell PGE, the entry into another such proposed deal and its termination, not to mention the bankruptcy of the whole company—Enron's exemption application has remained pending at the SEC and, as a result, the QF status of certain of its projects has remained intact, regardless of whether that status is actually merited. At no point has the SEC ruled on the application or, apparently, even asked that it be withdrawn in light of changes in circumstances. Perhaps more troubling is the fact that neither FERC nor the SEC has questioned whether the application was, or continues to be, in good faith, as FERC requires for it to serve as a basis for an exemption from the ordinary QF ownership requirements.[202] Thus, although the circumstances that Enron now finds itself in are radically different than when it first sought the exemption nearly 2½ years ago, and Commission staff are aware that Enron continues to rely on the application in

[200] Motion to Intervene and Opposition of Southern California Edison Company, March 26, 2002, *Enron Corp.,* SEC File No. 70–09661.

[201] Memorandum of Law in Response to Motion to Intervene and Opposition of Southern California Edison Company, April 30, 2002, *Enron Corp.,* SEC File No. 70–09661.

[202] Staff of each agency, in fact, disclaimed responsibility for doing so. The SEC, for its part, observed that the decision to rely on a good faith application was FERC's and suggested that it was up to FERC to determine if the application met that agency's standards for good faith. Committee staff interview with SEC Staff, Division of Investment Management (September 3, 2002). FERC, for its part, argued that the application was made to the SEC and that an attempt by FERC to determine whether such an application was in good faith before the SEC had a chance to rule on it would be preemptively second guessing in advance its sister agency's decision. Committee staff meeting with FERC staff (September 6, 2002). According to staff at both agencies, they did not discuss between the two agencies the pending application.

its FERC matters, the SEC has allowed the application to remain open throughout this period.

Had the SEC reviewed Enron's application earlier, it would not necessarily (or even likely) have led to the SEC's earlier discovery of the accounting misdeeds that lay behind the sale and repurchase of some of its windfarms.[203] The SEC's failure to take any action on Enron's application, however, may mean that Enron has been able to collect more money than the company is legitimately entitled to from ratepayers of utilities that purchased their electricity from Enron QFs. Moreover, the lack of coordination between the SEC and FERC permitted Enron to take full advantage of the gaps and overlaps in the agencies' jurisdiction and may have prevented the SEC from learning about the full context of the QF transactions.

4. Exemption from the Investment Company Act of 1940

On May 15, 1996, Enron and two of its subsidiaries, Enron Oil & Gas Company and Enron Global Power & Pipelines, L.L.C., filed with the SEC an application for an exemption from the Investment Company Act of 1940.[204] The Investment Company Act governs companies, such as mutual funds, that engage primarily in investing, reinvesting and trading in securities. It requires these companies to comply with certain disclosure requirements and places certain limits on the companies' investment activities and affiliate transactions; it also provides for a particular corporate structure.

At the time of the application, Enron's growing investments in foreign infrastructure projects threatened to bring it within the scope of the Act. Enron and its affiliates were engaged in developing numerous power plants, gas transmission lines and other infrastructure projects throughout the developing world and typically did so through the establishment of SPEs created specifically to operate these projects. For what Enron described as legitimate tax, liability and governance reasons—including the fact that certain countries prohibited foreign control of corporations in their jurisdictions—Enron generally did not own a majority interest in these entities. The Investment Company Act applies to a company that owns investment securities having a value exceeding 40 percent of the company's total assets. Securities of a subsidiary that is majority owned by the company are excluded from the definition of "investment securities" and do not count toward the 40 percent limit. Because the entities that operated the foreign infrastructure projects, however, were not majority owned by Enron or its affiliates, they would ordinarily be considered "investment securities," and, consequently, Enron and/or its affiliates, as their foreign infrastructure ventures expanded, would potentially be considered investment companies subject to the Act.

[203] *See* note 193 above. In contrast to FERC, with which Enron filed a request for recertification of the QF status of its windfarms in 1997 that described the sale transaction between Enron and RADR, *see* Request for Recertification of Qualifying Facility Status for Small Power Production Facility, May 14, 1997, *Zond Windsystems Holding Co.,* FERC Docket No. QF87–365–003, the SEC became involved in this matter only when the PUHCA exemption application was filed in 2000 in anticipation of that interest being repurchased. The exemption application submitted to the SEC did not address the windfarms' ownership issues.

[204] 15 U.S.C. § 80a–1 *et seq.* Enron subsequently added a third subsidiary, Enron International, Inc., to the application.

Enron initially sought an exemption from the Investment Company Act from Congress as part of what became the National Securities Markets Improvement Act of 1996,[205] but was unsuccessful.[206] Nonetheless, in its report on the bill, the House Committee on Energy and Commerce devoted three paragraphs to addressing this issue and appeared to urge the SEC to grant the exemption administratively. Specifically, the House Report noted that "the Committee supports appropriate administrative action by the [SEC] to prevent the Investment Company Act from having unintended and adverse consequences to U.S. companies in the business of developing or acquiring and operating foreign infrastructure projects"; that "the activities of U.S. companies involved in foreign infrastructure projects are not the sort of activities the Investment Company Act was designed to regulate"; and that, when exemptive relief was a requirement for investments in these projects, "the Committee expects the [SEC] to take administrative action expeditiously."[207] Although the SEC staff appears to have opposed the grant of a broad statutory exemption—they believed that a generally applicable exemption might lead to unpredictable results, that it might suggest that the Commission did not have the authority to grant such an exemption itself, and that it was better to proceed on a case-by-case basis—they did not object to Enron seeking similar relief through the SEC's own administrative procedures.[208]

Thus, as its next step, Enron filed its application with the SEC to obtain an exemption administratively.[209] Under section 6(c) of the Investment Company Act, the SEC has broad power to exempt a company from the provisions of the Act if the exemption is deemed to be in the public interest and consistent with investor protection and the purposes of the Act.[210] Staff in the Commission's Division of Investment Management met with Enron concerning its request for an exemption[211] and provided written comments on the application.[212] Enron subsequently submitted three amended applications.[213] A notice summarizing the penultimate version of the application was published in the *Federal Register* on February 24, 1997;[214] no comments on the application were received.[215] On March 13, 1997, the Division of Investment Management, acting

[205] Pub. L. No. 104–290.

[206] *See* Committee staff interview with SEC staff, Division of Investment Management (July 2, 2002); Committee staff interview with Barry Barbash, Attorney, Shearman & Sterling, and former Director of the Division of Investment Management, SEC (August 1, 2002); Committee staff interview with Craig Tyle, General Counsel, Investment Company Institute (June 24, 2002).

[207] H. Rept. No. 104–622, at 19 (June 17, 1996). The conference report, which included only a brief discussion beyond the final text of the bill itself, did not address this issue. *See* H. Rept. 104–864 (September 28, 1996).

[208] Committee staff interviews with SEC staff, Division of Investment Management (July 2, 2002), Barry Barbash (August 1, 2002), and Craig Tyle (June 24, 2002).

[209] Application for an Order of the Securities and Exchange Commission Pursuant to Section 6(c) of the Investment Company Act of 1940 Exempting Applicants from All of the Provisions of the Act, May 15, 1996, *In re Enron Corp., et al.,* SEC File No. 812–10150.

[210] 15 U.S.C. § 80a–6(c).

[211] SEC Response at 21.

[212] Letters from David W. Grim, Staff Attorney, Division of Investment Management, SEC to Robert Baird, Esq., Vinson & Elkins LLP, dated Sept. 17, 1996 and January 21, 1997.

[213] These were filed with the SEC on October 22, 1996, February 12, 1997, and February 21, 1997, respectively.

[214] 62 Fed. Reg. 8279. (The application was publicly released on February 14, 1997, but did not appear in the *Federal Register* until 10 days later).

[215] SEC Response at 119.

under delegated authority from the Commission, issued an order granting the application for exemption.[216]

Experts with whom Committee staff spoke disagreed about whether the exemption was appropriate.[217] Some suggested that investments in overseas ventures that Enron did not legally control posed substantial risks to shareholders of the sort that the Investment Company Act was specifically designed to protect against. Others argued that Enron was clearly an operating company, not a passive investor of the sort at which the Act was directed, and that the risks posed were associated with these operations. SEC staff, in addition to agreeing with the latter argument, also noted that because Enron's foreign infrastructure projects took the form of joint ventures, which are not considered investment securities, it was possible that Enron did not need the exemption at all.[218] The SEC further reported that similar exemptions were granted to companies engaged in foreign infrastructure projects both before and after it granted an exemption to Enron.[219]

Everyone with whom staff spoke about this issue, however, agreed that Enron, as an operating company (in contrast to a classic investment company, such as a mutual fund), could not have functioned within the strict constraints of the Investment Company Act. Nevertheless, as with PUHCA, even had Enron's application for an exemption been rebuffed, it is likely that Enron would have in some fashion restructured its operations to remain outside the Act's restrictions.[220]

Of more concern, therefore, than the initial grant of the exemption itself—which was not clearly erroneous and had some Congressional support—was the SEC's lack of any means to monitor the continued appropriateness of the exemption. The exemption grant was expressly conditioned on Enron not "hold[ing] itself out as being engaged in the business of investing, reinvesting or trading in securities" and on the foreign infrastructure projects not "differ[ing] materially from that described in . . . [the] Application."[221] It is unclear whether Enron violated these conditions. At minimum, however, as Enron's business evolved in the late 1990's and it became less of an energy company and more of a trading enterprise—dealing increasingly in derivatives, for example, rather

[216] *In re Enron Corp., et al.,* Investment Company Act of 1940 Release No. 22560, 1997 SEC Lexis 571.

[217] *See, e.g.,* Committee staff interview with Mark Sargent, Dean, Villanova University School of Law (July 29, 2002) (expressing concerns about the SEC decision to grant the exemption); Committee staff interview with Tamar Frankel, Professor, Boston University School of Law (July 29, 2002) (supporting the decision to grant the exemption).

[218] *See* SEC Response at 117–118 n. 25; Committee staff interview with SEC staff, Division of Investment Management (July 2, 2002); Committee staff interview with Barry Barbash (August 1, 2002). According to Barbash, Enron indicated that it sought a formal exemption because it felt that a private legal opinion that it was not an investment company given the joint venture nature of its projects would not provide it with sufficient certainty.

[219] *See* SEC response at 119, n. 28. Some of these exemptions were granted not under section 6(c) of the Investment Company Act but rather under section 3(b)(2), which allows for an exemption where a company is engaged in a business other than that of an investment company. 15 U.S.C. § 80a–3(b)(2).

[220] It can be argued, however, that if Enron had to restructure its operations through increasing its formal control over these foreign infrastructure projects (assuming it could have done so), this in and of itself may have decreased risk for the company's shareholders.

[221] *See In re Enron Corp., et al.,* Investment Company Act of 1940 Release No. 22560, 1997 SEC Lexis 571; Third Amended and Restated Application for an Order of the Securities and Exchange Commission Pursuant to Section 6(c) of the Investment Company Act of 1940 Exempting Applicants from All of the Provisions of the Act, February 21, 1997, *In Re Enron Corp., et al.,* SEC File No. 812–10150, at 31.

than tangible items—it arguably came closer to being an "investment company" as envisioned by the Act.[222] The SEC, however, had not incorporated any conditions into the exemption it granted that would have required Enron to demonstrate in the future that it still merited an exemption, and the SEC staff did not routinely follow up on their own. As a result, the changing nature of Enron's business and its relationship with its foreign infrastructure projects—a number of which have ultimately been linked to problems for Enron and its shareholders[223]—were left unexamined by the Commission.

III. RECOMMENDATIONS

Since the first Federal securities laws were passed in response to the 1929 stock market crash, oversight of the securities markets has been entrusted to a combination of public and private entities. In crafting the Securities Act of 1933, Congress expressly rejected the idea of direct government audits of companies' books. Reasoning that private sector controls would allow for a more efficient and flexible system of checks on wrongful conduct, our system of regulation relies in the first instance on boards of directors and private, independent auditors, responsible to shareholders and the public, respectively.

In the case of Enron—and the corporate collapses that have since followed—we have witnessed a fundamental breakdown in this system. Apparently, the SEC cannot rely on company auditors and boards of directors to assume the lion's share of responsibility for ensuring honest public disclosure of company finances, as assumed by the securities laws. Thus, although our investigation found no willful malfeasance by the Commission with respect to Enron, Committee staff has concluded that the Commission's largely hands-off approach to the company—combined with the failure of the auditors and board of directors to do their jobs—allowed inaccurate and incomplete information to flood the market, leading to significant financial losses for thousands of Enron employees and an even greater number of investors. Unfortunately, through the 1990's, the SEC had reason to question whether auditors and boards of directors were playing their appointed roles in the system—and, indeed, did question it—yet the Commission did little to adjust its own role to fill the gap. The failure of the SEC's approach became all too evident in its limited interactions with Enron—its lack of review of company financial statements that would have raised questions, for example, and its failure to monitor the effects of Enron's permitted shift to mark-to-market accounting.

---

[222] *See* Committee staff interview with Tamar Frankel (July 29, 2002).

[223] Some of these projects have garnered attention as having had substantial financial difficulties and/or having been used by Enron in dubious ways to enhance its financial statements. *See, e.g.,* Powers Report at 135–138 (detailing Enron's sale to, and subsequent repurchase from, the Fastow-controlled LJM1 partnership of an interest in an entity building a power plant in Cuiaba, Brazil, enabling Enron to avoid consolidating the entity on its balance sheet and to record as income projected proceeds from a gas supply contract Enron had with the project—as well as providing LJM1 with a substantial, and seemingly unjustified, return on its investment); Rebecca Smith and Kathryn Kranhold, "Enron Knew Foreign Portfolio Had Lost Value," *The Wall Street Journal*, May 6, 2002 (reporting that Enron's portfolio of foreign assets had lost as much as half of its value); Saitha Rai, "New Doubts on Enron's India Investment," *The New York Times*, November 21, 2001 (reporting on the history of problems at Enron's $2.9 billion Dabhol power plant); "Enron Spanned the Globe With High-Risk Projects; Deals Lost Money but Helped Hide Troubles," *The Washington Post,* February 16, 2002.

Accordingly, for our public-private method of oversight to continue to work effectively, significant improvements will need to be made. Tightening up the controls on the private gatekeepers is a key first step, and this effort is already underway. The recently enacted Sarbanes-Oxley Act provides, among other things, for an independent board, subject to SEC oversight, to oversee the practices of auditors,[224] prohibits auditors from engaging in much of the consulting work for their audit clients causing potential conflicts of interest,[225] and places additional obligations on corporate officers and directors.[226] Others are taking action in this area as well: The New York Stock Exchange, for example, recently announced additional listing requirements designed to force boards of directors to more effectively oversee the accounting practices of their companies.

Beyond imposing stricter standards on the private players, however, it is also critically important that the SEC enhance its effectiveness.[227] The SEC needs not only to find ways of improving its performance in its traditional roles of ensuring compliance with disclosure requirements and enforcing the laws against those who commit fraud, but also to work directly to uncover fraud, serving as a backstop when other parts of the system fail. The public rightly expects that the SEC will be there to ensure our capital markets are operating fairly.

Some of the necessary improvements at the SEC will require additional resources, as has already been contemplated in the Sarbanes-Oxley Act. More central, however, is the need for the Commission, in some measure, to reconceptualize its role as a more proactive force in protecting the marketplace against financial fraud. Based on our investigation, we believe, more specifically, that it is important the SEC take the following actions to more effectively protect investors and help restore public confidence in the markets:

Review More Filings and Review Them More Wisely and Efficiently. While most types of fraud cannot be detected simply through an examination of a company's periodic filings, a greater number of reviews (particularly of the right filings) nonetheless increases the chances of uncovering information that may lead to the discovery of wrongdoing. The increased likelihood that a company's filings will be reviewed can also deter certain misleading reporting practices. In large measure, this is a resource question—300 people are simply not enough to review a meaningful portion of the filings the SEC receives. Indeed, the relatively stable size of the SEC's workforce in the face of increasingly large and complex markets has been well-documented, including in a recent General Account-

[224] Pub. L. No. 107–204 §§ 101–109.

[225] *Id.* at §§ 201–209.

[226] *Id.* at §§ 301–308.

[227] On March 20, 2002, following GAO's call for the agency to engage in better strategic planning, the SEC announced that, with the help of an outside consulting firm, it was undertaking an ambitious, 4-month long study to examine "the Commission's operations, efficiency, productivity, and resources." "Pitt Announces Special Study of SEC Operations, Resources," SEC Press Release, March 20, 2002, available at http://www.sec.gov/news/press/2002–42.txt. The study was to be completed in August, with a report expected this fall. We commend the SEC for this self-examination, and look forward to its results.

ing Office study,[228] and additional resources—such as have been authorized in the Sarbanes-Oxley Act[229]—will undoubtedly have to be part of any solution.

The Sarbanes-Oxley Act now requires that the SEC review companies' periodic reports at least once every 3 years.[230] This is an important start, but regular reviews will not necessarily be enough. Rather, the Commission's challenge is to find better ways to identify those filings that need attention or that present higher risk to investors The SEC currently attempts to do this through its selective review criteria, as well as through certain ad hoc measures. Such measures include the creation in the late 1990's of an earnings management task force to identify and review those filings that had indicia of the sort of earnings management that former Chairman Levitt was publicly inveighing against at the time, as well as the Commission's recent decision to review the annual reports of the Nation's 500 largest companies. Though well-intentioned, there is little evidence that this relatively informal system has been particularly successful, and more sophisticated means of risk analysis appear to be needed.

A number of those with whom Committee staff spoke emphasized the importance of technology in this process.[231] Computer systems that can rapidly sift through large amounts of corporate data can be a valuable tool for SEC staff, enabling them to make more effective use of the available data and freeing staff up for less mundane tasks. Such systems, it was reported to us, are used by both auditing firms to spot problems with clients' financial reports and certain equity analysts seeking to identify vulnerable stocks.[232] The SEC currently employs what appears to be a basic version of such software in conjunction with its manual screening; it is in the process of upgrading to a more sophisticated system that will enable it to access a greater range of data and sort through it more easily and effectively.[233] While such technology will not eliminate the difficult task of identifying and continually revising the criteria for high-risk filings—nor the basic need to have capable, well-trained staff to review filings[234]—used wisely, it can potentially facilitate this selection process.

Look for Fraud. One of the reasons the SEC did not uncover much of the fraud that has been the subject of recent scandals is that it does little to proactively look for it. The public filing review

[228] U.S. General Accounting Office, "SEC Operations: Increased Workload Creates Challenges," GAO–02–302, March 2002.

[229] Pub. L. No. 107–204 § 601. Such additional resources have not yet been appropriated, however.

[230] Pub. L. No. 107–204 § 408(c).

[231] *See* Committee staff interviews with Lynn Turner (June 24, 2002), Arthur Levitt (June 7, 2002), and David Martin, Attorney, Covington & Burling and former Director of the Division of Corporation Finance, SEC (June 25, 2002).

[232] *Id. See also* Committee staff interview with Mark Roberts, Director of Research and Principal, Off Wall Street Consulting Group, Inc. (June 6, 2002). Roberts explained that it was through his firm's computer screening process that he was initially able to identify Enron as a company with potential problems.

[233] Committee staff interview with SEC staff, Division of Corporation Finance (June 25, 2002).

[234] The former SEC officials who raised the issue of technology in their interviews with Committee staff each also noted the importance of hiring high quality professionals and providing them with good training. *See* Committee staff interviews with Lynn Turner (June 24, 2002), Arthur Levitt (June 7, 2002), and David Martin (June 25, 2002). Though it is beyond the scope of this report, a discussion of employee turnover and other human capital challenges faced by the SEC can be found in U.S. General Accounting Office, "Securities and Exchange Commission: Human Capital Challenges Require Management Attention," GAO–01–947, September 2001.

process, as discussed above, is designed almost exclusively to assure compliance with disclosure requirements, not to catch wrongdoing. On the other hand, the enforcement process, though it can allow investigators to dig deeply to unearth the details of corporate malfeasance, does not come into play until there is already significant evidence of illegality and, generally, after much of the harm has been done. If the SEC is to play a role in finding and rooting out financial fraud—as we believe it should—it will need to make this an explicit goal and develop new processes to support it. Random or targeted audits, in the manner of the IRS, though requiring significant resources, are one possibility that can be applied more broadly for uncovering not only fraud in particular cases, but also identifying emerging trends in how fraud is being carried out.[235] The SEC has taken a more proactive approach in other areas, such as internet fraud, where it has established a group specifically dedicated to finding fraud on the web, and it subjects broker-dealers to periodic inspections. Whether any of these models can be applied to cases of complex financial fraud, or whether there is a new, more appropriate model that can be developed is something that the SEC, in light of the recent vulnerabilities displayed by other parts of the system, will need to explore. Though uncovering fraud will appropriately remain, in the first instance, the province of auditors, the SEC must play a meaningful part in fraud detection if it wishes to fulfill its role of ensuring the integrity of the markets.

Follow Up To Ensure That Commission Mandates Are Met. When SEC staff raises an issue of concern, there appears often to be inadequate follow-up procedures to ensure that the concern is addressed. With respect to the SEC's decision to permit Enron to switch to mark-to-market accounting, we saw that the conditions imposed by Commission staff—that Enron rely on market prices where available and other objective data where not—were in fact the right ones and, had they been followed, the abuses associated with the valuation of Enron's energy contracts might not have occurred. Yet, the SEC staff, having issued its decision and set forth the conditions, apparently never had any intention of checking to see if they were complied with; indeed, they had no mechanism for doing so. Rather, having informed Enron of the conditions, the SEC staff simply assumed that the company would abide by them. Similarly, after imposing conditions on Enron's exemption from the Investment Company Act, SEC staff never attempted to ascertain whether these conditions continued to be met or whether the exemption continued to be appropriate—and did not see it as their role to do so.[236]

The lack of follow through—either as a result of lack of resources or lack of priority—is apparent on a broader level as well. Thus, for example, in an effort to help get accurate information to inves-

[235] The Sarbanes-Oxley Act provides for the new accounting oversight board to conduct inspections of the auditors' work, which also may prove of assistance to the SEC in addressing issues of fraud control. *See* Pub. L. No. 107–204 § 104.

[236] In implementing follow-up procedures, moreover, the SEC needs to ensure that there is coordination between its various offices. An initial policy decision may be made by one division (the Office of Chief Accountant and the Division of Investment Management, respectively, in the examples above), while later monitoring of the company is conducted by another (generally, the Division of Corporation Finance).

tors in an era of earnings management and aggressive accounting practices, the Commission, both before and after the collapse of Enron, has proposed a variety of new disclosure requirements, or augmented existing requirements, including identification of critical accounting policies,[237] increased disclosure about off-balance sheet entities, the valuation of mark-to-market transactions and effects of transactions with related parties,[238] and additional items or events to be reported on, and accelerated filing of, Form 8–K (a so-called "current report").[239] Such enhanced disclosure requirements, if followed, may well provide additional and needed clarity for investors. Given the relatively small number of filings that are currently reviewed, however, the SEC staff is not in a position to ensure that these disclosure obligations are met. Merely issuing increasing numbers of edicts for disclosure without reviewing those disclosures or otherwise ensuring that the new requirements are complied with is unlikely to prove effective. As recent events amply demonstrate, the SEC cannot simply assume that all companies will comply with the letter and spirit of the law.

Supplement Aggressive Enforcement With Other, More Proactive Measures. Since the collapse of Enron, the SEC has announced a number of high-profile enforcement actions.[240] The SEC Chairman, moreover, has frequently stated his commitment to aggressively pursue wrongdoers, and has emphasized that SEC staff will pursue a policy of "real time enforcement"—that is, cases will be brought quickly, particularly when violations of law are ongoing.[241] Committee staff strongly supports these efforts to hold those who violate the securities laws accountable, and believes that the prompt punishment of wrongdoers is important not only in and of itself but also to deter future fraud.

We note, however, that large-scale financial frauds are perhaps the cases least amenable to real time enforcement. The complexities of such cases require a great deal of resources and the time to do a close review of the usually large number of pertinent docu-

[237] Disclosure in Management's Discussion and Analysis About the Application of Critical Accounting Policies, 67 Fed. Reg. 35620 (May 20, 2002); Cautionary Advice Regarding Disclosure About Critical Accounting Policies, Securities Act Release No. 8040, Exchange Act Release No. 45149 (December 12, 2001), 66 Fed. Reg. 65013 (December 17, 2001).

[238] Commission Statement About Management's Discussion and Analysis of Financial Condition and Results of Operations, Securities Act Release No. 8056, Exchange Act Release No. 45321 (January 22, 2002), 67 Fed. Reg. 3746 (January 25, 2002).

[239] Additional Form 8–K Disclosure Requirements and Acceleration of Filing Date, 67 Fed. Reg. 42914 (June 25, 2002).

[240] *See, e.g.,* "SEC Charges Adelphia and Rigas Family with Massive Financial Fraud," SEC Press Release, July 24, 2002, available at http://www.sec.gov/news/press/2002–110.htm; "SEC Announces Fraud Charges Against Former Rite Aid Senior Management," SEC Press Release, June 21, 2002, available at http://www.sec.gov/news/press/2002–92.htm; "Waste Management Found and Five Other Former Top Officers Sued for Massive Fraud," SEC Press Release, March 26, 2002, available at http://www.sec.gov/news/press/2002–44.txt. In conjunction with the Department of Justice, the SEC is also, of course, conducting a far-reaching investigation into the Enron collapse, and has thus far brought charges in one case. *See* "SEC Charges a Former High-Ranking Enron Official With Fraud," SEC Press Release, August 21, 2002, available at http:/ /www.sec.gov/news/press/2002–126.htm.

[241] *See, e.g.,* Harvey L. Pitt, Remarks Before the National Press Club (July 19, 2002), available at http://www.sec.gov/news/speech/spch577.htm; Harvey L. Pitt, Speech at the Fall Meeting of the ABA's Committee on Federal Regulation of Securities (November 16, 2001), available at http://www.sec.gov/news/speech/spch524.htm; Harvey Pitt, Remark at the PLI 33rd Annual Institute on Securities Regulation (November 8, 2001), available at http://www.sec.gov/news/speech/520.htm; Hearings Before the Subcommittee on Commerce, Justice, State, and the Judiciary, Senate Committee on Appropriations, 107th Cong., S. Hrg. 107—– (March 7, 2002) at— (Printed Hearing Record Pending) (Statement of the Honorable Harvey L. Pitt, SEC Chairman), available at http://www.sec.gov/news/testimony/030702tshlp.htm.

ments. Trying to shortcut this process may well lead investigators to overlook the most deeply hidden practices.[242] The Enron case itself demonstrates the array of complexities that a financial fraud case can present; even after months of intensive scrutiny, there continue to be fresh revelations about Enron's fraudulent practices.

The SEC's current emphasis on enforcement, moreover, needs to be accompanied by equally strong action on proactive measures related to prevention and detection. Enforcement alone cannot prevent shareholders from unfairly losing their money, and it can only address the cases where wrongful practices have already come to light. Moreover, an overemphasis on enforcement presupposes that the problems the markets face now are primarily due to individual bad actors. For these reasons, an approach that combines enforcement with other, more systemic remedies is necessary to fully restore public trust in the market and our system of oversight.

Coordinate Better With Other Agencies. In administering PUHCA, the SEC's responsibilities interact substantially with those of FERC under the Federal Power Act, PURPA and other statutes relating to public utilities and public utility holding companies. Thus, it is essential that the SEC and FERC coordinate their activities in these areas. Effective coordination between agencies helps ensure consistency in policy determinations and prevents companies from exploiting the lack of oversight in areas where neither agency may have taken full responsibility—as Enron did in using its PUHCA exemption application to the SEC to obtain regulatory benefits from FERC under PURPA.

Better communication between agencies can also enable each agency to more fully understand the context surrounding the companies and transactions that they are overseeing. Had the SEC staff consulted with FERC staff about Enron's 2000 application for a PUHCA exemption, they might have learned important additional information about some of the ultimate objects of that application, the windfarms, and the ownership transactions surrounding them—information that Enron had provided to FERC, but not to the SEC. Such knowledge may have informed the SEC's evaluation of Enron's application and, perhaps, other matters as well. More generally, improved coordination could provide each agency with the benefit of additional, complementary expertise in their regulatory and oversight efforts, with FERC lending its broader energy and utility industry knowledge to the SEC, and the SEC bringing its experience in market oversight to FERC, an agency responsible for overseeing an increasingly deregulated and market-based energy system.

Determine Why the SEC Did Not Act on Enron's PUHCA Application and Ensure That Such Oversights Do Not Happen Again.

---

[242] In cases of large-scale financial fraud, it may be easy to miss significant portions of the wrongdoing without a comprehensive review. In its recent investigation of accounting fraud at Xerox Corp, for example, the SEC had uncovered approximately $3 billion in improperly booked revenue at the time it settled the case in April 2002; 2½ months later, Xerox revealed in a restatement that, in fact, over $6 billion in revenue had been improperly accounted for. *See* Kathleen Day, "Xerox Restates 5 Years of Revenue; 97–01 Figures Were Off by $6.4 Billion," *The Washington Post,* June 29, 2002; Claudia H. Deutsch, "Xerox Revises Revenue Data, Tripling Error First Reported," *The New York Times*, June 29, 2002. *See also* Michael Schroeder and Greg Ip, "Imperfect Guardian: SEC Faces Hurdles Beyond Low Budget in Stopping Fraud," *The Wall Street Journal*, July 19, 2002 (noting problems that may arise from attempting to bring cases too quickly).

Under both Federal securities law[243] and FERC practice, companies may obtain immediate benefits by filing a "good faith" application for a PUHCA exemption with the SEC. Thus, the Commission's failure to act promptly on requests for PUHCA exemptions can provide significant, and potentially unwarranted, regulatory and economic benefits to companies that submit such applications. The handling of Enron's exemption application described above raises troubling questions about the Commission's treatment of such applications. The Commission should thoroughly investigate the handling of this exemption request to determine (1) whether it represents a pattern of delay that has provided unwarranted benefits to, or been abused by, applicants; and (2) whether, in this specific instance, Commission staff agreed to Enron's request to hold this matter in abeyance in order to facilitate Enron's regulatory goals before FERC. If either is found to be true, it would be very disturbing, and the SEC should take immediate action to correct the problem. Moreover, the Commission should ensure that a consistent practice of prompt review is in place to avoid any similar results in the future.

PART TWO: MORE WATCHDOGS—WALL STREET SECURITIES ANALYSTS AND CREDIT RATING AGENCIES

As discussed in Part I of this report, the story of Enron and the financial watchdogs was one of catastrophic failure—one in which all of those overseeing the company and providing information to the markets about the company's finances for a variety of reasons failed to get accurate information to investors. As this Part of the report explains, that oversight failure was not limited to entities with legal obligations to watch over the company in the name of the investing public, such as the SEC or the company's board of directors and auditors. Two other groups that provided information to the markets about Enron also failed to accurately report on the company's condition, again to the detriment of the investing public.

These groups—Wall Street securities analysts and credit rating agencies—hold themselves out as unbiased and accurate assessors of various companies' financial conditions, a view shared, at least until recently, by large parts of the investing public. Yet, as with the entities discussed in Part I, Enron revealed both groups to be not nearly so reliable as the general public perceived them to be. Instead, Enron's case proved Wall Street analysts to be far less focused on accurately assessing a company's stock performance than on other factors related to their own employers' businesses and the credit rating agencies to be far less diligent and attentive to fulfilling their functions than they should have been.

This Part examines the stories of Enron and the analysts and the credit raters, explores how and why entities whose mission is to accurately assess a company's financial health failed so completely to do so, and offers some suggestions for improving the system and

[243] *See* 15 U.S.C. § 79c(c) (providing that the filing of application for a PUHCA exemption in good faith "shall exempt the applicant from any obligation, duty, or liability imposed in this chapter upon the applicant as a holding company until the Commission has acted upon such application"; the subsection also provides that the Commission must grant, deny or otherwise dispose of the application "within a reasonable time" after receipt).

ensuring that these entities do better what they say they are doing.[244]

I. ENRON AND THE WALL STREET ANALYSTS

In his testimony before the Governmental Affairs Committee in a January 24, 2002 hearing, Arthur Levitt declared, "I think Wall Street sell-side analysis has lost virtually all credibility."[245] This is significant, because, according to the testimony of Frank Torres of Consumers Union in the Committee's February 27, 2002 hearing, "The Watchdogs Didn't Bark: Enron and the Wall Street Analysts," small investors "rely on the expertise of [Wall Street] analysts to digest raw data, to talk to insiders, to put together the recommendations. Analysts' research is likely to be the most detailed information some investors have."[246] And investors relied on the recommendations they got: The PBS news magazine *Now With Bill Moyers* profiled three Jupiter, Florida women who had formed an investment club about their loss of thousands of dollars they invested in technology stocks. One, Fraeda Kopman, said: "I think that we put a lot of emphasis on the work that the analysts were doing for the various brokerage firms. Especially the big ones. Because we believed in them. I guess we were very naïve. And we thought that that information was correct. They were the ones that were visiting the companies. So obviously, they would know a lot more than I would know by just reading about a company."[247]

Until the Enron story broke and questions started being asked in the mainstream media about why analysts were recommending the stock until just before the company collapsed, the average American investor probably did not know that analysts' recommendations were often more euphemism than dependable investment advice. Furthermore, until April 2002, when, after a year-long investigation, New York Attorney General Eliot Spitzer released e-mails sent by analysts within Merrill Lynch calling a stock they were recommending "a piece of junk" and worse, many Americans did not suspect that the recommendations might be influenced more by the amount of the investment banking revenue that company could provide than by the quality of the company.

Nearly all of the Wall Street analysts who covered Enron recommended Enron as a stock to buy—meaning that they were telling investors that the stock was undervalued—well into the fall of 2001, even as Enron's hidden partnerships were revealed, the SEC initiated its investigation, and Enron restated its financials going back more than 4 years. Most troublesome, though, is that during the period well prior to Enron's collapse, analysts recommended the stock to investors even though at least some of those same analysts admittedly did not understand how Enron, which was generally

[244] In contrast to the Committee staff's review of the SEC's interactions with Enron, Committee staff did not conduct an in-depth investigation of the sell-side analysts or the credit rating agencies. This section of the Report is instead intended as a broad summary of their story, based on the Committee's February 27, 2002 and March 20, 2002 hearings and staff interviews leading up to them, as well as other public sources.

[245] The Fall of Enron: How Could It Have Happened, Hearing Before the Senate Governmental Affairs Committee, 107th Cong., S. Hrg. 107–376 (January 24, 2002) at 34.

[246] The Watchdogs Didn't Bark: Enron and the Wall Street Analysts, Hearing Before the Senate Governmental Affairs Committee, 107th Cong., S. Hrg. 107–385 (February 27, 2002) at 56.

[247] Transcript, *Now With Bill Moyers,* May 31, 2002, available at http://www.pbs.org/now/transcript/transcript120—full.html.

recognized as a "black box," made its money. Many of these analysts worked for banks that derived large investment banking fees from Enron deals, invested in Enron's off-balance-sheet partnerships, and/or had significant credit exposure to Enron.

This section of the report gives an overview of the so-called sell-side analysts who covered Enron. It first describes the role such analysts are supposed to play, then describes the assessments of Enron by analysts who covered the company prior to its bankruptcy. Following that, the report outlines factors affecting the objectivity of sell-side analyst recommendations, and then suggests some solutions that can be implemented by the SEC to implement the mandates of the historic Sarbanes-Oxley Act and to enhance the independence and therefore the integrity of Wall Street stock recommendations.

A. *Investment Research Analysts*

There are three types of analysts who evaluate stocks: Sell-side analysts, buy-side analysts, and independent analysts.[248] Sell-side analysts work for broker-dealers that offer brokerage services, usually to both institutional and retail clients. Buy-side analysts work for institutional money managers, including mutual funds or hedge funds, counseling them on what securities to buy or sell. Some independent analysts work for a broker-dealer that does not offer any client services, such as investment banking services, but which instead makes commissions from the sale of securities through a third-party brokerage. Other independent analysts sell their research through a retainer or subscription agreement to clients, usually institutional money managers who can afford their large fees.

There is no consistent template for all analysts to follow, but sell-side analysts generally publish periodic reports on each company they cover. A report will contain an assessment of the company's business itself, where the company fits into the overall trends in its industry, and any current or possible future good points or problems. The report will probably have a recommendation on the stock, a variation of either buy, sell, or hold, with each firm using its own variations on these terms. For some firms, "buy" is their highest rating; for others, it is their third-tier ranking for a stock. Research reports may also provide a target stock price, which represents what the analyst believes the stock is worth based on his or her analysis of the company. Sometimes analysts set earnings estimates for companies, usually in the form of earnings per share, prior to the companies announcing their earnings. Sell-side analyst reports, while much more widely disseminated than other analyst reports, are not freely available to the public at large, at least not in their entirety. Such reports are generally available only to firm clients, either through brokers or through the firm's website; some firms also sell their research reports through other brokerages or services, where investors may pay a fee to have access to them. Beyond firm clients and paying customers, the average investor's access to an analyst's research in written form is generally limited to the recommendation, the earnings per share estimate, and the

[248] *See generally* "Analyzing Analyst Recommendations," SEC Online Publication For Investors, http://www.sec.gov/investor/pubs/analysts.htm. This report's description of analysts and their business is derived from this publication.

target price, which are widely published on the internet or are discussed in financial journals or on cable networks like CNN Financial News Network, which regularly interview analysts about trends and stocks.

As a part of their analysis, sell-side analysts—who generally cover a number of companies within one industry sector—will compile information about that industry and follow closely the developments of the corporations they follow. They participate in regular conference calls with and even attend on-site presentations by the companies they cover. They get to know the management of these companies. Outside of a company's officers, directors and auditors, the analysts who regularly cover a company are among the foremost experts on the operations of that company. Indeed, the SEC has recognized that securities analysts are important to efficient operation of the securities markets.[249] This is why the information they provide to the market can be so valuable and why analysts can serve as real market watchdogs. In an ideal world, their expertise and close scrutiny of corporate disclosures and financial statements should position them to notice where problems may be afoot and to challenge a company on the issues management would prefer to avoid.

B. *The Wall Street Analysts' Assessments of Enron*

The analysts who covered Enron, as a group, maintained an optimistic outlook on that company's prospects, even as the stock slid over the course of 2001. After reaching a high of $90.75 in August 2000, the stock's high in 2001—$84—occurred on the first trading day of the year; by the end of September, the stock closed at about $25, after a fairly consistent fall throughout the year. Nevertheless, Enron analysts retained their bullish stance: Of 15 sell-side analysts who covered Enron,[250] 13 had a buy or strong buy on August 7, 2001; on October 17, 2001, the day after the company announced a $1 billion charge to earnings and the day that *The Wall Street Journal* broke the story of Enron's financial shenanigans involving related-party transactions with partnerships headed by Enron's own chief financial officer, 15 out of 15 of the major analysts who covered Enron had a strong buy or buy rating on the stock.[251]

Strong Wall Street analyst support continued as the problems at Enron became increasingly apparent: On October 24, 2001, Chief Financial Officer Andrew Fastow resigned, and 12 of 15 securities analysts retained a buy or strong buy rating on the stock.[252] On October 31, when Enron announced that the SEC had opened up a formal investigation into the allegations in *The Wall Street Jour-*

[249] *See* Regulation Analyst Certification, SEC Release Nos. 33–8119; 34–46301; File No. S7–30–02 (July 25, 2002); 67 Fed. Reg. 51510 (proposed August 8, 2002) ("[t]he Commission has stated that analysts, who 'ferret out and analyze information,' play an important role in the securities markets").

[250] This list, provided by Thomson Financial, does not purport to include all the firms that covered Enron, but does include the largest. The 15 are: A.G. Edwards, Banc of America Securities, Bernstein, CIBC, Citigroup Salomon Smith Barney, Credit Suisse First Boston, FAC Equity, Fulcrum Partners, Goldman Sachs, J.P. Morgan Chase, Lehman Brothers, Merrill Lynch, Prudential, Sanders Morris, and UBS Warburg.

[251] *See* The Watchdogs Didn't Bark: Enron and the Wall Street Analysts, Hearing Before the Senate Governmental Affairs Committee, 107th Cong., S. Hrg. 107–385 (February 27, 2002) at 127 (Chart entitled "Enron Stock Recommendation By Broker, August 7, 2001 through December 7, 2001," derived from information provided by Thomson Financial).

[252] *Id.*

nal report, 10 analysts kept a buy or strong buy rating on the stock, even as the stock price had slid to $13.90, practically a third of where it had been at the beginning of that month.[253] On November 8, when Enron filed with the SEC a document indicating its intention to restate its financial statements going back more than 4 years due to shoddy accounting, disclosing that it would take a charge to earnings of approximately $500 million—about 20 percent of earnings during that period—these 10 analysts did not budge from their buy or strong buy ratings on Enron's stock, which by then had gone down to $8.41.[254]

On November 9, 2001, Enron announced a planned merger with Dynegy, and many hoped despite the company's burgeoning accounting problems that this merger could save the company. Over the next 3 weeks, it became apparent that the merger was not going to go through. On November 28, 2001, Enron's credit rating was reduced from investment grade to junk, and the merger with Dynegy was called off. Still, that same day, four analysts retained a buy or strong buy rating on Enron's stock.[255] On December 2, Enron declared bankruptcy. As of that date, only two analysts rated Enron as a sell. Seven firms rated Enron as a hold, and one still rated Enron a buy.[256]

In the Committee's February 27, 2002 hearing, four of the Wall Street analysts who had recommended Enron stock as a strong buy well into the fall of 2001 were invited to explain the basis for their belief in Enron's stock despite its consistent downward movement throughout 2001: Richard Gross of Lehman Brothers, Anatol Feygin of J.P. Morgan Chase, Curt Launer of Credit Suisse First Boston, and Raymond Niles of Citigroup Salomon Smith Barney.

As late as October 24, 2001, Richard Gross of Lehman Brothers rated Enron stock as a strong buy, Lehman's highest rating, which is supposed to mean that the stock will outperform the market by 15 percent over the next year.[257] On October 16, 2001, after Chairman and CEO Ken Lay announced that Enron was taking a $1.2 billion charge to shareholder equity, Gross apparently remained unconcerned. He was quoted as saying: "The end of the world is not at hand. . . . We think investors should rustle up a little courage and aggressively buy the stock."[258] In his last report on Enron, dated October 24, 2001, Gross acknowledged growing concerns about Enron as its liquidity was waning and the scandal was mounting, but he maintained his strong buy rating on the stock.[259] Gross kept his strong buy rating on Enron until he dropped coverage of it on December 7; according to Gross, he could not reconsider his recommendation as of late October because Lehman was advising Dynegy on its proposed merger with Enron, and he had been brought in to assist the Lehman investment bankers in their work.[260]

---

[253] *Id.*
[254] *Id.*
[255] *Id.*
[256] *Id.*
[257] Information provided by Thomson Financial.
[258] Ben White, "Analysts Faulted For Forecasts," *The Washington Post,* January 11, 2002.
[259] Lehman Brothers Research Report on Enron Corp., October 24, 2001.
[260] Committee staff interview with Richard Gross, February 13, 2002. When an analyst assists the investment banking department in a transaction, the details of which are not yet public, that analyst, because of his or her exposure to this confidential information, cannot publicly

Anatol Feygin of J.P. Morgan maintained a buy recommendation—J.P. Morgan's highest rating—on Enron until October 24, 2001, when Andrew Fastow resigned as Enron's Chief Financial Officer amid the growing scandal. At that point, Feygin downgraded Enron to a long-term buy,[261] which by J.P. Morgan's definition meant that he expected the stock to maintain its value or grow by 10 percent over the next year.[262] In that report, Feygin indicated that "the appearance of impropriety" had caused "damage" to Enron's stock price, and that he agreed that "investors are justified in their reservations to buy" the stock at that point.[263] Nevertheless, the next day, Feygin wrote in a report that "we continue to have full faith in the propriety of Fastow's involvement with the controversial off-balance sheet financing vehicles. . . ."[264] Feygin retained the long-term buy rating on Enron until J.P. Morgan dropped coverage of Enron on November 29, 2001,[265] the day after the proposed merger with Dynegy fell apart.

Until October 26, 2001, by which time Enron's stock price had fallen to a closing price of $15.40, Raymond Niles of Citigroup Salomon Smith Barney recommended Enron stock as a buy, his firm's highest rating.[266] At that time, he downgraded it two levels to neutral,[267] which indicated, under Salomon Smith Barney's definition, that the stock price should stay steady over the following 12 months.[268] The day prior to the downgrade, Niles expressed confidence that Enron would survive and prosper once the scandal died down: "We are long term believers in the Merchant Energy story [Enron's trading business] and Enron." He added that the likelihood that "lingering uncertainty over financial practices may begin to impair Enron's commercial operations" was low with a "probability [of] 10 percent–15 percent."[269] When he downgraded his rating to neutral, Niles reaffirmed that he "continue[d] to think [Enron's growth] is the most likely outcome," although he acknowledged "a now higher probability 'worst case' outcome."[270] Although he retained the neutral rating, in his November 14, 2001 report, Niles expressed an expectation that Enron's stock price would go up due to the merger.[271] Even after Enron declared bankruptcy, Salomon Smith Barney maintained its "hold" rating on Enron.[272]

Curt Launer of Credit Suisse First Boston ("CSFB") rated Enron a strong buy, CSFB's highest rating, until November 29, 2001.[273]

speak about that company either until the transaction becomes public or until the transaction is abandoned. Referring to the so-called "Chinese" or ethical wall that exists between the research division and the investment banking division of a firm—which is generally set up to prevent such information from leaking to analysts, who might disclose it publicly before the company intends it—analysts are said to be "brought over the wall" when they assist in confidential investment banking transactions.

[261] J.P. Morgan Research Report on Enron Corp., October 24, 2001.

[262] Information provided by Thomson Financial.

[263] J.P. Morgan Research Report on Enron Corp., October 24, 2001.

[264] J.P. Morgan Research Report on Enron Corp., October 25, 2001.

[265] The Watchdogs Didn't Bark: Enron and the Wall Street Analysts, Hearing Before the Senate Governmental Affairs Committee, 107th Cong., S. Hrg. 107–385 (February 27, 2002) at 127.

[266] *Id.*

[267] *Id.*

[268] Information provided by Thomson Financial.

[269] Salomon Smith Barney Research Report on Enron Corp., October 25, 2001.

[270] Salomon Smith Barney Research Report on Enron Corp., October 26, 2001.

[271] Salomon Smith Barney Research Report on Enron Corp., November 14, 2001.

[272] The Watchdogs Didn't Bark: Enron and the Wall Street Analysts, Hearing Before the Senate Governmental Affairs Committee, 107th Cong., S. Hrg. 107–385 (February 27, 2002) at 127.

[273] *Id.*

On September 10, 2001, Launer concluded, based on his "analysis, discussions with management and reviews of recent filings" that "there is no truth" to the speculation in the market that Enron might have to restate earnings from prior quarters due to misplaced investments.[274] Despite the fact that it appears that management may have misled him on this point—Enron did have to restate earnings—Launer continued to believe in the company. In his October 19 report, Launer wrote that "the so-called LJM Partnerships were fully disclosed in Enron's financial statements and were subject to appropriate scrutiny by Enron's board, outside auditors and outside legal counsel. . . . Considering the disclosures made and the appropriateness of the accounting treatment . . . we anticipate that the negative sentiment surrounding these issues will dissipate over time."[275] In his October 29 report, Launer reiterated his confidence that no restatement would be required (although one did come just over 1 week later); moreover, despite the fact that Enron had just drawn down $3 billion in credit (exhausting its available credit lines), Launer stated that he viewed Enron's "credit ratings and balance sheet issues as unlikely to worsen materially."[276] On November 29, Launer downgraded Enron to a hold.[277] At that point, the proposed merger had fallen through and Enron's stock price had fallen to a close of 36 cents.

Despite the sell-side analysts' enthusiastic recommendations of Enron's stock throughout 2001, other observers correctly questioned whether Enron was a good investment. In the March 5, 2001 edition of *Fortune,* reporter Bethany McLean asked the question, "Is Enron Overpriced?" As she presciently noted, "It's in a bunch of complex businesses. Its financial statements are nearly impenetrable. So why is Enron trading at such a huge multiple [of earnings per share]?"[278] In her story, analysts joked about Enron's opaque financial statements; even analysts from credit rating agencies Standard & Poor's and Fitch said they could not figure out Enron's numbers. McLean warned that "the inability to get behind the numbers combined with ever higher expectations for the company may increase the chance of a nasty surprise." She quoted the J.P. Morgan equity strategist Chris Wolfe, Goldman Sachs analyst David Fleischer, and Bear Stearns analyst Robert Winters—all of whom believed in Enron—admitting that they could not piece together how Enron made its money.

The problem was that all along, even though Enron consistently beat earnings estimates by analysts by at least a penny per share, Enron simply was not providing answers to the questions about where its profits were coming from. As McLean reported in March 2001, Enron was giving two responses to concerns about its lack of transparency: (1) Enron's business is complicated and it would not take the time to explain it; and (2) how Enron made its money was "proprietary information, like Coca-Cola's secret formula."[279] Despite this lack of transparency—Enron's now infamous "black box" quality—and despite the company's falling stock price, analysts

[274] Credit Suisse First Boston Natural Gas & Power Research Report, September 10, 2001.
[275] Credit Suisse First Boston Research Report on Enron Corp., October 19, 2001.
[276] Credit Suisse First Boston Natural Gas & Power Research Report, October 29, 2001.
[277] Credit Suisse First Boston Research Report on Enron Corp., November 29, 2001.
[278] Bethany McLean, "Is Enron Overpriced?" *Fortune,* March 5, 2001.
[279] *Id.*

continued to recommend the company as a buy or strong buy. Particularly ironic was the comment of Carol Coale, an analyst at Prudential, after she was the first Wall Street analyst to downgrade Enron to a sell on October 24, 2001: "The bottom line is, it's really difficult to recommend an investment when management does not disclose the facts." [280]

Some independent analysts also questioned Enron's value well prior to its demise. A *Forbes.com* study found that, in contrast to sell-side analysts, six of eight independent investment newsletters were recommending that Enron stock be sold prior to November 2001—three as early as March or April 2001.[281] In a May 6, 2001 research report—nearly seven months before Enron's bankruptcy—the Off Wall Street Consulting Group, an independent research firm based in Cambridge, Massachusetts, suggested that Enron's stock was worth less than half of its then $60 price.[282] Off Wall Street pointed out that Enron's profit margins were declining and would likely continue to decline because, although the revenues from its trading operation—its most profitable division—were increasing, that division's actual profits were shrinking due to growing liquidity and less volatility in the energy markets.[283] Low return on capital was also a bad sign to Off Wall Street that Enron was not getting the benefit it should from its assets and investments.[284] Off Wall Street also expressed concern about Enron's heavy reliance on related-party transactions—including the fact that one of the entities with which Enron was trading was headed by CFO Andrew Fastow and the fact that sales to a related party of dark fiber (optical cable not in use) improved earnings in the previous quarter by 4 cents per share, allowing Enron to exceed earnings expectations.[285] Off Wall Street believed—correctly, it turned out—that Enron was resorting to the related-party transactions—transactions with entities controlled by Enron insiders or subsidiaries—to improve earnings appearance, and resorted to them more and more as profits became more elusive.[286] On August 15, 2001, Off Wall Street issued another report on Enron, noting that Enron was selling off assets and booking the payments as income to improve the appearance of profitability in its trading division in the second quarter; meanwhile, Enron was refusing to reveal how much profit it was booking from the sales, so analysts were unable to determine how much of its profits were recurring (from their business, a sign of health), as opposed to non-recurring (from one-time deals, booster-shots to earnings).[287]

An even earlier skeptic of Enron was James Chanos, President of Kynikos Associates, a New York investment firm. Chanos began

---

[280] Alex Berenson and Richard A. Oppel, Jr., "Once Mighty Enron Strains Under Scrutiny," *The New York Times*, October 28, 2001.

[281] "Enron: An Unreported Triumph For Investment Letters," *Forbes.com,* December 7, 2001, available at http://www.forbes.com/2001/12/07/1207newsletterwatch.html.

[282] Off Wall Street Consulting Group, Inc., Research Report Regarding Enron, May 6, 2001 at 1. In that report, Off Wall Street valued Enron, which was at the time trading at nearly $60 per share, at $30 per share and recommended that its clients sell the stock at the then-current levels.

[283] *Id.* at 3.

[284] *Id.* at 7.

[285] *Id.* at 10–11.

[286] *Id.* at 11, 13.

[287] Off Wall Street Consulting Group, Inc., Research Report Regarding Enron, August 15, 2001.

to research Enron after reading a piece in the Texas regional edition of *The Wall Street Journal* on September 20, 2000, entitled "Energy Traders Cite Gains But Math Is Missing,"[288] questioning whether Enron's profits, which were largely non-cash, were inflated by accounting tricks.[289] Chanos, like Off Wall Street, was concerned about low return on capital, large and frequent insider stock sales, and the general opacity of the company's financial statements. Chanos began shorting Enron's stock—a bet that its price would go down—in November 2000. (Although Enron's stock price actually stayed fairly stable at the $70 to $80 range from November through February 2001, in March 2001, Chanos' bets started paying off—the stock price started to decline steadily).

There were other market participants who were doubtful of Enron's prospects—after all, its stock price was falling throughout 2001. Howard Schilit, President of the independent research firm Center for Financial Research and Analysis, testified at the Committee's February 27 hearing that there were a number of red flags that would have been revealed by a mere perusal of the financial statements. Although Dr. Schilit did not cover Enron prior to its collapse, he testified that he reviewed the financial statements of the company for 1 hour on the evening prior to his testimony and took down "three pages of warnings" that there were problems at Enron, "words like 'non-cash sales,' words like '$1 billion of related party revenue.'"[290] Dr. Schilit told the Committee that "for any analyst to say there were no warning signs in the public filings, they could not have read the same public filings that I did."[291]

Despite these red flags, nearly all the sell-side analysts who covered Enron were bullish on the stock. The analysts who testified at the Committee's February 27 hearing insisted that their conclusions about Enron were based on what they saw as positive performance by the company over the course of years.[292] They cited Enron's increasing revenue, its "strong" business model, and its impressive "bench" of capable managers.[293] The analysts maintained that their support for Enron was reasonable given the information that was publicly available and the information they had been given by the company itself.[294] In short, they argued that they had been misled, just like everyone else. Although prospects for the company may have dimmed by early November 2001, as more questions arose about Enron's related-party transactions, its Chief Financial Officer resigned and Enron announced it was restating its financial statements going back more than 4 years, the analysts said that they believed that the prospective merger with Dynegy,

---

[288] *See* note 46 above and accompanying text.

[289] Scott Sherman, "Enron: Uncovering the Uncovered Story," *Columbia Journalism Review,* March/April 2002.

[290] The Watchdogs Didn't Bark: Enron and the Wall Street Analysts, Hearing Before the Senate Governmental Affairs Committee, 107th Cong., S. Hrg. 107–385 (February 27, 2002) at 40.

[291] *Id.* It should be noted that stock analysts, in contrast to government regulators such as the SEC, are not necessarily looking just for fraud in a company's public filings, but also for signs that a company's stock is overvalued. Therefore, what should be "red flags" to an analyst looking at whether a company has problems may or may not also be indicia of fraud. *See* Committee staff interview with Scott Budde, Director, Equity Portfolio Analytics, TIAA–CREF (July 26, 2002).

[292] The Watchdogs Didn't Bark: Enron and the Wall Street Analysts, Hearing Before the Senate Governmental Affairs Committee, 107th Cong., S. Hrg. 107–385 (February 27, 2002) at 25, 26, 69, 84.

[293] *Id.* at 26, 69.

[294] *Id.* at 22, 38, 78–79, 85.

made public on November 8, was a positive development that they thought would have averted the company's collapse.[295] They also cited instances of what they believed to be affirmative misrepresentations by the company to dupe them into seeing Enron in a more positive light. For example, Curt Launer of CSFB testified that in January 1998, he along with 100 other analysts visited Enron to view the new trading floor of Enron Energy Services, Enron's retail business. Impressed at the time, Launer since learned from news reports that the trading floor had apparently been entirely staged.[296] (Enron executives, including former CEO Jeffrey Skilling, deny this.) As Launer of CSFB put it, "[H]indsight allows a view that I as an analyst never had. I based my views and ratings on the information that was available every step of the way."[297]

Nevertheless, Chanos, the independent research firm Off Wall Street, and those investment newsletters counseling their readers to sell Enron in Spring 2001 came to their conclusions about Enron based on the same public information that the sell-side analysts relied on; one might wonder why these Wall Street analysts, who made their careers following the energy sector and companies like Enron, missed what Off Wall Street, Chanos, and the investment newsletters saw. This is particularly the case given that at least some of these analysts knew of Off Wall Street's and Chanos' reasoning about Enron and yet still remained firm that Enron was a strong buy. In a May 9, 2001 report by *The Street.com* on the May 6, 2001 Off Wall Street research report advising clients to sell Enron stock, the reporter shared the research report on Enron with an unnamed Wall Street analyst bullish on Enron. That Wall Street analyst expressed his view that Off Wall Street misunderstood the energy markets, but agreed that Enron's heavy use of related-party transactions was troubling, remarking, "Why are they doing this? It's just inappropriate."[298] At the Committee's February 27 hearing, Curt Launer of CSFB testified that he had "made it a practice throughout [his] career not to use other research reports written by anybody," but acknowledged that he was aware of the points made by Off Wall Street about Enron, which had been brought to his attention by institutional investors. Launer felt that the Off Wall Street objections to Enron "were relatively easy to answer analytically through our own work," and accordingly he dismissed them.[299]

Launer and Niles similarly dismissed Chanos' work in early 2001. Chanos testified before the House Energy and Commerce Committee on February 6, 2002 that he met sometime early in 2001 with the analysts covering Enron from CSFB and Salomon Smith Barney, and he questioned them about their unwavering support for the company in the face of the red flags that led Chanos to sell the stock short. Chanos testified: "[T]hey saw some troubling signs. They saw some of the same troubling signs we saw.

---

[295] *Id.* at 70–71.
[296] *Id.* at 19.
[297] *Id.*
[298] Peter Eavis, "Why One Firm Thinks Enron Is Running Out of Gas," *TheStreet.com,* May 9, 2001, available at http://www.thestreet.com/comment/detox/1422781.html.
[299] The Watchdogs Didn't Bark: Enron and the Wall Street Analysts, Hearing Before the Senate Governmental Affairs Committee, 107th Cong., S. Hrg. 107–385 (February 27, 2002) at 27.

. . . A year ago management had very glib answers for why certain things looked troubling and why one shouldn't be bothered by them. Basically that's what we heard from the sell-side analysts. They sort of shrugged their shoulders. . . . [O]ne analyst said, 'Look, this is a "trust me" story.' "[300] Launer and Niles confirmed at the Committee's February 27, 2002 hearing that they each met with Chanos and had this conversation. However, in their testimony before the Committee, neither indicated that they had had concerns about "troubling signs" in early 2001, and neither suggested that their view on Enron was based on "a trust me story." Rather, they testified that they formed their opinions of Enron based on what they believed was the strong "core business" of the company.[301]

The investigation by the New York Attorney General involving internet stock analysts at Merrill Lynch, the results of which were first announced in April 2002, offers an inside look into other cases where analysts have produced rosy reviews of overvalued stocks, even when they privately doubted them. New York Attorney General Eliot Spitzer conducted a 10-month investigation into the recommendations by the internet analysts at Merrill Lynch from 1999 through 2001.[302] He found that although they were wholeheartedly endorsing stocks of companies like InfoSpace, Excite@Home, GoTo.com, and Lifeminders, all with long-term ratings of "buy" and short term ratings of, at worst, "neutral," the Merrill research analysts were internally saying that these equities were a "piece of junk" (InfoSpace), "piece of sh-t" (Lifeminders), "nothing interesting about the company except banking fees" for Merrill (GoTo.com) and "such a piece of crap" (Excite@Home).[303] Based on these findings, Spitzer brought an injunctive proceeding against Merrill in New York State Supreme Court under the Martin Act, a provision of New York law that prohibits any fraud or deception relating to securities while engaged in the purchase, sale, or distribution of, or in making investment advice regarding, those securities in New York. In May 2002, Merrill settled with Spitzer, agreeing, among other things, to reform its research department practices and to pay penalties of $100 million.[304]

C. *Factors Affecting the Objectivity of Sell-Side Analyst Recommendations*

Overly rosy stock recommendations by sell-side analysts were not unique to Enron. Instead, Wall Street analysts have long exhibited a clear bias towards rating stocks a "buy." Charles Hill, Director of Research at Thomson Financial/First Call, testified at the Committee's February 27, 2002 hearing that, in 2001, about two-thirds of sell-side analysts' recommendations were "buys," about one-third were "holds," and less than 2 percent were sell recommenda-

[300] Developments Relating to Enron Corp., Hearing Before the House of Representatives Energy and Commerce Committee, 107th Cong., Hrg. No. 107–83 (February 6, 2002) at 133.
[301] The Watchdogs Didn't Bark: Enron and the Wall Street Analysts, Hearing Before the Senate Governmental Affairs Committee, 107th Cong., S. Hrg. 107–385 (February 27, 2002) at 22.
[302] Affidavit in Support of Application for an Order Pursuant to General Business Law Section 354, by Eric Dinallo, April 8, 2002, *Spitzer v. Merrill Lynch, et al.,* New York Supreme Court, County of New York, Index No. 02–401522 ("Dinallo Affidavit") at 2–3.
[303] *Id.* at 13.
[304] "Spitzer, Merrill Lynch Reach Unprecedented Agreement to Reform Investment Practices," Press Release, Office of New York State Attorney General Eliot Spitzer, May 21, 2002.

tions.[305] If taken at their word, this would mean that analysts believe that less than two of every 100 companies will experience a fall in stock price in the coming months; the rest would either stay constant or go up. This seems unlikely and especially questionable given that over the past 2 years, as sell-side analysts' recommendations have remained basically consistent, the S&P 500 index has fallen from over 1,500 to the lows we are seeing now. One explanation for this optimism—and the optimism of the Enron analysts—is that the context in which sell-side analysts work has built-in conflicts and pressures that discourage sell recommendations and encourage buy recommendations.

As David Becker, former General Counsel of the SEC, said in a speech last year: "Let's be plain: broker-dealers employ analysts because they help sell securities. There's nothing nefarious or dishonorable in that; but no one should be under any illusion that brokers employ analysts simply as a public service."[306] This ability to help sell securities affects the business of the analysts' employers on a number of fronts. Most significantly, analysts' recommendations can affect their firms' investment banking relationships in either a positive or negative way. Even though analysts and investment bankers are supposed to be separated by a so-called "Chinese" or ethical wall, this wall is not per se mandated by rule or law, and to the extent that it does exist at Wall Street firms, it exists mainly to protect non-public material information learned by bankers in the course of deals from being given to the analysts, who might be tempted to use it in making their assessments, which might violate insider trading laws.[307] Therefore the wall is mainly set up—if it exists at all—to protect the bankers and the companies, not the independence of the analysts. For example, many investment banks invested in the partnerships run by Enron CFO Andrew Fastow while the analysts working for those firms were recommending Enron stock; the firms could not share information about the fact or operation of these partnerships with the analysts due to confidentiality agreements. Columbia University Law School Professor John Coffee called this an example of "the Chinese wall working to injure public investors, rather than benefit them."[308] Moreover, despite this wall, analysts are still influenced by investment banking considerations.[309]

[305] The Watchdogs Didn't Bark: Enron and the Wall Street Analysts, Hearing Before the Senate Governmental Affairs Committee, 107th Cong., S. Hrg. 107–385 (February 27, 2002) at 109. From March 2002 to May 2002, there was an increase in the proportion in sell recommendations, according to Thomson Financial, to 2.5 percent; this was largely due to the poor performance of the market in general, although it was also due to Morgan Stanley's revision of its rating system, which resulted in 22 percent of its ratings being in the lowest category—underweight, which is the equivalent of a sell recommendation. *See* Kathleen Pender, "Less Bull on Wall Street? What The Settlement With Merrill Lynch Means For Investment Research," *San Francisco Chronicle,* May 23, 2002.

[306] David Becker, "Analyzing Analysts," Remarks Before the Committee on Federal Regulation of Securities of the American Bar Association, August 7, 2001, available at http://www.sec.gov/news/speech/spch510.htm.

[307] *See* Marc I. Steinberg and John Fletcher, "Compliance Programs For Insider Trading," 47 SMU L. Rev. 1783, 1804 (July-August 1994).

[308] Kurt Eichenwald, "Investors Lured to Enron Deals By Inside Data," *The New York Times*, January 25, 2002.

[309] In addition to the evidence uncovered by the New York Attorney General in his Merrill investigation, *see, e.g.,* Roni Michaely and Kent L. Womack, "Conflict of Interest and the Credibility of Underwriter Analyst Recommendations," *Review of Financial Studies,* vol. 12, no. 4, 653–686 (1999) at 683 (finding that analysts were less accurate and more optimistic in rec-

Continued

Most broker-dealers who offer investment banking services make much if not most of their profits from these services, which include such things as underwriting securities offerings or advising on mergers, acquisitions, or sales of businesses. Because fees from these services can be quite high, banks compete fiercely for these deals. Companies—particularly companies like Enron that have a lot of investment banking business[310]—are unlikely to choose as their business partner a bank whose analyst is criticizing their stock, and banks are unlikely to appreciate analysts who issue recommendations that hamper their ability to obtain lucrative deals. For example, as the Senate Permanent Subcommittee on Investigations recently showed in its July 30, 2002 hearing, "The Role of the Financial Institutions in Enron's Collapse," a memorandum from investment bankers at Merrill Lynch to its President indicated that Enron was pressuring Merrill Lynch to improve its rating in 1998, by threatening to withhold investment banking business. Soon thereafter, the analyst responsible for reporting on and rating Enron left Merrill, and was replaced by another analyst who immediately changed Enron's rating to a buy.[311]

In the New York Attorney General's investigation of Merrill, the evidence indicates that Merrill used its research department to sell its investment banking services to companies, essentially promising that positive ratings from the influential Henry Blodget, Merrill's lead internet analyst, would be used to convince investors to invest in those companies, increasing their stock price. One e-mail from a banker to an analyst at Merrill made clear their strategy: "We should aggressively link coverage with banking—that is what we did with [a prior client] (Henry [Blodget] was involved) . . . if you are very bullish . . . we can probably get by on a 'handshake.'"[312] Indeed, Blodget estimated that his group would spend at least 50 percent of their time on investment banking matters. In one e-mail, Blodget essentially conceded that the main driver behind his group's ratings was investment banking concerns; frustrated about negotiations with the investment banking group about a rating for one particular company, Blodget threatened to "just start calling the stocks (stocks not companies), including [the one at issue], like we see them, no matter what the ancillary business consequences are."[313]

Indeed, given the importance of investment banking fees to the firms, and the effect ratings can have on client relationships, it should not be surprising that many analysts have, as a matter of practice, shared their research with the companies they cover prior to issuing the reports. The SEC found in a survey conducted last year that six out of nine investment banks studied had analysts give companies, as well as the investment bankers at the analyst's firm who work with those companies, advance notice of any pend-

---

ommendations regarding client companies after initial public offerings than analysts from firms that were not involved in IPO).

[310] According to information provided to the Committee by Thomson Financial, Enron did about 30 securities offerings in 2000–2001.

[311] The Role of Financial Institutions in Enron's Collapse, Hearing Before the Permanent Subcommittee on Investigations, Senate Governmental Affairs Committee, 107th Cong., S. Hrg. 107-618 (July 30, 2002) at— (Printed Hearing Record Pending) (Statement of Subcommittee Chairman Carl Levin), available at http://www.senate.gov/?gov—affairs/073002levin.htm.

[312] Dinallo Affidavit, note 302 above, at 15.

[313] *Id.* at 19.

ing change in their recommendation status.[314] In March 2001, a memo from the head of European equities research at J.P. Morgan Chase was leaked to the press, which set forth this policy with the additional requirement that the analyst incorporate any change requested by the company unless he or she can make an argument why the change should not be made, calling it "a communication process," not an "approval process."[315] Anatol Feygin, the J.P. Morgan Chase analyst who testified at the Committee's February 27, 2002 hearing said that the rules reflected in the March 2001 memo did not apply for U.S. research analysts at J.P. Morgan. Nevertheless, a J.P. Morgan Chase Vice President in the United States commented to the press that providing advance notice to companies of a change in their rating was standard operating procedure on Wall Street.[316] At Merrill, despite a policy that analysts were not to disclose proposed investment ratings to company management, the internet group analysts did so freely; Henry Blodget, the head of the internet analyst group, claimed not to even know of this policy.[317] In one case, the company management agreed to a particular rating from Merrill only so long as its main competitor was downgraded to a similar rating. That company was accommodated.[318]

The analysts who covered Enron and who testified at the Committee's February 27 hearing denied that their coverage was in any way affected or influenced by their firm's investment banking ties or other exposure to Enron, even though all of the banks they worked for had significant relationships with Enron.[319] Enron entered into a large number of investment banking transactions, it actively used financial products, and in general it had a lot of business to give banks.[320] Other deals, including structured finance and trading, earned banks additional fees. For example, J.P. Morgan's Mahonia Limited entered into natural gas trades with Enron, which may have earned the bank as much as $100 million.[321] These transactions, and similar transactions with an entity set up by Citigroup, appear to have been structured so that Enron could obtain financing that would appear on its financial statements as trading liabilities rather than debt, with the proceeds treated as cash flow from operations rather than cash flow from financing.[322]

Moreover, banks that invested in Enron's related-party partnerships or that underwrote offerings by certain SPEs knew that the

---

[314] Analyzing the Analysts, Hearing Before the Subcommittee on Capital Markets, Insurance, and Government-Sponsored Enterprises, House of Representatives Committee on Financial Services, Hrg. No. 107–25 (July 31, 2001) at 231–33 (Statement of the Honorable Laura Unger, former Acting Chairman of the SEC).

[315] "JP Morgan Reins in Analysts," *The Times (London),* March 21, 2001.

[316] Kathleen Pender, "Sell Ratings Were Few As Market Tanked," *San Francisco Chronicle,* March 28, 2001.

[317] Dinallo Affidavit, note 302 above, at 22.

[318] *Id.*

[319] The Watchdogs Didn't Bark: Enron and the Wall Street Analysts, Hearing Before the Senate Governmental Affairs Committee, 107th Cong., S. Hrg. 107–385 (February 27, 2002) at 26.

[320] Beth Piskora and Erica Copulsky, "Don't Take Stock in Buy Boosters—Wall Street Firms Cash in While Rating Losers High," *New York Post,* February 4, 2002.

[321] Jathon Sapsford and Anita Raghavan, "Trading Charges: Lawsuit Spotlights J.P. Morgan Ties to Enron Debacle," *The Wall Street Journal*, January 25, 2002.

[322] *See* The Role of Financial Institutions in Enron's Collapse, Hearing Before the Permanent Subcommittee on Investigations, Senate Governmental Affairs Committee, 107th Cong., S. Hrg. 107-618 (July 23, 2002) at— (Printed Hearing Record Pending) (Statement of Robert Roach, Counsel and Chief Investigator, Permanent Subcommittee on Investigations), available at http://www.senate.gov/?gov—affairs/072302roach.pdf.

entities were backed by Enron stock; it was clearly in the banks' interest to ensure that the stock price stayed up. Enron CFO Andrew Fastow may have sent a letter to banks, telling them that their profits from the partnerships were tied directly to the price of the stock.[323] Investment bank investors in the partnerships reportedly included Merrill Lynch at $22 million, Wachovia at $25 million, Credit Suisse First Boston at $15 million, Lehman Brothers at $10 million, and Citigroup at $10 million, among others.[324] During hearings before the House Energy and Commerce Committee, witnesses including Enron Vice President Sherron Watkins testified that banks had been pressured to invest in the partnerships by Andrew Fastow.[325]

Another way analysts can affect their firms' bottom line with their recommendations is if those firms' mutual funds or institutional investor clients hold large positions in a stock; a sell-side analyst's positive recommendation can drive the price of that stock higher, improving those portfolios' performance.[326] In Attorney General Spitzer's investigation, for example, an e-mail regarding the Merrill analysts' continued support for one company even as its stock price tumbled indicated that a reason for its good ratings were that that company was "very important to [Merrill] from a banking perspective, in addition to our institutional franchise. . . ."[327] In the February 27 Committee hearing, the Enron analysts testified that they, unlike the Merrill analysts, were not aware of the positions of their firms.[328]

Another factor that could influence analysts' behavior is the effect a poor rating for a stock might have on their compensation.[329] Although every firm compensates its analysts differently, the general rule of thumb on Wall Street is that compensation is mostly—perhaps more than 75 percent—comprised of a bonus, and this bonus, for some of the better paid analysts, can often be in the six-figure range.[330] Despite their impressive salaries, the analysts' research itself does not generate any income for the bank; thus a bank's evaluation of the value an analyst brings to the firm will be based on other things. The specific structure of bonuses will differ,

---

[323] "Wall Street Investment Banks Facing Lawsuits For Sharing Responsibility For Huge Losses Caused by Enron's Collapse," *NBC News,* February 22, 2002. According to this report, however, it was unclear whether banks had actually received the letter; the copy of the letter NBC obtained was unsigned.

[324] Charles Gasparino and Randall Smith, "Merrill Executives Invested Their Money In Enron Partnership That the Firm Sold," *The Wall Street Journal*, January 30, 2002.

[325] *See* Financial Collapse of Enron Corp., Hearing Before the Subcommittee on Oversight and Investigations, House of Representatives Energy and Commerce Committee, 107th Cong., Hrg. No. 107–89 (February 14, 2002), at 54 (Statement of Enron Vice President Sherron Watkins) ("Mr. Fastow was almost somewhat threatening; that if you didn't invest in LJM, Enron would not use you as a banker or an investment banker again. That he was threatening the institutions, that, to get Enron business, they should invest in LJM"); *see also* Kurt Eichenwald, "Enticements Are Cited By Bankers in Enron Case," *The New York Times*, February 21, 2002 (bankers confirming that pressure tactics took place).

[326] Kent L. Womack and Leslie Boni, "Wall Street's Credibility Problem: Misaligned Incentives and Dubious Fixes?," *The Brookings-Wharton Papers in Financial Services* (2002), at 19.

[327] Dinallo Affidavit, note 302 above, at 35 (emphasis added.).

[328] The Watchdogs Didn't Bark: Enron and the Wall Street Analysts, Hearing Before the Senate Governmental Affairs Committee, 107th Cong., S. Hrg. 107–385 (February 27, 2002) at 41–42.

[329] Analyzing the Analysts, Hearing Before the Subcommittee on Capital Markets, Insurance, and Government-Sponsored Enterprises, House of Representatives Committee on Financial Services, Hrg. No. 107–25 (July 31, 2001) at 230 (Statement of the Honorable Laura Unger, former Acting Chairman of the SEC).

[330] Committee staff interview with Richard Gross, February 13, 2002; also confirmed by information provided by Thomson Financial.

but at the very least, analysts' bonuses are tied to the success of the firm in general—the better a bank does in a given year, the higher the bonuses. The analysts who testified at the February 27 hearing said that their bonuses were dependent in this regard on the overall profitability of their firms.[331] Given that "buy" recommendations contribute to more business for firms—particularly with respect to potential investment banking clients—while negative ratings of companies contribute to less, analysts on that count alone have incentive to be positive about the companies they cover.

In an interview prior to the February 27 hearing, Richard Gross of Lehman Brothers gave Committee staff a more specific description of the factors on which his bonus was based than he provided at the hearing. Gross said that his bonus was determined by a number of factors, including the volume of commissions earned by the brokerage from stock sales in the industry he covers and the assistance he has provided to the investment bankers in helping them evaluate or formulate deals or strategy.[332] Compensation based on specific deals is now prohibited by the new NASD and NYSE rules, though analysts are commonly compensated based on overall assistance to investment banking, which, for all intents and purposes, amounts to the same thing.[333]

Attorney General Spitzer's investigation determined that the Merrill analysts' compensation was based, at least in part, on assistance to investment banking, perhaps in a way much like Gross was describing. In a Fall 2000 survey relating to compensation sent by the head of the Merrill research department, analysts were asked to provide details about their contributions to investment banking, including about "involvement in [each] transaction, paying particular attention to the degree your research coverage played a role in origination, execution and follow-up."[334] Merrill analyst Blodget, in his response to this request, indicated that his group had been involved in all aspects of 52 transactions, amounting to $115 million in business for Merrill. According to Blodget's description, those efforts included pitching the client, marketing the offering and initiating follow-on coverage. After providing this information, Blodget's minimum cash bonus increased from $3 million to $12 million.[335]

Annual compensation itself is not the only reason for analysts to maintain a positive outlook on companies; optimism also brings better job prospects. A recent study by economists Harrison Hong of Stanford University and Jeffrey Kubik of Syracuse University found that analysts are much more likely to be promoted if their recommendations are optimistic, and optimism is rewarded more in

[331] The Watchdogs Didn't Bark: Enron and the Wall Street Analysts, Hearing Before the Senate Governmental Affairs Committee, 107th Cong., S. Hrg. 107–385 (February 27, 2002) at 47.

[332] Committee staff interview with Richard Gross, February 13, 2002; *see also* Michaely and Womack, note 309 above, at 660.

[333] *See* Melvyn Teo, "Strategic Interactions Between Sell-side Analysts and the Firms They Cover," Working Paper, December 2000, available at http://papers.ssrn.com/sol3/papers.cfm?abstract—id=258028, at 5 ("it is common for a significant portion of a research analyst's compensation to be determined by the analyst's 'helpfulness' to the corporate finance department").

[334] Dinallo Affidavit, note 302 above, at 20.

[335] *Id.* at 21.

that regard than accuracy.[336] Conversely, analysts who offer negative ratings can experience pressure to improve their outlook on companies they cover. As Professor John Coffee testified before the Senate Banking Committee, "In self reporting studies, securities analysts report that they are frequently pressured to make positive buy recommendations, or at least to temper negative opinions. . . . According to one survey, 61 percent of all analysts have experienced retaliation—threats of dismissal, salary reduction, etc.—as a result of negative research reports. Clearly, negative research reports (and ratings reductions) are hazardous to an analyst's career."[337]

Finally, analysts may feel pressure from the companies they cover to offer positive recommendations. As Thomas Bowman, President and Chief Executive Officer of the Association of Investment Management and Research, testified at the Committee's February 27 hearing:

> [S]trong pressure to prepare "positive" reports and make "buy" recommendations comes directly from corporate issuers who retaliate in both subtle, and not so subtle, ways against analysts they perceive as "negative" or who don't "understand" their company. Issuers complain to Wall Street firms' management about "negative" or uncooperative analysts. They are also known to bring lawsuits against firms—and analysts personally—for negative coverage. But the more insidious retaliation is to "blackball" analysts by not taking their questions on conference calls or not returning their individual calls to investor relations or other company management. This puts the "negative" analyst at a distinct disadvantage relative to their competitors, increases the amount of uncertainty an analyst must live with in doing valuation and making a recommendation, and disadvantages the firm's clients who pay for that research. Such actions create a climate of fear that does not foster independence and objectivity. Analysts walk a tightrope when dealing with company managements. A false step may cost them an important source of information to their decision-making process and ultimately can cost them their jobs.[338]

In order to do their jobs, analysts must have regular, meaningful contact with the companies they cover. Having a good relationship

[336] Paul Taylor, "Bullish Analysts More Likely to Be Promoted," *Financial Times (London)*, February 1, 2002.

[337] *See* Accounting and Investor Protection Issues Raised by Enron and Other Public Companies, Hearing Before the Senate Committee on Banking, Housing and Urban Affairs, 107th Cong., 107—– (March 5, 2002) at— (Printed Hearing Record Pending) (Statement of Columbia University Law School Professor John Coffee), available at http://banking.senate.gov/02—03hrg/030502/coffee.htm.

[338] The Watchdogs Didn't Bark: Enron and the Wall Street Analysts, Hearing Before the Senate Governmental Affairs Committee, 107th Cong., S. Hrg. 107–385 (February 27, 2002) at 105–106. *Accord* Analyzing the Analysts, Hearing Before the Subcommittee on Capital Markets, Insurance, and Government-Sponsored Enterprises, House of Representatives Committee on Financial Services, Hrg. No. 107–25 (July 31, 2001) at 240 (Statement of the Honorable Laura Unger, former Acting Chairman of the SEC) ("The management of companies an analyst follows may pressure him/her to issue favorable reports and recommendations. Less than favorable recommendations may not be well received by management and issuers may threaten to cut off an analyst's access to its management if the analyst issues a negative report on the company. This could cause the analyst to issue a more favorable report than his/her analysis would suggest.").

with those companies means that their phone calls will be returned and their questions will be answered. Although companies cannot refuse to share material information with certain analysts while sharing it with others—Regulation F–D, promulgated by the SEC in 2000, prohibits companies from selectively disclosing material information to any person or group[339]—companies can give favored analysts certain non-material tidbits, while shutting disfavored analysts out. Nevertheless, the analysts who testified at the February 27 hearing denied that Enron in any way influenced their recommendations.[340]

D. *Solutions*

Like the SEC, Arthur Andersen, and Enron's Board of Directors, the analysts covering Enron failed to do what the market expected of them. The analysts failed to provide accurate and unbiased analyses of Enron and the value of its stock. The unreliable nature of the analysts' recommendations may well have been an open secret on Wall Street. However, it was largely unknown to individual investors like the Jupiter, Florida women profiled on *Now with Bill Moyers* who relied on Henry Blodget's research, probably unaware of these clear, inherent conflicts faced by research analysts until the Enron implosion and Attorney General Spitzer's investigation. They most likely thought that these analysts were providing their unvarnished opinions, based on years of expertise and study. Even if some analysts thought they were providing honest assessments, they were most likely affected in some respect by the business pressures of the firm, the companies they covered, and the potential that their own compensation could suffer. How else to explain these analysts' near universal bullishness on virtually all stocks in the face of market realities telling them their advice statistically just could not be right?[341] Whatever the cause, Enron demonstrated without doubt that there was a problem.

So the challenge we face now is how to address this situation, to ensure that those who hold themselves out as giving unbiased, expert advice are in fact doing so. There is no easy or complete solution.

Most sell-side analysts work for broker-dealers, which are regulated by the SEC, and are member firms of self-regulatory organizations (SROs) like NASD (formerly the National Association of Securities Dealers) and the New York Stock Exchange (NYSE). The SEC has delegated rulemaking and enforcement authority to these SROs under section 13 of the Securities Exchange Act of 1934, pursuant to which the SROs oversee broker-dealer activity. Until recently, analysts were not subject to any specific regulation much beyond the general anti-fraud provisions of the securities laws and

[339] 17 C.F.R. § 243.100.

[340] The Watchdogs Didn't Bark: Enron and the Wall Street Analysts, Hearing Before the Senate Governmental Affairs Committee, 107th Cong., S. Hrg. 107–385 (February 27, 2002) at 26.

[341] As the S&P 500 index fell, analysts' recommendations stayed constant overall on the S&P 500 companies. According to Thomson Financial, in the 2 years from January 2000 through January 2002, as the S&P fell from a high of 1,500 to approximately 1,100, the "consensus recommendation" on those 500 companies—the average rating—remained at a buy, and fell only slightly in July 2001. *See* The Watchdogs Didn't Bark: Enron and the Wall Street Analysts, Hearing Before the Senate Governmental Affairs Committee, 107th Cong., S. Hrg. 107–385 (February 27, 2002) at 128 (chart entitled "S&P 500 Price Index Versus S&P 500 Consensus Recommendation").

NASD requirements regarding broker-dealer advertisements that all representations be fair, balanced and not misleading. Recently, however, the landscape of regulation for analysts changed significantly. On May 10, 2002, the SEC approved proposed rule changes by NASD and NYSE to address analyst conflicts of interests.[342] Further, the Sarbanes-Oxley Act, which was signed by the President on July 30, 2002, set new standards for analyst conduct and conflict disclosures and required the SEC or the SROs to issue additional rules, which will hopefully close the expectation gap for investors in analyst recommendations.[343] The NASD/NYSE rules,[344] now in place, are:

Reducing Pressure/Influence on Analyst Recommendations

- *No Control by Investment Banking Department.* Research analysts may not be subject to the supervision or control of the investment banking division of the bank. To the extent that analysts communicate with investment bankers regarding research reports, such communication must be only for verification of accuracy or review of potential conflicts of interest that should be disclosed and must be monitored by the legal department.
- *Companies May Not Review Ratings In Advance.* Companies may review research reports about them in advance of their release only to check for accuracy, and may not review in advance the rating or the price target.
- *Analyst Compensation.* Analyst compensation may not be tied to specific investment banking transactions. To the extent that analysts are compensated based on investment banking revenues at all, it must be disclosed in research reports.
- *No Quid Pro Quos.* No firm may directly or indirectly offer a favorable rating or price target or threaten an unfavorable rating or price target in exchange for business.

Disclosures of Conflicts

- *Disclosure of Company Relationship With Firm.* Research reports, or analysts in public appearances (if they know or have reason to know), must disclose if the analyst's firm or its affiliates received compensation from the subject company within the last 12 months, or expect to receive compensation in the 3 months following the report.

[342] Exchange Act Release No. 45908 (May 10, 2002), 67 Fed. Reg. 34968 (May 16, 2002). In addition to these rules, private associations to which analysts or their firms may belong have guidelines. Some analysts are Chartered Financial Analysts (CFAs), a designation indicating that they have at least 3 years of experience and have passed 3 day-long exams. The Association for Investment Management and Research (AIMR) administers these exams and awards the CFA. Many analysts are CFAs, though very few sell-side analysts are. AIMR expects all CFAs to follow their Code of Ethics and Standards of Professional Conduct, which among other things requires that analysts "use reasonable care and exercise independent professional judgment," and "exercise diligence and thoroughness in making investment recommendations . . . [and] [h]ave a reasonable and adequate basis, supported by appropriate research and investigation, for such recommendations." The Securities Industry Association (SIA), the industry trade group covering all securities broker-dealers, has also issued a set of "best practices" for research.

[343] Pub. L. No.107–204 § 501.

[344] The new rules can be found as NASD Rule 2711 and amendments to NYSE Rules 351 and 472.

- *Disclosure of Firm's or Analyst's Ownership of Company Stock.* An analyst must disclose, in reports or public appearances, if the analyst, or the analyst's firm, has a financial interest in the subject company.

Limits on Trading/Ownership

- *Quiet Periods.* A firm may not issue a research report on a company for 40 days following its IPO or 10 days following a secondary offering if the firm acted as a manager or co-manager of the offering, unless significant events warrant a report.
- *Blackout Period for Analysts' Trading Before and After Report, Change in Rating or Price Target.* Analysts may not trade in the stock of a company on which they issue a report or change their rating or price target for the 30 days prior, and 5 days after, such report or change. (There are some limited exceptions to this rule.)
- *No Trading Against Recommendations.* An analyst may not trade against the analyst's own recommendations.
- *No Pre-IPO Shares.* No analyst or member of the analyst's household may receive pre-IPO securities of a company in the industry sector he/she covers.

Clarifying Ratings

- *Ratings Must be Defined and Firms Must Show How They Rated All the Companies They Cover, and Within Those Categories, How Many Were Investment Banking Clients.* Research reports must clearly define rating systems (e.g., "strong buy" means the stock will go up by 10 percent in the next year) and must show the distribution of the firms' recommendations for all the companies they cover across three categories—buy, hold, or sell—and within those categories, how many were investment banking clients (e.g., of all recommendations, 75 percent were buys, 90 percent of which were investment banking clients; 20 percent were holds, 2 percent of which were investment banking clients; and 5 percent were sells, 0 percent of which were investment banking clients).
- *Track Record Chart.* A firm must include in all research reports a price chart that maps the price of the subject stock over time and indicates points at which the analyst assigned a rating and/or price target, enabling investors to compare recommendations over time with actual stock performance. The chart would not have to extend back further than 3 years.

The Sarbanes-Oxley Act has gone further in addressing the issue of analyst independence and disclosure.[345] That Act amended the Securities Exchange Act of 1934 to require the SEC, or the SROs under the direction of the SEC, to promulgate rules to enhance analyst independence and to require disclosures regarding conflict of interest. The Act requires the SEC, or the SROs, to issue rules to achieve the following goals:

[345] Pub. L. No.107–204 § 501.

Enhancing Independence

- *Separation of Research and Investment Banking.* Structural and institutional safeguards must be established to ensure that analysts are partitioned from the review, pressure, or oversight by investment banking, activities that might potentially bias analysts' judgment.
- *Restrict Pre-Approval of Reports.* Pre-publication clearance or approval of research reports by non-research department staff at the analyst's firm, such as investment bankers, must be restricted.
- *Limit Supervision/Evaluation of Analysts to Research Department.* Supervision of analysts, or evaluations of analysts related to compensation, must be limited to non-investment banking personnel.
- *No Retaliation for Unfavorable Rating.* Retaliation against an analyst for an unfavorable rating of an issuer, which may negatively affect the firm's investment banking relationship with that issuer, is prohibited.
- *Quiet Periods.* The SEC or the SROs must establish certain time periods during which firms involved in a public offering of securities for an issuer may not issue research reports on that issuer.

Disclosure

- *Investment of Analyst in Covered Issuer.* The SEC or the SROs must adopt rules requiring analysts to disclose in reports or in appearances if they have investments in the companies covered in those reports or appearances.
- *Compensation Received by Analyst or Firm.* The SEC or the SROs must adopt rules requiring analysts to disclose any compensation received from rated companies, with exceptions permitted to prevent disclosure of material non-public information, consistent with the public interest and investor protection.
- *Client Relationship.* The SEC or the SROs must adopt rules requiring firms to disclose whether an issuer that is the subject of their research reports is also a client, and must disclose the types of services provided.
- *Analyst Compensation.* The SEC or the SROs must adopt rules requiring analysts to disclose whether they have received compensation from the issuer related to any research reports, or whether they have received compensation based on investment banking revenues.

The NASD/NYSE rules are a step in the right direction—prior to their existence there were no rules directly addressing these issues at all. The Sarbanes-Oxley Act, however, has provided the guiding principles that should govern SEC action going forward. The Sarbanes-Oxley Act's requirement that the separation between the investment banking and research departments be shored up is particularly important. If the SEC or the SROs work aggressively with the firms to find a workable solution to fulfill the mandate of Sarbanes-Oxley, it will provide meaningful protection to the independence and objectivity of research, which should assist in restoring market confidence in analyst recommendations.

In order to meet the goals set by the Sarbanes-Oxley Act both to enhance the independence of analysts and provide useful disclosure, the SEC clearly needs to go further than the current NASD/NYSE rules. For instance, the NASD/NYSE rules prohibit analyst compensation from being tied only to specific investment banking transactions. Even at Merrill Lynch, with its alleged abuses, compensation seems to have been decided on overall contribution to the investment banking department, not individual deals. Indeed, even basing analyst compensation on overall profitability—particularly when investment banking makes up a significant portion of a firm's revenue—allows analysts to be compensated informally based on the work they do to prop up the investment banking side of their firms. Thus, there is an incentive to help smooth the investment banking relationship. Disclosure of any compensation analysts receive based even generally on investment banking revenue, required by the NASD/NYSE rules and the Sarbanes-Oxley Act, is an important tool for savvy investors, but disclosure is not sufficient to achieve the separation of investment banking from research envisioned by Sarbanes-Oxley.

Similarly, the NASD/NYSE "quid pro quo" rule, prohibiting firms from offering positive ratings in exchange for business, whether directly or indirectly, arguably misses the mark; companies already public are likely to work with banks that favor their stock and companies going public are likely to seek a firm that is likely to be favorable. The Sarbanes-Oxley Act's prohibition on retaliation by firms against analysts who issue negative ratings will be helpful to minimize the effect of this phenomenon on analysts. To give this provision full effect, however, the SEC should try to address the "carrot" as well as the "stick" approach by firms in encouraging undue optimism among their analysts. Given that studies, cited above, have shown that analysts are promoted more often for optimism than accuracy, the SEC or the SROs should work with firms to ensure that analysts are rewarded for getting it right for investors, not for their rosy outlooks.

In addition, the NASD/NYSE rule prohibiting firms from sharing investment ratings with subject companies in advance of releasing the research report does not go far enough. Analysts are still permitted, and may be required by their firms, to share the text of the report with the covered company, supposedly to ensure accuracy. Reading the text of the report will certainly give companies an indication of the ratings conclusion. In order to help relieve analysts of the strong pressure they face from the companies they cover, there should be a rule prohibiting sharing the full text of the reports, allowing analysts to provide only so much as is necessary to fact-check their work.

Finally, it would be very helpful if the disclosures required by the NASD/NYSE rules, particularly those regarding the firm's rating track record, would be available more widely than just on the research reports themselves. Many investors who are not brokerage clients of a large firm obtain information about analyst ratings from other sources, including financial websites and cable financial news shows. These investors will not benefit from these disclosures if they only appear on the face of the research reports.

In addition to the NASD/NYSE rules and just before the enactment of the Sarbanes-Oxley Act, the SEC proposed Regulation A–C, which would require that analysts personally certify that their reports accurately reflect their own views and whether they have been or expect to be compensated specifically for any individual rating.[346] The first part of this rule may, as securities attorney Sam Scott Miller said, "focus people's attention"—particularly analysts, hopefully—on the issue of analyst independence and the importance of being honest.[347] However, it does not appear to do much more than that; if the rating is issued under the analyst's name, it is reasonable to assume that the rating represents his or her opinion, and NASD rules already prohibit issuing reports that are contrary to the beliefs of the analyst who writes them.[348] The second part of the rule merely certifies that the analyst has followed the law: If an analyst is compensated for a rating, the Sarbanes-Oxley Act requires that such compensation must be disclosed.

In order to further enhance analyst independence and disclosure of analyst and firm conflicts to meet the goals set by the Sarbanes-Oxley Act, the Committee staff has the following recommendations for the SEC:

- *Separate analysts from investment banking's influence.* Probably the most basic conflict in this system is that the compensation an analyst receives if he or she works for a firm that does a significant amount of investment banking work will be derived largely from investment banking; to the extent that negative ratings can affect their compensation, analysts will be loath to issue them. This compromises their objectivity, a problem the SEC should address, and indeed is required to address under the Sarbanes-Oxley Act. Recent reports indicate that the SEC is considering proposing a rule requiring complete separation of investment banking and research departments at firms, perhaps by mandating that they operate through entirely separate, though affiliated entities.[349] If these reports are accurate, the SEC is moving in precisely the right direction.[350] In addition, in order to further strengthen the objectivity of stock recommendations, the system of compensation and reward for analysts should be structured to offer them incentives to issue their best rather than their most flattering assessments of

[346] SEC Release Nos. 33–8119; 34–46301; File No. S7–30–02 (July 25, 2002); 67 Fed. Reg. 51510–51516 (August 8, 2002).

[347] Michael Schroeder, "SEC Moves on New Rule," *The Wall Street Journal*, July 23, 2002.

[348] *See* NASD Notice to Members 02–39 (May 2002) ("If a member issues a report or a research analyst renders an opinion that is inconsistent with the analyst's actual views regarding a subject company, NASD considers such action to constitute a fraudulent act and conduct inconsistent with just and equitable principles of trade.").

[349] Susan Pulliam and Randall Smith, "SEC's Pitt Seeks Split of Banking, Analyst Areas," *The Wall Street Journal*, September 26, 2002.

[350] Concerns have been expressed, however, about whether the research divisions will remain economically viable without being a part of the same entity through which investment banking revenue flows, given that many Wall Street firms derive so much of their profits from investment banking activities. Many average investors depend on sell-side analysis to assist them in making their investment decisions because most can ill-afford much more expensive independent research. Therefore, the SEC must be careful to craft a rule that does not have the unintended result of cutting off access to this relatively affordable information.

companies. One possible path may lie in performance-based compensation, which would reward accuracy over optimism. At the Committee's February 27, 2002 hearing, Charles Hill of Thomson Financial/First Call endorsed the system used when he was a Wall Street analyst, in which large customers would give feedback to the firms to indicate which analysts' research they relied on.[351] Merrill Lynch apparently has instituted such a system as part of its settlement with the New York Attorney General. The SEC or the SROs should ensure that all other Wall Street firms follow suit.

- *Firms should not be permitted to share research reports with the subject companies at all prior to their release.* If analysts know they might have to show their reports to companies in advance of release, analysts will feel pressure to soft-pedal their language and their ratings. Firms that rely on good relationships with these companies have no incentive to protect the analysts if they do not have to. There is no need for analysts to show companies their reports in order to fact-check them. Fact-checking can be achieved by asking targeted questions about specific matters that need verification.
- *In addition to prohibiting retaliation for negative ratings, firms should be prohibited from incentivizing positive ratings.* The Sarbanes-Oxley Act's prohibition on retaliation for negative ratings is an extremely important step towards protecting the integrity of research. In issuing rules to effect this prohibition, the SEC or the SROs should consider whether it might be equally useful to prohibit rewards for optimism over accuracy. A rule in this vein would further the spirit of the ban on retaliation, and would minimize another source of pressure faced by analysts to make their ratings rosier than they might otherwise do: Studies showing that optimistic research nets promotions more often than accurate research on Wall Street.[352] Perhaps such an effort could be achieved in concert with the establishment of a performance and accuracy based compensation system for analysts.
- *Disclosures should be made more widely available.* While the NASD/NYSE rules requiring firms to indicate their overall ratings distribution and their track record with respect to the companies covered (ratings and target stock prices compared to actual performance) are a significant step in providing investors with information to assess the value of those firms' ratings, many investors obtain ratings information from places other than research reports, which are generally available only to clients of the firms that produce them or through other brokerage houses those firms may partner with. These disclosures should be made publicly available, either on the firms' websites or on the NASD or NYSE websites.

[351] The Watchdogs Didn't Bark: Enron and the Wall Street Analysts, Hearing Before the Senate Governmental Affairs Committee, 107th Cong., S. Hrg. 107–385 (February 27, 2002) at 59.
[352] Paul Taylor, "Bullish Analysts More Likely to Be Promoted," *Financial Times (London)*, February 1, 2002.

- *When firms drop coverage of a company without first downgrading it to the equivalent of a sell, they should be required to publish a release indicating why they are dropping coverage.* This was a part of the settlement agreement between the New York State Attorney General and Merrill Lynch; many firms—including Merrill—will drop coverage of a company rather than issuing a sell rating. This is a common practice; the firms of three of the four analysts who testified at the Committee's February 27 hearing did this with Enron. The problem with this practice is that unlike a downgrade, which comes along with an explanation, it does not provide a sufficient indication to investors of the problems with the company that brought about the analyst's change of heart. In the case of Enron, most investors were aware of the troubles with the company at the time the firms' dropped coverage: The earliest was J.P. Morgan Chase's drop on November 29, 2001, the day after the Dynegy merger fell through, when rampant news reports were predicting the company's imminent bankruptcy. But where investors have purchased stock in companies that are not in the center of the media spotlight based on analyst recommendations to buy, they should be alerted by those very same analysts that there are problems sufficient to lead their firms to abandon coverage.

II. ENRON AND THE CREDIT RATING AGENCIES

Like the analysts, another outside watchdog failed the public with respect to Enron: The credit rating agencies. These companies do what their name implies: Rate the creditworthiness of entities, such as public companies, and the debt they issue, so that those wishing to extend credit—by buying bonds, for example—can better understand the risk that they may not see a return on that investment. Ratings have taken on great significance in the market, with investors trusting that a good credit rating reflects the results of a careful, unbiased and accurate assessment by the credit rating agencies of the rated company. But as with so many other market players, Enron caused this legendary reliability to be called into question. It was not until just 4 days before Enron declared bankruptcy that the three major credit rating agencies lowered their ratings of the company to below the mark of a safe investment, the investment grade rating. And as with other market participants, like securities analysts, auditors, and corporate directors, the example of Enron shows that rating agency reform is needed if the actual performance of these organizations is to live up to public expectations.

This section of the report will provide a brief description of credit ratings, their use and history, and will describe how the credit rating agencies made their assessments of Enron, and where they failed. Finally, it will outline the current regulatory environment in which credit rating agencies operate, and make recommendations for how improvements can be achieved to restore market confidence in the operation of these firms.

A. *History and Uses of Credit Ratings*

John Moody, the founder of what is now Moody's Investors Service ("Moody's"), is generally credited with devising credit ratings for public debt issues at the beginning of the 20th Century. At that time, the United States had the largest corporate bond market in the world, comprised mostly of railroad bond issues. Investors, however, had few sources beyond bankers and the financial press for information about the quality of those bonds. Moody's credit ratings, first published in 1909, met that need. It was followed by Poor's in 1916, Standard in 1922, and Fitch in 1924. (Standard and Poor's merged in 1941 to become Standard & Poor's ("S&P").)[353] Moody's—now the largest of the three—offers ratings on over $30 trillion of debt and 4,300 corporations.[354]

Credit ratings, which are expressed in a letter grade, provide an assessment of creditworthiness, or the likelihood that debt will be repaid.[355] Generally, companies will receive a long-term "issuer" rating, which is intended to measure the entity's ability to meet its "senior" financial obligations: Obligations that have not been "subordinated" to other obligations by law or by agreement.[356] Each of the letter grades may be modified with a plus or a minus, indicating relative standing within the categories. S&P and Fitch use the same ratings system.[357] Their first four categories, AAA, AA, A, and BBB, are considered "investment grade," or of good or better credit quality, AAA+ representing the highest credit quality, BBB- representing the lowest investment grade credit quality. BBB generally indicates that economic conditions may weaken the capacity of the issuer to meet its obligations, but overall, the issuer has adequate ability to meet its commitments in a timely manner. Lower ratings—BB, B, CCC, CC, C, and D—indicate that a company is of "speculative grade." The BB and B ratings indicate that company is able currently to meet its financial commitments, but has significant vulnerability to adverse conditions; lower ratings indicate a current vulnerability and significant likelihood of some default. Bonds given a "speculative" rating are sometimes referred to as "junk" bonds.

Moody's uses a slight variation on the S&P/Fitch approach: Investment grade is reflected by Aaa, Aa, A, or Baa, with Aaa being the most creditworthy, and Baa being the lowest investment grade rating.[358] Moody's "speculative" or "junk" ratings are Ba, B, Caa,

[353] *See* Richard Cantor & Frank Packer, "The Credit Rating Industry," *Federal Reserve Bank of New York Quarterly Review,* Summer/Fall 1994 at 2. Although other credit rating agencies have existed and still exist in the United States, many, such as Duff & Phelps and Thomson BankWatch, have each merged into one of the main three: Moody's, S&P, and Fitch. *See* Lawrence J. White, "Bond Raters Troika," *U.S. Banker,* May 2002.

[354] *See* "Introduction to Moody's," http://www.moodys.com.

[355] *See* Rating the Raters: Enron and the Credit Rating Agencies, Hearing Before the Senate Governmental Affairs Committee, 107th Cong., S. Hrg. 107–471 (March 20, 2002) at 82 ("Standard & Poor's Understanding Credit Ratings," January 2002, attached to the Statement of Ronald Barone); "Fitch Ratings Definitions: Issuer Financial Strength Ratings," http://www.fitchratings.com.

[356] The issuer ratings described here are just one type of rating offered by the credit rating agencies; they also offer short-term ratings (which are most often used to determine issuers' creditworthiness relating to commercial paper), ratings for individual debt offerings, or even ratings of countries' creditworthiness. This report focuses on Enron's long-term issuer ratings, so for simplicity, the other ratings systems are not described here.

[357] *See generally* "Standard & Poor's Understanding Credit Ratings," and "Fitch Ratings Definitions," note 355 above.

[358] *See* "Ratings Definitions: Issuer Ratings," http://www.moodys.com.

Ca, and C. Moody's does not use pluses or minuses as modifiers; instead it uses numbers: 1 being equivalent to a plus, 2 as consistent with no modifier, and 3 being the same as a minus. In addition to issuing letter-grade ratings, if the agency is about to lower or raise a rating, S&P may put out a "CreditWatch" with a negative (likely to downgrade) or positive (likely to increase) outlook.[359] Fitch has a similar "ratings watch," and Moody's puts companies "on review" for an upgrade or downgrade.[360]

When John Moody first initiated the credit rating system, credit ratings simply provided guidance for investors.[361] According to the credit rating agencies, this remains the primary driver of ratings: As S&P explains on its website, its "recognition as a rating agency ultimately depends on investors' willingness to accept its judgment." If history is a guide, credit rating agencies generally get it right: Bonds rated AAA have a less than 1 percent default rate over 10 years or more,[362] and S&P has found that there is almost an 88 percent likelihood that companies with ratings of A or above will still have that rating 1 year later.[363] On the other hand, bonds rated BB (below investment grade) have an approximately 20 percent default rate over 15 years, while bonds with a B rating have a 35 percent rate of default and bonds with a CCC rating have a 55 percent default rate over that same period.[364]

Nevertheless, since the days of John Moody, the uses of credit ratings have evolved. Ratings are currently used more as benchmarks for market participants than as a source of information for investors. Approximately 95 percent of corporate bonds are held by institutional investors,[365] which have their own in-house analysts to assess the value of the bonds in which they invest.[366] To the extent that sophisticated private parties use credit ratings for their own purposes, they tend to use them in agreements, such as merger or loan agreements, as conditions or triggers for certain rights or obligations.[367] A contract might, for example, specify that if a company's rating from S&P or Fitch falls below a specified grade, payments may be accelerated or additional obligations (such as in-

[359] "Standard & Poor's Understanding Credit Ratings," note 355 above, at 2–3.

[360] "Fitch Ratings Definitions: Issuer Financial Strength Ratings," note 355 above.

[361] *See* David C. Gates, "Rating Agencies and the SEC Asleep at the Switch? Complying With the Basel Capital Accord," *Risk Management Association Journal,* October 1, 2001, at 3.

[362] Rating the Raters: Enron and the Credit Rating Agencies, Hearing Before the Senate Governmental Affairs Committee, 107th Cong., S. Hrg. 107–471 (March 20, 2002) at 63–64; "Moody's Rating System in Brief," provided under cover of letter from John J. Goggins, Esq., Senior Vice President and General Counsel, Moody's Corporation, to Cynthia Lesser, Counsel, Senate Governmental Affairs Committee, dated March 6, 2002.

[363] Leo Brand and Reza Bahar, "Corporate Defaults: Will Things Get Worse Before They Get Better," *S&P CreditWeek,* January 31, 2001, at 15, 27.

[364] Rating the Raters: Enron and the Credit Rating Agencies, Hearing Before the Senate Governmental Affairs Committee, 107th Cong., S. Hrg. 107–471 (March 20, 2002) at 64.

[365] *See* The Status of "Corporate Trades I," Hearing Before the Subcommittee on Securities, Senate Banking, Housing and Urban Affairs Committee, 106th Cong., S. Hrg. 106–537 (May 26, 1999) at 22 (Statement of Nelson D. Civello, Chairman, Bond Market Association).

[366] Even though the State statutes and regulations limiting the investments allowed to be held by State pension funds to bonds with a certain level of investment grade rating are intended as sufficient protection from too many defaulting bonds, State pension funds are looking for additional "credit-rating tools" beyond the ratings of the three credit agencies to assess the risk associated with potential investments in the wake of WorldCom and Enron. *See, e.g.,* "State Pension Funds Hit But Not Crippled By Enron, WorldCom," *Associated Press,* June 29, 2002.

[367] Rating the Raters: Enron and the Credit Rating Agencies, Hearing Before the Senate Governmental Affairs Committee, 107th Cong., S. Hrg. 107–471 (March 20, 2002) at 142 (Statement of Jonathan Macey, Professor, Cornell University Law School).

creased interest rates or escrows) may be imposed on the company.[368]

Government agencies have found additional uses for credit ratings. In the 1930's, the Federal Reserve began using credit ratings on bonds to assess the safety of the portfolio investments of member banks.[369] In 1931, the Comptroller of the Currency adopted credit ratings as measures of quality for the national banks' bond accounts, first allowing non-investment grade bonds as long as banks discounted their value, taking into account their riskiness, then later prohibiting national banks from investing in non-investment grade bonds altogether.[370] State laws and regulations soon adopted similar standards for State banks, pension funds, and insurance companies, and additional Federal regulation followed.[371]

In 1975, the SEC, by rule, significantly enhanced the importance of credit ratings. In 1970, Penn Central Railroad defaulted on its bonds, leading to unexpected and significant losses for investment firms. The bonds, like many others in the market at the time, had not been rated by any of the credit rating agencies. Due to a general concern about corporate creditworthiness at the time, the SEC adopted new net capital requirements, or asset requirements, for broker-dealers, firms that trade securities in the market, either for themselves (dealers) or on behalf of others (brokers).[372] These requirements assure investors that their broker-dealers have sufficient assets to back up the funds that investors entrust them with. Informally called the "haircut" rule, Rule 15c3–1 requires broker-dealers to take a larger discount on below-investment grade bonds—a "haircut"—when calculating their assets for the purposes of the net capital requirements than for investment grade corporate bonds. This rule specified that the ratings come from a "nationally recognized statistical ratings organization," or NRSRO.[373] The term was not defined, but it caught on.

The Federal Reserve and the SEC are not alone in giving legal significance to the ratings of NRSROs. Currently, at least eight Federal statutes and 47 Federal regulations, along with over 100 State laws and regulations, reference NRSRO ratings as a benchmark. On the Federal level, they are related primarily to banks and commodities or securities regulation, but a few relate to education (qualifications for schools to participate in a financial assist-

[368] For example, Enron in one instance used S&P ratings in a debt covenant, otherwise known as a ratings trigger. The trigger was included in an agreement intended to provide additional credit backing to an affiliated limited partnership. When Enron's S&P rating fell to a BBB- on November 9 (the triggering event in the covenant), the partnership was entitled to accelerate payment of a $690 million note from Enron to November 27, 2001. Enron Corp. Form 10–Q for Quarter Ended September 30, 2001 (filed November 19, 2001) at 70. Enron also had ratings triggers in agreements backing two related trusts, the Marlin and the Osprey trusts. Those covenants required Enron to repay $2.4 billion for Osprey and $915 million for Marlin if Enron's stock price fell below a certain level and its credit rating by any of the three rating agencies fell below investment grade (below BBB- or Baa3). Enron Corp. Form 10–Q for Quarter Ended September 30, 2001 (filed November 19, 2001) at 69.

[369] Frank Partnoy, "The Siskel and Ebert of Financial Markets: Two Thumbs Down For the Credit Rating Agencies," *77 Wash. U. L.Q.* 619 (1999), at 687.

[370] *Id.* at 688.

[371] *Id.* at 688–89.

[372] *See* Adoption of Amendments to Rule 15c3–1 and Adoption of Alternative Net Capital Requirements for Certain Brokers and Dealers, Release No. 11497 (June 26, 1975) 40 Fed. Reg. 29795 (July 16, 1975). *See also* Gates, note 361 above, at 4–5 (describing Penn Central collapse and aftermath); Andrew Fight, The Ratings Game, Wiley & Sons Ltd (2001), at 6 (same).

[373] Rating the Raters: Enron and the Credit Rating Agencies, Hearing Before the Senate Governmental Affairs Committee, 107th Cong., S. Hrg. 107–471 (March 20, 2002) at 132 (Statement of the Honorable Isaac Hunt, SEC Commissioner).

ance program under Title IV of the Higher Education Act),[374] to transportation (highway projects must be rated investment grade by an NRSRO to obtain funding under program),[375] and telecommunications (requirements for approval of loan guarantees from the Federal Government).[376] On the State level, most of the State statutes and regulations referring to NRSRO ratings—which number over 100—relate to permissible investments by insurance companies and State funds, banking and State securities laws and regulations. Because so many regulations affecting institutional investors incorporate NRSRO ratings, issuers must seek out ratings from one of the NRSROs—Moody's, S&P, or Fitch—in order to ensure that they have full access to the capital markets with respect to their debt instruments.

B. *Efforts to Regulate Credit Rating Agencies*

Although the NRSRO designation has never been formally defined in statute or regulation, the SEC, as the agency that coined the term, has taken on the task of granting requests from rating firms for NRSRO status.[377] Upon request, the staff of the Division of Market Regulation provide a "no-action" letter to the firm granting the status.[378] Since the inception of the designation, the SEC has granted NRSRO status to seven companies, including the three that remain today; the other four merged with Fitch.[379]

Though it has not received that much attention, the informal designation process and the small oligopoly it has created have been somewhat controversial. Throughout the 1990's, Congressman John Dingell wrote a number of letters to the SEC calling for increased competition in the industry and a setting of national standards for NRSROs.[380] The Justice Department initiated and subsequently closed an investigation of the credit rating agencies in 1996 to determine if they were engaging in anti-competitive practices.[381] In addition, in the mid-1990's, a school district in Colorado sued Moody's after it issued unsolicited, and according to the school district, inappropriately low ratings of a bond issue after the school district had chosen to retain a different credit rating company. Following Moody's rating, the school district alleged that it had to re-

[374] 20 U.S.C. § 1087–2.
[375] 23 U.S.C. §§ 181, 182 .
[376] 47 U.S.C. § 1103.
[377] Rating the Raters: Enron and the Credit Rating Agencies, Hearing Before the Senate Governmental Affairs Committee, 107th Cong., S. Hrg. 107–471 (March 20, 2002) at 133 (Statement of the Honorable Isaac Hunt, SEC Commissioner).
[378] *See* Capital Requirements for Brokers or Dealers Under the Securities Exchange Act of 1934, Release No. 39457, 62 Fed. Reg. 68018 (December 17, 1994) at 68019 (describing the current process for determining whether an entity is an NRSRO).
[379] Rating the Raters: Enron and the Credit Rating Agencies, Hearing Before the Senate Governmental Affairs Committee, 107th Cong., S. Hrg. 107–471 (March 20, 2002) at 133–34 (Statement of the Honorable Isaac Hunt, SEC Commissioner). Then SEC Commissioner Isaac Hunt recently indicated that the SEC may be planning to grant the designation to additional credit rating agencies; he was quoted as saying that "we may have more than three by the end of the year." Alyne Van Duhn, "Big Three Learn Lessons From Enron: Ratings Agencies," *Financial Times (London)*, May 27, 2002. There are a few agencies that have been trying to achieve the designation for some time. John Labate and Jenny Wiggins, "Ratings Agencies Live in Hope of Gaining That Elusive Rise in Status," *Financial Times (London)*, May 21, 2002.
[380] Rating the Raters: Enron and the Credit Rating Agencies, Hearing Before the Senate Governmental Affairs Committee, 107th Cong., S. Hrg. 107–471 (March 20, 2002) at 135 (Statement of the Honorable Isaac Hunt, SEC Commissioner).
[381] The antitrust investigation was closed in 1999. Kenneth Gilpin, "Justice Dept. Inquiry on Moody's Is Over, With No Charges Filed," *The New York Times*, March 13, 1999.

price the bonds at a cost of over $750,000.[382] The school district lost the suit.

Recognizing that concerns existed and that the public was increasingly relying on NRSROs, the SEC in 1994 asked for public comment on the SEC's role in the use of the NRSRO designation.[383] The Commission received 25 comment letters in response, encouraging it to adopt a formalized process for giving the designation. As a result, the SEC proposed a rule in 1997, seeking to define the term "NRSRO" and provide for a process both for granting the status and removing it, including an appellate process before an Administrative Law Judge.[384] The proposed rule set forth the criteria the staff had been relying on: Namely, whether the applicant's ratings were nationally recognized, and whether the applicant was independent, sufficiently staffed, had systematic procedures designed to produce credible and accurate ratings, and had internal procedures to protect against the misuse of inside information. The rule would have required NRSROs to register as investment advisers under the Investment Advisers Act of 1940,[385] and would have required NRSROs to inform the SEC of any significant organizational changes. The rule would have officially given the SEC power to withdraw the NRSRO designation if a credit rating agency failed to maintain the required criteria. The 16 commenters on the proposed rule criticized it. Although the rule would have done no more than to codify the status quo—for example, the NRSROs have all voluntarily registered as investment advisers, although they maintain they are not required to—the credit rating agencies nonetheless opposed the rule because they oppose any formal regulation of their business.[386] The Justice Department criticized the rule for perpetuating the current anti-competitive environment of credit rating agencies.[387] The proposed rule was never finalized.

Even though NRSROs are not subject to any formal process for designation, monitoring or removal, they do receive special treatment in securities regulation. First, they are given special access to companies. SEC Regulation F–D prohibits issuers from making selective disclosure of material information in order to ensure that all investors have access to significant corporate news at the same time.[388] The rule was prompted by concern that some favored analysts and market participants received information first, while the rest of the market had to wait to find out. Credit rating agencies,

[382] *Jefferson County Sch. Dist. v. Moody's Investors Service,* 988 F. Supp. 1341 (D. Colo. 1997), aff'd, 175 F.3d 848 (10th Cir. 1999).

[383] Nationally Recognized Statistical Ratings Organizations, Release No. 34616, 59 Fed. Reg. 46314 (September 7, 1994).

[384] *See* Capital Requirements for Brokers or Dealers Under the Securities Exchange Act of 1934, Release No. 39457, 62 Fed. Reg. 68018 (December 30, 1997).

[385] The Investment Advisers Act prohibits fraud, imposes fiduciary duties on advisers with respect to their advice, requires advisers to maintain certain books and records, and allows the SEC to examine advisers to determine compliance with the Act. *See generally* 15 U.S.C. 80b–1 *et seq.*

[386] *See, e.g.,* Comments of Moody's Investors Service in the Matter of File No. S7–33–97, Release No. 39457, Capital Requirements for Brokers or Dealers Under the Securities Exchange Act of 1934, dated March 2, 1998.

[387] Comments of the United States Department of Justice in the Matter of File No. S7–33–97, Proposed Amendments to Rule 15c3–1 Under the Securities Exchange Act of 1934, dated March 6, 1998.

[388] 17 C.F.R. § 243.100.

however, are expressly exempted from Regulation F–D.[389] The analysts from Moody's, S&P or Fitch can have private conversations with company management that no other analyst can have, and the credit rating analysts can see financial information that no other analyst could see without the company disclosing it publicly. Moreover, NRSROs are officially shielded from liability for all but fraud under the securities laws. SEC Rule 436, promulgated under the Securities Act, expressly shields NRSROs from liability under Section 11 of the Securities Act in connection with an offering of securities.[390] This means that NRSROs are not held even to a negligence standard of care for their work.[391]

The NRSRO designation has had a significant beneficial effect on the profitability of credit rating agencies. Until the late 1960's, the rating agencies made their money by publishing their ratings and selling them to investors.[392] This ceased to be profitable due to the increasing use of improved information sharing technology—basically the photocopying machine—by users of the ratings.[393] Starting around 1970, the rating agencies began to charge issuers of debt instruments for ratings.[394] That is the system that exists today. With a credit rating effectively required by law for so many purposes, issuers in most instances seek the ratings out of necessity. Credit rating agencies generally charge companies per transaction—for a simple transaction, typically 2 or 3 basis points (.02 or .03 percent of the total amount of the deal), or somewhat more for a complex one.[395] If an issuer is extremely active in the markets, agencies also accept an annual fee.[396] Some critics suggest that this arrangement causes a conflict of interest,[397] although it is unclear how great an impact any such conflict has, given that issuers have no choice but to obtain a rating from one of the limited number of firms offering the service. In other words, the credit

[389] 17 C.F.R. § 243.100(b)(2)(iii). Moody's and S&P supported this exemption. *See* Comments of Standard & Poor's in the Matter of File No. S7–31–99, Release Nos. 33–7787, 34–42259, IC–24209, Regarding Selective Disclosure and Insider Trading, April 17, 2000; Comments of Moody's Investors Service in the Matter of File No. S7–31–99, Release Nos. 33–7787, 34–42259, IC–24209, Regarding Proposed Rule: Selective Disclosure and Insider Trading, April 27, 2000.

[390] 17 C.F.R. § 230.436(g)(2). Interestingly, the SEC makes clear in the adopting release for this rule that this rule only applies to NRSROs; to the extent that companies wish to disclose the ratings of non-NRSROs in their filings, those credit rating agencies are required to file consents as attachments to the registration statements (rendering them subject to liability under section 11 of the Securities Act of 1933). *See* 47 Fed. Reg. 11380, 11392 n. 55 (March 16, 1982).

[391] NRSROs argue that they would not be subject to liability under a negligence standard in any event because their ratings constitute opinions protected by the First Amendment. This has been accepted by at least one court. *See, e.g., County of Orange v. McGraw Hill,* 245 B.R. 151 (C.D. Cal. 1999) (where county alleged S&P had negligently issued defective ratings of municipal bonds, court held that in order to prove S&P liable for botched ratings, county had to show actual malice, the standard for protected speech).

[392] Bethany McLean, "The Geeks Who Rule the World," *Fortune,* December 24, 2001.

[393] Lawrence J. White, "The Credit Rating Industry: An Organizational Analysis," February 2001 (Working Draft) at 13, available at http://papers.ssrn.com/sol3/papers.cfm?abstract—id=267083.

[394] Bethany McLean, "The Geeks Who Rule the World," *Fortune,* December 24, 2001.

[395] Partnoy, note 369 above, at 653.

[396] Committee staff interviews with Moody's (March 8, 2002), S&P (March 6, 2002), and Fitch (March 5, 2002), described at note 404 below.

[397] The SEC solicited comments on this practice in its 1997 proposed rule. *See also* Fight, note 372 above, at 227 (noting "the obvious potential conflict of interest just from the fact that the rating company is taking ratings fees from the companies it rates"); Dave Lindorff, "Judging the Judges: Are the Top Rating Agencies Too Slow to Downgrade?" *Investment Dealers Digest,* August 13, 2001 (taking fees from issuers is "'a built-in conflict,' says credit rating agency Egan-Jones' Managing Director Bruce Jones, previously a senior analyst at Moody's. '[Moody's] charges issuers for their ratings, and yet their public posture is to turn double cartwheels to insist that their constituency is the investor.'")

rating agencies probably do not feel pressure to please issuers to get their business.[398]

This enviable market position appears to provide strong profitability: Rating agencies can benefit from active capital markets without having to risk any of their own capital. Though S&P is a division of McGraw-Hill (and therefore its individual profitability is not publicly available), and Fitch is a subsidiary of a private corporation, Moody's was recently spun off as its own publicly-held company by Dun & Bradstreet and publicly reports its earnings. Moody's—which is an S&P 500 company and has a market capitalization of approximately $7.7 billion[399]—had record results in 2001. Its revenue was $797 million, an increase of a full 32 percent from 2000. Its operating income was $399 million, 38 percent higher than 2000. Its profits were $212 million in 2001, 34 percent more than 2000.[400] Ratings generate approximately 85 percent of Moody's revenues.[401]

Although they do not consult with one another on ratings, the rating agencies generally appear to approach the business of rating issuers in a very similar way.[402] They will assign each company to one primary analyst (that analyst will cover a number of companies, perhaps between 10 and 30), who typically works with a junior analyst. Analysts work in groups divided by industry sector; the analysts covering the companies within that sector are overseen by a managing drector in charge of that sector. When a company has been rated before and is being monitored by the rating agencies, analysts will review the company's periodic SEC filings and other public information relevant to the company, including press reports or industry information. The analysts will periodically meet and speak to the company's management and visit the company's facilities. The focus of the rating agencies' analysis is the company's ability to generate cash in comparison to the company's liabilities; the extent to which the former easily covers the latter will be a significant determinant of the rating. In analyzing a company's prospects for paying its obligations, in addition to reviewing the company's own historical performance and industry trends, the credit raters will generally request additional, non-public information. Although the credit raters stress that they rely primarily on public information, they will also ask to review the company's projections of future cash flows and will generally seek a breakdown of cash flows by company segment, to see how each of its businesses have done and how the company believes they will do in the future. According to Moody's, that "segmentation information" is fundamental to assessing a company's creditworthiness. The credit raters

---

[398] The credit rating agencies, in rare cases, also provide ratings even when they do not get paid. Although Moody's informed Committee staff in an interview that it only does this now for high-yield junk bonds in the United States, S&P and Fitch told Committee staff in interviews that they provide unsolicited ratings as they see fit.

[399] Calculated based on closing price of $49.69 on September 10, 2002.

[400] "Moody's Corporation Reports Record Results for Fourth Quarter and Full Year 2001," Moody's Corporation Press Release, February 4, 2002; *see also* Moody's Corporation Annual Report on Form 10–K for year ended December 31, 2001 (filed March 22, 2002), at Item 7, pp. 15–16.

[401] Moody's Corporation Annual Report on Form 10–K for year ended December 31, 2001, at Item 7, p. 16.

[402] The following description of the credit raters' methodology was derived from telephonic Committee staff interviews with officials from Moody's (March 8, 2002), S&P (March 6, 11, 13, 2002), and Fitch (March 5, 2002), described at note 404 below.

will also generally ask for full disclosure of all significant liabilities of the company, including those "off-balance sheet."[403]

To determine a rating, analysts will convene a credit committee. The committee will consist of anywhere from 4 to 12 people, including the analysts working on the company, their managing director, and other analysts, management, or staff with useful expertise. The analyst will make a recommendation, and the committee will vote. The deliberations of a credit committee, and the identities of the participants, are kept confidential. The rating is usually made public through a press release. Companies are generally notified of their ratings in advance of the publication if there is a change or if it is a new rating to allow the issuer to respond if it believes that the rating does not accurately reflect its creditworthiness—S&P refers to this process as an "appeal." Such an "appeal," if the company requests it, is conducted within a day or two of the ratings announcement. S&P has indicated that it is rare that it will change a rating. With a company that has been rated and is being monitored, a committee will be convened periodically, perhaps once a year or once every 18 months, to reaffirm or change the rating. Prior to a ratings change, a company may be put on a "watch" or "review." An analyst may initiate a "watch" or "review" without a meeting of the credit committee.

C. *Chronology of Enron's Ratings*

Given the significant and market-wide impact of credit ratings, one would expect the rating agencies to perform a careful and searching inquiry into companies they rate. They have access enjoyed by no other corporate watchers—companies can and do share non-public material information with them without disclosing it to the public at large—and with their ability to downgrade a company's credit ratings, the rating agencies can essentially restrict a company's access to the capital markets. Indeed, one must question whether so many State and Federal laws, as well as private contracts, would vest such authority in the ratings of these agencies if anyone suspected that the credit raters were not using their power and access to obtain the best information possible.

Unfortunately, at least in Enron's case, the credit rating agencies did not perform as expected. Based on a number of interviews conducted by Committee staff with officials from Moody's, S&P, and Fitch,[404] Committee staff has concluded the agencies did not per-

[403] Committee staff interviews with Fitch (March 5, 2002), Moody's (March 8, 2002) and S&P (March 11 and 13, 2002), described at note 404 below.

[404] Staff interviewed officials from each of the agencies in preparation for the March 20 Committee hearing. On March 5, 2002, Committee staff interviewed Fitch General Counsel Charles Brown, Glenn Grabelski, Fitch Managing Director, and Ralph Pellecchia, the senior analyst on the Enron credit for Fitch. On March 6, Committee staff interviewed S&P officials, including Leo O'Neill, President of S&P, Executive Vice President Vickie Tillman, and Counsel for Regulatory Affairs Rita Bolger. On March 8, Committee staff interviewed Moody's officials, including Moody's President Ray McDaniel, Pamela Stumpp, Chief Credit Officer, and John Diaz and Stephen Moore. Moore was the primary analyst on the Enron credit for Moody's, but his work was closely overseen by Diaz, Managing Director for the Power and Energy Group. Diaz had been the Moody's analyst following Enron prior to Moore, and thus he maintained watch on the company after he was promoted to managing director. On March 11, Committee staff conducted a second interview with S&P officials, including Ronald Barone, Managing Director for the Utilities, Energy & Project Finance Group. On March 13, Committee staff conducted a third interview with S&P officials, including Todd Shipman, an S&P analyst. Shipman was the primary analyst on Enron for S&P, but his work was also closely overseen by Barone, as Barone had also followed Enron when he was an analyst.

form a thorough analysis of Enron's public filings; did not pay appropriate attention to allegations of financial fraud; and repeatedly took company officials at their word, without asking probing, specific questions—despite indications that the company had misled the rating agencies in the past.

As of late March 2000, the three agencies gave Enron the same rating: Moody's[405] gave it a Baa1, and S&P[406] and Fitch[407] both rated Enron as BBB+, indicating an upper level within the category of good credit quality.[408] Retaining this investment grade rating, and even improving it, was vital to Enron because its ability to operate and grow its trading business as well as to access the capital markets for its liquidity needs were absolutely dependent upon the stability that the rating provided. In fact, the company consistently lobbied for a higher rating.[409] Nevertheless, given the volatility inherent in an industry that was in the process of deregulation, and given that Enron was a company that took a number of risks, the rating agencies did not consider a higher rating appropriate.[410]

In early October 2001, Enron's assistant treasurer, Tim DeSpain, called Moody's and S&P to tell them that Enron would soon announce: (1) a $1 billion writedown on after-tax income due to bad investments, and (2) a $1.2 billion reduction in shareholder's equity, which DeSpain described only as an accounting adjustment. Moody's analysts were surprised because they had been assured by Enron just weeks before, after CEO Skilling's resignation on August 14, 2001, that a writedown was not imminent. Both Moody's and S&P were concerned about the effect of the large writedown on Enron's financial strength, but neither appeared significantly concerned about the equity reduction.[411] Based on information provided to Committee staff, it does not appear that they made any effort to obtain a cogent explanation for why the reduction was taking place or how such a significant accounting error could have occurred.

On or about October 12, Ken Lay, who had resumed his position as Enron CEO following Jeffrey Skilling's resignation in August,

---

[405] Paul Chivers, "Empowering Enron," *Euromoney Institutional Investor,* June 1, 2000.

[406] "Standard & Poor's Affirms Enron Ratings Re Cogen Technologies Acquisition," *PR Newswire,* November 3, 1998.

[407] "Fitch IBCA Affirms Enron Corp. at BBB+," *Business Wire,* November 8, 1999.

[408] *See* "Standard & Poor's Understanding Credit Ratings," note 355 above; "Fitch Ratings Definitions," note 355 above; "Ratings Definitions: Issuer Ratings," http://www.moodys.com, note 358 above.

[409] *See, e.g.,* Rating the Raters: Enron and the Credit Rating Agencies, Hearing Before the Senate Governmental Affairs Committee, 107th Cong., S. Hrg. 107–471 (March 20, 2002) at 65–66, 122.

[410] As S&P's Barone pointed out in his written testimony, the rating agencies, in consideration of these factors, added back "debt-like burdens" into the numbers it used to calculate Enron's rating. Barone stated that "over the years Standard & Poor's 'put back' onto Enron's balance sheet off-balance sheet amounts of between $2 billion and $4 billion in debt-like obligations for purposes of our ratings analysis." Rating the Raters: Enron and the Credit Rating Agencies, Hearing Before the Senate Governmental Affairs Committee, 107th Cong., S. Hrg. 107–471 (March 20, 2002) at 66–67.

[411] Committee staff interviews with Moody's (March 8, 2002) and S&P (March 11 and 13, 2002), described at note 404 above. In his testimony at the March 20 hearing, Moody's Diaz said that Moody's was "questioning and scratching our heads about the type of accounting that they were using for that charge and how did that $1.2 billion of equity actually come about." However, he said that Moody's was "not satisfied with [Enron's] explanations" for the actions. Nevertheless, he testified that Moody's "discussions [with Enron] during that time were concentrated on understanding the liquidity position of the company and how that was impacting the trading business." Rating the Raters: Enron and the Credit Rating Agencies, Hearing Before the Senate Governmental Affairs Committee, 107th Cong., S. Hrg. 107–471 (March 20, 2002) at 13.

called both S&P and Moody's after hearing that the credit raters were considering a downgrade. Lay tried to reassure the agencies that Enron would shore up its balance sheet, selling off assets as necessary to create additional reserves to cover obligations.[412] Neither Moody's nor S&P questioned Lay about the enormous equity adjustment.

On October 16, Enron made the earnings announcement about which it had advised Moody's and S&P nearly 2 weeks earlier. On October 17, *The Wall Street Journal* broke the story about partnerships run by Enron CFO Andrew Fastow being used to hide Enron losses and debt.[413] On October 22, Enron revealed that the SEC was investigating the allegations in the report. Two days later, on October 24, Fastow resigned. Although all the analysts said that they asked Enron officials about the allegations in *The Wall Street Journal* story, they never received—or appear really to have pressed for—a clear explanation from Enron officials, who, according to the analysts, simply denied knowledge of the details.[414] In fact, the credit analysts were not focused on Enron's questionable transactions or accounting, despite the possible serious wrongdoing these practices indicated. Despite their stated goal of assessing long-term corporate strength, the raters focused almost exclusively on the cash position of the company, a short-term consideration. It was only when Enron informed the credit rating firms that it was going to draw down on and exhaust its lines of credit—indicating it was in a cash crisis and that it was having difficulty placing its commercial paper—that the raters acted.[415]

On October 25, S&P changed Enron's ratings outlook to negative (though it kept Enron at BBB+).[416] Fitch, having digested the news from the earnings announcement and concerned about the drawdown on credit, also placed Enron on watch for a downgrade.[417] On October 29, Moody's downgraded Enron one notch to Baa2 (still investment grade) and kept it on review for another downgrade.[418] According to its press release, Moody's main concern was Enron's shrinking access to liquidity and the reduction in equity: Neither the SEC investigation nor the underlying allegations about possible financial fraud were mentioned.[419] That same day, S&P's primary Enron analyst, Todd Shipman, appeared on CNN Financial News Network. Even though S&P had placed Enron on CreditWatch negative, Shipman said, "Enron's ability to retain something like the rating they're at today"—meaning an investment grade rating—"is

[412] Committee staff interviews with Moody's (March 8, 2002) and S&P (March 11 and 13, 2002), described at note 404 above.

[413] John Emshwiller and Rebecca Smith, "Enron Jolt: Investments, Assets Generate Big Loss; Part of Charge Tied to 2 Partnerships Interests Wall Street," *The Wall Street Journal*, October 17, 2001.

[414] Committee staff interviews with Moody's (March 8, 2002) and S&P (March 11 and 13, 2002), described at note 404 above.

[415] Committee staff interviews with Fitch (March 5, 2002), Moody's (March 8, 2002) and S&P (March 11 and 13, 2002), described at note 404 above.

[416] "Ratings on Enron Corp. Affirmed; Outlook to Negative," S&P Press Release, October 25, 2001.

[417] Rating the Raters: Enron and the Credit Rating Agencies, Hearing Before the Senate Governmental Affairs Committee, 107th Cong., S. Hrg. 107–471 (March 20, 2002) at 11 (Testimony of Ralph Pellecchia).

[418] "Moody's Downgrades Enron Corp. Long-Term Debt Ratings (Senior Unsecured to Baa2) and Keeps Them Under Review For Downgrade," Moody's Press Release, October 29, 2001.

[419] *Id.*

excellent in the long term."[420] When asked about the off-balance sheet partnerships, Shipman remarked that S&P was "confident that there's not any long term implications to that situation and that's something that's really in the past."[421] As he appears to have gotten no information from Enron about the allegations of questionable transactions and accounting, it is unclear what basis Shipman had for those remarks.[422]

Despite Shipman's public comments of confidence in Enron, on November 1, S&P downgraded Enron to BBB (two notches above junk), and placed it on negative CreditWatch, although in its press release, S&P indicated its belief that Enron was sufficiently liquid to get through "the current period of uncertainty."[423] On November 2, the very next day, in a public conference call set up by S&P to answer questions about Enron,[424] Shipman, this time along with Ronald Barone, his supervisor and S&P Managing Director, again commented on S&P's "confidence" that there would be no more revelations about off-balance sheet partnerships at Enron. Barone said, "We have a great deal of confidence there are no more surprises to come." Shipman added, "We're confident we capture or are privy to the obligations that Enron has." Barone finished, "I think it's gonna take a little bit more time before everybody can get fully comfortable that there's not something else lurking out there. But at this point, we feel very confident that that's unlikely."[425]

On November 5, Fitch issued a two-notch downgrade on Enron to BBB- (just one level above junk).[426] In its release regarding the downgrade, Fitch mentioned the SEC investigation as "an additional uncertainty," and cited as a concern "an erosion in investor confidence" but expressed the belief that "Enron should be able to manage through this challenging environment, ultimately recognizing the values of the company's core businesses," which Fitch said have "generated strong, predictable performance." Fitch expressed this confidence in Enron's "strong performance" despite the reports about its questionable transactions, which may have been used to make the company's performance seem better than it was.

In the meantime, on or around November 5, Moody's and S&P were informed by Enron about the upcoming announcement of a merger with Dynegy.[427] Fitch was also notified of the merger plans

[420] Interview of Todd Shipman, S&P, by Deborah Marchini (CNNFN Street Sweep, October 29, 2001), available on Lexis/Nexis, Transcript #102915cb.l06.

[421] *Id.*

[422] Barone testified at the March 20 hearing that Enron officials had told him that "they would be surprised if they found anything further," but conceded that he had told Committee staff that Enron officials had said that "they didn't know what else was out there." Rating the Raters: Enron and the Credit Rating Agencies, Hearing Before the Senate Governmental Affairs Committee, 107th Cong., S. Hrg. 107–471 (March 20, 2002) at 14.

[423] "Enron Corp.'s Rating Lowered, Placed on CreditWatch Negative," S&P Press Release, November 1, 2001.

[424] This conference call was open to the public; anyone who wanted to listen in or ask questions could call into a number provided by S&P.

[425] Transcript of S&P Teleconference re: Enron, dated November 2, 2001, provided to the Committee under cover of letter from Floyd Abrams, Esq. to Cynthia Gooen Lesser, Counsel, Senate Governmental Affairs Committee, dated March 19, 2002.

[426] "Fitch Downgrades Enron to 'BBB-'; Maintains Rtg Watch Negative," *Business Wire,* November 5, 2001.

[427] It was in connection with the discussions about the merger that Moody's received telephone calls about Enron's credit rating, mostly from Enron's bankers. According to a description of these calls provided to Committee staff by Moody's attorneys on March 19, 2002, after receiving a copy of the merger term sheet on November 8, 2001, Moody's was concerned that the merger terms too easily allowed Citigroup and J.P. Morgan Chase, the banks financing the merger, and

Continued

in advance. All the credit raters said that they retained Enron's credit rating at above investment grade through November 28 solely because of the proposed merger.[428] On November 9, Fitch essentially improved Enron's credit outlook by putting it on an "evolving" ratings watch, rather than a negative one, due to the good prospects from the merger. In its November 9 release, Moody's downgraded Enron to Baa3 (one notch above junk) due to shrinking investor confidence, but indicated that it would view "a substantial near term injection of equity capital as a stabilizing event," an implicit reference to the merger.[429] S&P also downgraded Enron to BBB- (one notch above junk), with a negative watch on November 9, with its investment grade rating at this point due entirely to the merger.[430] Despite the fact that Enron had just 1 day before, on November 8, announced a restatement for the past 4½ years, with a charge to earnings of approximately $500 million—about 20 percent of earnings during that period—none of the credit rating agencies showed concern about the possibility of financial fraud and the damage that such illegalities could cause Enron and its merger partner.[431]

On November 19, Enron filed its Form 10–Q, which reported its third quarter results. For the first time, to the surprise of all the credit rating agencies, Enron disclosed that the November 9 S&P downgrade to BBB- had triggered a demand obligation for $690 million.[432] Although the credit rating agencies were aware of other

---

Dynegy, Enron's prospective acquirer, to drop the deal. Moody's told Enron that it was seriously considering downgrading Enron below investment grade as a result of this uncertainty. After that, the CEO of Moody's, John Rutherfurd, received a number of telephone calls. Former Treasury Secretary Robert Rubin, Chairman of Citigroup's Executive Committee, and Michael Carpenter, CEO of Citigroup Salomon Smith Barney, conference called Rutherfurd, who was in his car on his cellphone at the time. Before the call got started, Rubin apparently was dropped from the call; he and Rutherfurd did not speak again on the matter. Carpenter told Rutherfurd that he was concerned about the possible Enron downgrade; Rutherfurd replied that he did not get involved with ratings matters, and told Carpenter he would have Debra Perry, a senior managing director and executive officer of Moody's, call him. Rutherfurd called Perry, who called Carpenter, and set up a meeting with her and James Lee, another Citigroup official, and William Harrison, CEO of J.P. Morgan Chase. (Harrison left a message for Rutherfurd also, but they never spoke.) In Perry's meeting with Harrison and Lee, Lee mentioned that William McDonough of the Federal Reserve might call, but neither he, nor any other government official ever did. (Richard Grasso, CEO of the New York Stock Exchange, left a message for Rutherfurd that day, but by the time Rutherfurd called him back, the issue had been resolved and they never discussed Enron.) Ultimately, Lee and Harrison agreed to change the terms of the merger to accommodate Moody's concerns; Dynegy agreed to similar changes. Neither S&P nor Fitch received such calls, according to their testimony at the Committee's March 20 hearing. Rating the Raters: Enron and the Credit Rating Agencies, Hearing Before the Senate Governmental Affairs Committee, 107th Cong., S. Hrg. 107–471 (March 20, 2002) at 28.

[428] Committee staff interviews with Fitch (March 5, 2002), Moody's (March 8, 2002) and S&P (March 11 and 13, 2002), described at note 404 above.

[429] "Moody's Downgrades Enron Corp. Long-Term Debt Ratings And Keeps Them Under Review For Downgrade," Moody's Press Release, November 9, 2001.

[430] "Dynegy Ratings Placed on Watch Negative; Enron Rating Lowered to BBB-," S&P Press Release, November 9, 2001.

[431] To the extent that the credit rating agencies expressed concerns in this regard, they were limited to concerns about counterparty and investor confidence as a result of the allegations—a short-term concern—not about the inherent, long-term damage that serious fraud could inflict on a corporation. *See, e.g.,* Rating the Raters: Enron and the Credit Rating Agencies, Hearing Before the Senate Governmental Affairs Committee, 107th Cong., S. Hrg. 107–471 (March 20, 2002) at 11, 13.

[432] Enron Corp. Form 10–Q for Quarter Ended September 30, 2001, filed November 19, 2001, at 10, 33. News reports have indicated that the $690 million obligation was associated with an entity called Whitewing. *See, e.g.,* Peter Behr, "Enron Raised Funds in Private Offering; Shareholders in Dark, Documents Show," *The Washington Post,* January 22, 2002. Whitewing was an Enron-affiliated entity that the credit rating agencies were well aware of; they had rated debt offerings that were associated with Whitewing. Indeed, the other obligations Enron had with ratings triggers that the rating agencies knew about were related to Whitewing. The credit rating agencies told Committee staff that their understanding was that the $690 million obligation

such agreements backing other special purpose entities associated with Enron, they did not know about this one. According to what the credit analysts told Committee staff in interviews, the analysts had never specifically asked Enron if other triggers dependent on credit ratings existed.[433] Enron officials told S&P that current Enron management had not even known about the $690 million obligation; it was a surprise to them when the trustee for the affected entity had exercised the trigger.[434] S&P not only failed to ask if there were other "surprises" regarding credit triggers or other obligations, but the S&P analysts appear to have also been unconcerned about the fact that Enron management itself appeared to lack knowledge about a major company commitment.[435] On November 20, the day after this disclosure, S&P reaffirmed its investment grade rating with a negative watch. S&P said that it believed Enron could deal with the $690 million obligation (without mentioning the fact that Enron had failed to disclose a significant financial obligation and that S&P believed the obligation was a surprise even to management at Enron).[436]

Over the next few days, however, the credit rating agencies heard about a renegotiated deal for the proposed merger, and the likelihood of the merger seemed more and more remote. Finally, on November 28, after hearing that the terms had been revised to give Dynegy additional ways to terminate the transaction, and without additional cash from the banks involved, the rating agencies decided to give up on Enron.[437] On November 28, all three agencies downgraded Enron to below investment grade: Moody's downgraded Enron to B2 (5 notches below the previous rating),[438] S&P downgraded Enron to B- (6 notches below previous rating),[439] and Fitch lowered Enron to CC (more than 8 notches below previous rating).[440] Currently, Fitch and S&P rate Enron as a D and Moody's rates Enron as a Ca.

D. *Problems With the Agencies' Analyses and Actions*

While the credit rating agencies did not completely ignore problems at Enron when those problems became very apparent, their monitoring and review of the company's finances fell far below the careful efforts one would have expected from organizations whose ratings hold so much importance. Instead, based on what the credit rating analysts told Committee staff in interviews and the analysts' testimony at the Committee's hearing on March 20, 2002, entitled "Rating the Raters: Enron and the Credit Rating Agencies," it ap-

was associated with a partnership called Rawhide that the credit raters were unaware of prior to the Form 10–Q filing.

[433] Committee staff interviews with Fitch (March 5, 2002), Moody's (March 8, 2002) and S&P (March 11 and 13, 2002), described at note 404 above.

[434] Committee staff interviews with S&P (March 11 and 13, 2002), described at note 404 above.

[435] *Id.*

[436] "Enron Corp.'s Ratings Still Watch Negative," S&P Press Release, November 20, 2001.

[437] Committee staff interviews with Fitch (March 5, 2002), Moody's (March 8, 2002) and S&P (March 11 and 13, 2002), described at note 404 above.

[438] "Moody's Downgrades Enron Corp.'s Long-Term Debt Ratings (Senior Unsecured to B2); Commercial Paper Confirmed at Not Prime; Ratings Remain Under Review For A Downgrade," Moody's Press Release, November 28, 2001.

[439] "Enron Rating Cut to 'B-'; Doubt Cast on Dynegy Merger," S&P Press Release, November 28, 2001.

[440] Rating the Raters: Enron and the Credit Rating Agencies, Hearing Before the Senate Governmental Affairs Committee, 107th Cong., S. Hrg. 107–471 (March 20, 2002) at 12.

pears that the credit raters took Enron at their word and failed to probe more deeply. Moreover, in general, the ratings analysts appear to have taken too narrow a focus in determining what Enron's problems were: They focused on short-term problems, like cash flow or counterparty confidence, rather than deep-rooted problems, such as questionable transactions or suspect accounting. In short, based on the credit rating agency analysts' testimony at the March 20 hearing, and what they told Committee staff in interviews, the Committee staff has concluded that the credit rating agencies' approach to Enron fell short of what the public had a right to expect, having placed its trust in these firms to assess corporate creditworthiness for the purposes of Federal and State standards. It is difficult not to wonder whether lack of accountability—the agencies' practical immunity to lawsuits and non-existent regulatory oversight—is a major problem.

Insufficient Review of Company Materials. When asked if he thought the credit rating agencies had done a good job, former SEC Chief Accountant Lynn Turner testified that his own initial review of Enron's financial statements "raised more questions than they answered," and that anyone doing a similar review should have been given pause by their opacity.[441] One of the more glaring concerns Committee staff developed based on their interviews of the credit rating agencies was that the analysts who worked on Enron appear to have been less than thorough in their review of Enron's filings, even though they said that they rely primarily on public filings for information in determining credit ratings. Enron's disclosure in its 2000 Form 10–K filing about related-party transactions—footnote 16—where information about the company's questionable deals with partnerships and special purpose entities run by Enron insiders should have been disclosed, was very difficult to understand. When Committee staff asked the analysts if they understood the disclosures in footnote 16, Moody's and Fitch told staff they did not understand precisely what those disclosures referred to, but were only concerned about the impact these transactions had on cash flow, which they believed had been disclosed elsewhere. The analysts from Moody's and Fitch told Committee staff that they were not concerned about the details of the transactions themselves, despite that the fact that those details might have indicated a problem—that Enron was gaining significant income from deals with partnerships run by its own CFO—and led them to wonder whether fraud was afoot. The S&P analysts told Committee staff that they simply assumed that the opaque disclosures regarding related-party transactions in the 2000 Form 10–K referred to the off-balance sheet entities of which they were aware (because S&P rated some of these in connection with debt offerings). According to their remarks to Committee staff, the S&P analysts did nothing to confirm their understanding.

In fact, the S&P analysts could have checked their understanding of this disclosure, to some extent, by reviewing Enron's proxy statement, which is required to contain additional informa-

[441] The Role of Financial Institutions in Enron's Collapse, Hearing Before the Permanent Subcommittee on Investigations, Senate Governmental Affairs Committee, 107th Cong., S. Hrg. 107-618 (July 23, 2002) at— (Printed Hearing Record Pending) (Testimony of Lynn Turner, former Chief Accountant of the SEC).

tion about related-party transactions. (Proxy statements also have other relevant information not found in other filings, such as disclosures about certain insider sales.) The analysts from S&P said that they did not read Enron's proxy statements.[442] In fact, they told Committee staff that they did not even know how the information they could find in a proxy statement in this regard might differ from that found in the 10–K. If the S&P analysts had read Enron's 2001 proxy statement, they may have learned that their assumption about Enron's 2001 Form 10–K disclosure was incorrect. The proxy contains a more explicit description of the related-party transactions than is contained in the 10–K; for instance, the proxy statement specifically states that the company had engaged in numerous transactions with an entity called LJM2 (not the Whitewing, Osprey, and Marlin entities with which the S&P analysts said that they were familiar) and indicates that Enron Chief Financial Officer Andrew Fastow was the general partner of that entity.[443]

Short Term v. Long Term Focus. The agencies told Committee staff that their ratings reflect an analysis of long-term creditworthiness. In the case of Enron, however, the credit raters, according to their remarks to Committee staff in interviews, failed to do simple things one would expect from someone conducting a long-term evaluation of a company's financial health. For example, based on the information gathered by Committee staff, it appears that the credit analysts did not look for fundamental problems at the company by scrutinizing the financial statements or assessing the aggressiveness of Enron's accounting methods. When asked by Committee staff whether they considered as a qualitative factor in their analysis whether the company was engaging in aggressive accounting, the agencies indicated that they rely on the auditors' work. This was consistent with their testimony at the hearing.[444] In the Committee staff interviews, the credit rating analysts resisted staff's suggestion that a company's accounting methods should be part of their analysis, because even when financial statements comply with Generally Accepted Accounting Principles (GAAP), they nevertheless may not present all the information an investor would want to know, or all the information a credit rater would want to know. This is troubling, because the fact that a company may be using the flexibility of GAAP to hide problems should be a consideration, particularly if the credit raters take a long-term view.

Moreover, despite their stated effort to take a long-term approach to ratings, the credit rating agencies appear to have focused primarily on short-term issues with Enron, like access to cash in the near term, counterparty confidence, or whether the Dynegy merger would succeed, even as there continued to be revelations about Enron's questionable use of off-balance sheet entities run by its CFO. For example, when Enron's $690 million obligation was disclosed for the first time—to the surprise of everyone, including,

[442] Committee staff interviews with S&P (March 11 and 13, 2002), described at note 404 above. It is worth noting that proxy statements are incorporated by reference in Forms 10–K; a thorough review of any 10–K would have to include a review of the proxy statement as well.

[443] Enron Corp. Definitive Proxy Statement (Schedule 14A) (filed March 27, 2001) at 26.

[444] Rating the Raters: Enron and the Credit Rating Agencies, Hearing Before the Senate Governmental Affairs Committee, 107th Cong., S. Hrg. 107–471 (March 20, 2002) at 29.

S&P believed, company management—S&P analysts told Committee staff that they did not ask if there were other potential triggers (nor did any of the other credit rating agencies), nor did they appear to register much concern about Enron management's expressed lack of knowledge. Indeed, although the credit analysts told Committee staff that they asked Enron officials about *The Wall Street Journal* allegations, they acknowledged that they did not press for a detailed answer when none was forthcoming, even after an SEC investigation was announced. Both Moody's and S&P stressed to Committee staff that the revelations in *The Wall Street Journal* were just allegations, and the analysts were not inclined to render judgment until all the facts were in.[445] In interviews with Committee staff, the credit analysts seemed unwilling to distinguish between rendering judgment and asking probing questions—and demanding answers.

Lack of Inquisitiveness. Leo O'Neill, S&P's President, said in a staff interview that fixed income analysts ask "green-eyeshade questions," referring to the green eyeshades auditors were noted for wearing in earlier times, and the tough, probing queries for which they were then known.[446] Credit rating analysts should take a similar approach—they, like fixed income analysts, assess the ability of the company to repay debt (fixed income analysts focus on bonds, as opposed to equity analysts, who focus on stocks). Based on their testimony at the March 20 hearing and their remarks to Committee staff in interviews, however, Committee staff concluded that the credit rating agency analysts did not take this skeptical approach. Not only did they apparently fail to scrutinize Enron's public filings (indeed, they failed even to read all the major filings), the credit analysts in general appear to have taken the company officials at their word, simply assuming that they were telling the truth. As Ronald Barone of S&P testified at the March 20 hearing, "we do rely on what senior management tells us. It is in their best interest to tell us and be forthright and not convey a different message, because if we convey a message to the market that is different that what the market perceives over the long term, then the credibility of Standard & Poor's and then ultimately the credibility of the company is at risk. . . . And so it is in their best interest to tell us the truth, and we rely on that."[447] Senator Thompson called this reasoning "a chicken-and-egg deal," pointing out that corporate executives might instead view it in their best interests "to minimize bad news and stretch the truth."[448]

In addition, from what the credit analysts told Committee staff, they did not pursue what even they admitted was fundamental information, despite the fact that the credit raters publicly acknowledged that Enron was a complex company. In a March 2001 article about Enron's opaque financial statements, in response to the question of how Enron makes its money, S&P's Todd Shipman, the analyst working under Ronald Barone, was quoted as saying, "If you figure it out, let me know," and Fitch's Ralph Pellecchia joked, "Do

---

[445] Committee staff interviews with Moody's (March 8, 2002) and S&P (March 11 and 13, 2002), described at note 404 above.

[446] Committee staff interview with S&P (March 6, 2002), described at note 404 above.

[447] Rating the Raters: Enron and the Credit Rating Agencies, Hearing Before the Senate Governmental Affairs Committee, 107th Cong., S. Hrg. 107–471 (March 20, 2002) at 15.

[448] *Id.*

you have a year?"[449] The point of this article was that Enron was generally understood by Wall Street to be a "black box," difficult to understand and loath to answer too many questions about ambiguities. While Pellecchia explained at the Committee's March 20 hearing that his response was merely a "glib answer," he acknowledged that the "spirit of the answer was Enron's a big company, a complex company. . . ."[450] In other words, these analysts well understood that getting a clear picture of Enron's financial situation was not a simple matter. Yet, they apparently failed to use the necessary rigor—the "green-eyeshade" approach—to ensure that their analysis of such a company was sound.

As early as May 2001, the independent research firm Off Wall Street Consulting Group called Enron a bad bet. Off Wall Street's analysis showed that Enron's trading operation—its most profitable venture—was starting to turn weaker profits as the market it helped open up became more liquid and prices less volatile.[451] Enron did not, in its public filings, indicate how much money its trading business made as distinct from the rest of its "Wholesale Division," which contained other investments and businesses. Accordingly, there was no way to tell how its trading business was really doing. When the credit rating agencies asked for this information—information which Moody's Chief Credit Officer Pamela Stumpp told Committee staff was "fundamental" to a credit analysis[452]—Enron, according to the credit analysts, told them that it did not have that kind of detail. Enron's response appears to be either not credible or a sign of a company in trouble. A company must know how each of its businesses is performing in order to monitor it. Nevertheless, even though the credit rating agencies were allowed to ask for and receive this information under their exemption from SEC Regulation F–D (their special access to material information not shared with the rest of the market), and even though they knew that Enron was very concerned about its credit rating, the credit rating agencies acknowledge that they did not push for the information. According to what the credit analysts told Committee staff, they simply accepted Enron's refusal.

In interviews with Committee staff, all the agencies acknowledged that they could withdraw a rating for failure to provide sufficient information. In the March 20 hearing, for example, S&P's Barone said that "if we knew . . . then what we know now, we would have withdrawn Enron's rating for failure to disclose proper information."[453] Nevertheless, the agencies told Committee staff in interviews that in response to Enron's refusal to provide important information—like information about the trading operation—they did not even raise the possibility of withdrawing the rating, a sug-

---

[449] Bethany McLean, "Is Enron Overpriced?," *Fortune,* March 5, 2001.

[450] Rating the Raters: Enron and the Credit Rating Agencies, Hearing Before the Senate Governmental Affairs Committee, 107th Cong., S. Hrg. 107–471 (March 20, 2002) at 23.

[451] Off Wall Street Consulting Group, Research Report Regarding Enron Corp., May 6, 2001 at 3.

[452] Committee staff interview with Moody's (March 8, 2002), described at note 404 above.

[453] Rating the Raters: Enron and the Credit Rating Agencies, Hearing Before the Senate Governmental Affairs Committee, 107th Cong., S. Hrg. 107–471 (March 20, 2002) at 29.

gestion which, if made, might have convinced Enron to send the agencies the information requested.[454]

Similarly, and as noted above, based on what they told Committee staff, when S&P analysts read the related-party transactions disclosure in Enron's 2000 Form 10–K, they assumed, without asking, that the entire footnote referred to the Osprey and Marlin transactions. It is unclear whether the disclosure's text is entirely consistent with this assumption, but the analysts appear to have done nothing to verify their beliefs. Moreover, according to what the S&P analysts said to Committee staff in interviews, *The Wall Street Journal* article did not lead them to question their assumptions. To the extent that any of the analysts asked about the allegations in *The Wall Street Journal,* they accepted the answer from the company that a special committee would investigate, without questioning whether the problems were so deep that they might permanently scar Enron's future. In short, as Glenn Reynolds, Chief Executive Officer of independent credit research firm CreditSights, Inc., stated in his testimony before the Committee at the March 20 hearing, "As we look back at the performance of the rating agencies in the case of Enron, we are hard pressed to recall a situation where the rating agencies held so much sway over a company and had such commanding leverage to extract information, and yet were so ineffective at doing so."[455]

At the Committee's March 20 hearing, the credit rating analysts—in particular Ronald Barone of S&P—stressed over and over again that they were simply duped by Enron management, and there was nothing they could do. When Chairman Lieberman asked the analysts whether in retrospect, they felt they should have asked more questions of Enron, Barone responded, "Senator, we rely on the audited financial statements. . . . We are not forensic accountants, if that is the question, and we don't have subpoena power. . . ."[456] Barone attached to his written testimony what he referred to as the "kitchen sink" documents, which were presentations made by Enron to the credit raters, in October 1999 and in January 2000, to convince the agencies to improve Enron's credit rating.[457] Barone pointed out in his testimony that, in fact, Enron did not reveal all of its obligations in this presentation; one example he gave was that Enron did not disclose that it had billions of dollars in derivative transactions that were, in substance though not in form, loans.[458] Committee staff asked Barone and Shipman in interviews prior to the hearing whether they had ever asked about Enron's portfolio of derivatives, or whether, knowing that

[454] Committee staff interviews with Fitch (March 5, 2002), Moody's (March 8, 2002) and S&P (March 11 and 13, 2002), described at note 404 above.

[455] Rating the Raters: Enron and the Credit Rating Agencies, Hearing Before the Senate Governmental Affairs Committee, 107th Cong., S. Hrg. 107–471 (March 20, 2002) at 157 (Statement of Glenn Reynolds, Chief Executive Officer, CreditSights, Inc.).

[456] *Id.* at 29.

[457] Rating the Raters: Enron and the Credit Rating Agencies, Hearing Before the Senate Governmental Affairs Committee, 107th Cong., S. Hrg. 107–471 (March 20, 2002) at 87–115.

[458] Rating the Raters: Enron and the Credit Rating Agencies, Hearing Before the Senate Governmental Affairs Committee, 107th Cong., S. Hrg. 107–471 (March 20, 2002) at 70. On July 23, 2002, PSI held a hearing on these transactions, with witnesses from the credit rating agencies as well as from Citigroup and J.P. Morgan, the banks that had facilitated the deals. The Role of Financial Institutions in Enron's Collapse, Hearing Before the Permanent Subcommittee on Investigations, Senate Governmental Affairs Committee, 107th Cong., S. Hrg. 107-618 (July 23, 2002) at— (Printed Hearing Record Pending).

Enron was engaging in some rather complex transactions, they had ever consulted with a derivatives expert at S&P to get a more specific sense of the obligations Enron could be facing in connection with its derivative transactions. While they could not remember if they ever consulted with such an expert, both Barone and Shipman acknowledged that they had never specifically asked Enron to detail derivative transactions that could have loan-like characteristics.[459] Similarly, Barone stated in his testimony that S&P was misled by Enron's failure to provide information about the LJM partnerships.[460] However, if he or Shipman had reviewed Enron's proxy statement, they would have discovered these entities, and could have inquired about them. Barone summed up his attitude about S&P's responsibility with respect to Enron when he made the following statement in response to a question by Senator Bunning at the March 20 hearing: "Senator, this was not a ratings problem. This was a fraud problem."[461]

Moody's took a more measured approach at the March 20 hearing. Diaz of Moody's had the following exchange in response to a question by Senator Thompson about the related-party transaction disclosures in Enron's 2000 10–K (which appeared in footnote 16 to the financial statements in that filing):

> DIAZ: "I think in looking at footnote 16, clearly what needs to be done in those situations is try to get behind it and try to understand a lot more of what's there. You know, looking in hindsight at how that impacted the ultimate confidence in the company, it's pretty clear that there were—and from my point of view, we certainly look at a situation where we could have dug more into and tried to get behind that."
>
> SENATOR THOMPSON: "It would be fair to say that if you ran across this same situation again, you would delve into it deeper?"
>
> DIAZ: "Yes sir."[462]

In addition, in his written testimony, Diaz stated that "[g]oing forward, we are enhancing the ratings process by putting increased focus in several areas," including "corporate governance and how aggressive or conservative are accounting practices" at the companies Moody's is rating.[463]

Lack of Accountability. The credit rating agencies are aware of how much their decisions can affect the fortunes of the companies they rate (and therefore the fortunes of the companies' investors). Nevertheless, based on the testimony of the credit analysts at the March 20 hearing and the remarks of the analysts in interviews with Committee staff, Committee staff concluded that the credit analysts do not view themselves as accountable for their actions. For example, the remarks of S&P analysts Ronald Barone and Todd Shipman in late October and early November about their "confidence" that there would be no more surprises from Enron do

---

[459] Committee staff interviews with S&P (March 11 and 13, 2002), described at note 404 above.

[460] Rating the Raters: Enron and the Credit Rating Agencies, Hearing Before the Senate Governmental Affairs Committee, 107th Cong., S. Hrg. 107–471 (March 20, 2002) at 72.

[461] *Id.* at 25.

[462] *Id.* at 16.

[463] *Id.* at 128.

not appear to be based on anything more than assumption. In his testimony at the Committee's March 20 hearing, Barone said that he gained the confidence from a conversation with Enron management, but conceded after specific questioning that management had told him that they did not know whether other entities or special purpose entities existed, and a special committee had just begun an investigation.[464] The credit rating agencies acknowledged in interviews with Committee staff that others in the market believe the agencies have access to more information about companies than any other outsiders due to their market power (their ability to downgrade) and their exemption from SEC Regulation F–D. Despite this public expectation about their superior level of knowledge, S&P, for example, could not cite to Committee staff any policies to ensure that its analysts conducted themselves responsibly in media appearances, or in making public statements similar to those Shipman and Barone made on CNN and in the S&P conference call (which was reported in the press[465]).

When asked by Committee staff about accountability concerns, the rating agencies had two responses. First, they said that their concern for their reputation keeps them on their toes: As S&P's Barone stated in his testimony: "Standard & Poor's recognition as a rating agency ultimately depends on the credibility of its opinions with investors, importantly, but also with bankers, financial intermediaries, and securities traders."[466] The second response, which the raters stated a number of times in interviews with Committee staff, was that their ratings were just opinions, protected by the First Amendment.[467] Fitch's general counsel referred to the letter grades given by the credit rating agency as "the world's shortest editorial."[468] The credit rating agencies seem to be trying to walk a fine line between maintaining enormous market power through both official and unofficial uses of their ratings, and insisting that their ratings are purely their "opinion," and therefore pure speech under a First Amendment analysis. First Amendment-protected opinions about matters of public concern can give rise to liability only when, to the extent they convey facts, they convey them with actual knowledge of or reckless disregard for their accuracy.[469] This standard poses such a high barrier that it virtually insulates the speaker from liability.

Indeed, courts have extended First Amendment protections to credit ratings, shielding the agencies from liability.[470] Courts have

[464] *Id.* at 14.

[465] Tom Fowler, "S&P: 'No More Surprises For Enron,'" *Houston Chronicle,* November 3, 2001.

[466] Rating the Raters: Enron and the Credit Rating Agencies, Hearing Before the Senate Governmental Affairs Committee, 107th Cong., S. Hrg. 107–471 (March 20, 2002) at 60.

[467] S&P arranged a meeting for Committee staff with Floyd Abrams, its First Amendment counsel, who also prepared a memorandum for staff laying out the basis for S&P's First Amendment argument.

[468] Committee staff interview with Fitch (March 5, 2002), described at note 404 above.

[469] *Milkovich v. Lorain Journal Co.,* 497 U.S. 1, 20–21 (1990) ("where a statement of 'opinion' on a matter of public concern reasonably implies false and defamatory facts regarding public figures or officials, [plaintiff] must show that such statements were made with knowledge of their false implications or with reckless disregard of their truth").

[470] *See, e.g., County of Orange v. McGraw Hill Cos., Inc.,* 245 B.R. 151, 156 n. 4 (C.D. Cal. 1999) ("Standard & Poor's ratings are speech and, absent special circumstances, are protected by the First Amendment. In reaching this ruling, the Court assumed any First Amendment protected speech, as a matter of public concern, would receive the heightened protection of the actual malice standard"); *Jefferson County Sch. Dist. v. Moody's Investors Service,* 175 F.3d 848 (10th Cir. 1999) (applying the *Milkovich* standard to a claim that the Moody's rating of the school district's bonds was an injurious falsehood).

even refused to require that credit rating agencies produce records in connection with their work, citing the "journalist's" privilege.[471] However, the fact that the market seems to value the agencies' ratings mostly as a certification (investment grade vs. non-investment grade) or as a benchmark (the ratings triggers in agreements) and not as information,[472] and the fact that the law, in hundreds of statutes and regulations, also uses their work that way, seems to indicate that their ratings are not the equivalent of editorials in *The New York Times*. The fact that the rating agencies have received First Amendment protection for their work should not preclude greater accountability.

The rating agencies, however, have escaped regulation thus far. In his testimony at the March 20 hearing, then SEC Commissioner Isaac Hunt stated that all three of the current NRSROs were registered with the SEC under the Investment Advisers Act of 1940,[473] which prohibits fraud, imposes fiduciary duties on advisers with respect to their advice, requires that advisers maintain certain books and records, and allows the SEC to examine all registered advisers to assure compliance with the Act. According to Commissioner Hunt's testimony, the Act would therefore require that NRSROs have an adequate basis for their ratings.[474] Commissioner Hunt testified in addition that the SEC does examine NRSROs, as with other investment advisers, approximately every 5 years. In the course of those examinations, the SEC reviews the books, records, and the operation of the agencies. The legal application of the Investment Advisers Act to the credit rating agencies, however, is in doubt. As part of the designation, the agencies agreed to voluntarily register, but they insist that they are not covered by the Act and that any information they provide the SEC is given strictly on a voluntary basis, not pursuant to the requirements of the Act. The Act, in defining investment advisers, contains an exception for publishers,[475] and the credit rating agencies would argue that they fit under that exception.[476] To the extent that they are correct—and the case law on this point is very favorable to them—none of the requirements of the Investment Advisers

[471] *See, e.g., In re Pan Am Corp.,* 161 B.R. 577, 581–583 (S.D.N.Y. 1993) (quashing subpoena to S&P for records of communications with Delta Air Lines based on qualified journalist's privilege because "S&P functions as a journalist when gathering information in connection with its ratings process").

[472] *See* Rating the Raters: Enron and the Credit Rating Agencies, Hearing Before the Senate Governmental Affairs Committee, 107th Cong., S. Hrg. 107–471 (March 20, 2002) at 143 (Statement of Jonathan Macey, Professor, Cornell University Law School) ("Academic studies tend to show that information in credit ratings is of marginal value at best because the information contained in the ratings had already been incorporated into share prices. One well-known study showed that the ratings provided by rating agencies lagged the information contained in securities prices by a full year.").

[473] 15 U.S.C. 80b–1 *et seq.*

[474] Rating the Raters: Enron and the Credit Rating Agencies, Hearing Before the Senate Governmental Affairs Committee, 107th Cong., S. Hrg. 107–471 (March 20, 2002) at 136.

[475] 15 U.S.C. § 80b–2(a)(11)(D) (exempting any publisher of "any bona fide newspaper, news magazine or business or financial publication of general and regular circulation" from coverage of the Act).

[476] They rely on *Lowe v. Securities and Exchange Comm'n,* 472 U.S. 181 (1985), which held that the publisher exception, in concert with the legislative history of the Act, indicates that meaning of "investment adviser" cannot include those who do not provide personalized advice directly to clients. The Court held: "As long as the communications between petitioners and their subscribers remain entirely impersonal and do not develop into the kind of fiduciary, person-to-person relationships that were discussed at length in the legislative history of the Act and that are characteristic of investment adviser-client relationships, we believe the publications are, at least presumptively, within the exclusion and thus not subject to registration under the Act." 472 U.S. at 210.

Act would apply to them.[477] In any event, the SEC has never taken enforcement action against the rating agencies based on their ratings, whether under the Investment Advisers Act or otherwise.

E. *Conclusions and Recommendations*

Although the credit rating agencies' ratings are generally right, when they are wrong, the consequences can be serious. In the case of Enron, their poor performance, along with the failures of all the other market watchdogs, has had a market-wide effect, leading investors to wonder whether they can count on the information upon which they may have previously relied in making their investment decisions. It may well be the case that most companies, particularly those with balance sheets strong enough to have an investment grade rating, are providing the investing public with a fairly accurate picture of their financial state, with disclosures that are full and fair enough to provide the credit rating agencies with the information they need to perform their analysis. We have learned, however, that when company officials are not honest, and their auditors are too entrenched or conflicted to call management out on problems, investors need someone to raise a red flag. Credit raters, with their special access, strong market power, and lack of conflicts, are in the perfect position to do this.

The problem is that the credit rating agencies have no incentive to catch the few wrongdoers, no matter how huge the consequences to the market. Duke Law School Professor Steven Schwarcz argued in his testimony at the Committee's March 20 hearing that reputational concerns are sufficient incentive for the credit rating agencies to be diligent in their work, and he cited their strong track record as proof.[478] Assuming that most companies are honest, however, credit rating agencies will be correct in most cases without having to go much beyond the face of financial statements. Their limited liability and their entrenched position of power means that they do not have to go to additional lengths in order to expose the outlier corporations that are not being truthful.

Under the current system, credit rating agencies arguably act in many respects like government agencies. In the March 20 hearing, Chairman Lieberman likened the role of the rating agencies to the Food and Drug Administration: The FDA does not "let a drug go out on the market . . . until [it has] gone over all sorts of investigations to guarantee it is safe, and then doctors prescribe the drug, people use it in reliance on that. To some extent, we have asked [the credit rating agencies] to play . . . a similar role with regard to corporations."[479] As with drug companies and FDA approval, corporations wishing to issue debt need ratings in most instances. But unlike FDA, which is accountable to Congress, the raters answer to no authority. In addition, unlike a government agency, they profit from every transaction they rate, thereby reaping the benefits of the capital markets without risking any capital.

---

[477] It is the position of the ratings agencies that they have been providing information to the SEC over the years voluntarily, not pursuant to an examination requirement.

[478] Rating the Raters: Enron and the Credit Rating Agencies, Hearing Before the Senate Governmental Affairs Committee, 107th Cong., S. Hrg. 107–471 (March 20, 2002) at 170.

[479] *Id.* at 30.

Some have suggested replacing credit ratings required in regulation and statute with a market indicator,[480] but no market indicators appear to be sufficiently reliable.[481] There have also been suggestions that the credit rating agencies be subject to additional liability for their actions.[482] Other suggestions have been that government agencies—particularly the SEC—exercise additional oversight over the credit rating agencies' procedures and actions to ensure diligence and thoroughness.[483] In fact, at the March 20 hearing, then SEC Commissioner Hunt testified that the SEC planned to "engage in a thorough examination, which may include hearings, to ascertain facts, conditions, practices and other matters relating to the role of rating agencies in the U.S. securities markets. . . . We believe it is an appropriate time and in the public interest to re-examine the role of rating agencies in the U.S. securities markets."[484] In addition, the Sarbanes-Oxley Act requires the SEC to conduct a study into the role and function of credit rating agencies in the securities market, including a consideration of any impediments to their accurate appraisal of the financial resources or risks of the issuers of securities that the agencies rate.[485]

The SEC has not finished this process, but Committee staff recommends that the SEC, in consultation with other agencies that use the NRSRO designation in their regulations—particularly banking agencies—set conditions on the NRSRO designation through additional regulation. Those conditions should include imposing a set of standards and considerations that the rating agencies must use in deriving their ratings, such as accounting issues. In addition, the SEC should also require a level of training for analysts working for credit rating agencies, including training as to the information contained in the periodic filings with the SEC and other government agencies that oversee companies in the particular sector each analyst is assigned to as well as training in basic forensic accounting. The SEC should monitor the compliance with these requirements, and in the event of a future corporate meltdown such as Enron, the SEC should investigate to ensure that the ratings were derived in accordance with those standards. If the public and the government is to rely on the ratings of these agencies, and give them legal force, then it must ensure that they are the product of diligent and effective analysis. Meaningful SEC oversight is the best way to ensure such an outcome.

---

[480] Partnoy, note 369 above, at 705.

[481] Rating the Raters: Enron and the Credit Rating Agencies, Hearing Before the Senate Governmental Affairs Committee, 107th Cong., S. Hrg. 107–471 (March 20, 2002) at 144–45 (Statement of Jonathan Macey, Professor, Cornell University Law School).

[482] Partnoy, note 369 above, at 710–11; *see also* Comments of the Investment Company Institute in the Matter of File No. S7–33–977, Proposed Definition of Nationally Recognized Statistical Ratings Organization, dated March 2, 1998 ("ICI NRSRO Comments") (suggesting that the Rule 436 exemption afforded NRSROs from liability under Section 11 of the Securities Act of 1933 be removed). The problem with this suggestion, of course, is that to the extent that credit ratings are constitutionally protected by the First Amendment, there is no way to impose additional liability in the courts beyond the applicable actual malice standard short of a constitutional amendment.

[483] *See* Rating the Raters: Enron and the Credit Rating Agencies, Hearing Before the Senate Governmental Affairs Committee, 107th Cong., S. Hrg. 107–471 (March 20, 2002) at 146 (Statement of Jonathan Macey, Professor, Cornell University Law School); ICI NRSRO Comments, at note 482 above.

[484] Rating the Raters: Enron and the Credit Rating Agencies, Hearing Before the Senate Governmental Affairs Committee, 107th Cong., S. Hrg. 107–471 (March 20, 2002) at 137.

[485] Pub. L. No. 107–204 § 702.

APPENDIX: Note 16 to Financial Statements, Enron Corp. Form 10–K for the Year Ended December 31, 2000

16 RELATED PARTY TRANSACTIONS

In 2000 and 1999, Enron entered into transactions with limited partnerships (the Related Party) whose general partner's managing member is a senior officer of Enron. The limited partners of the Related Party are unrelated to Enron. Management believes that the terms of the transactions with the Related Party were reasonable compared to those which could have been negotiated with unrelated third parties.

In 2000, Enron entered into transactions with the Related Party to hedge certain merchant investments and other assets. As part of the transactions, Enron (i) contributed to newly-formed entities (the Entities) assets valued at approximately $1.2 billion, including $150 million in Enron notes payable, 3.7 million restricted shares of outstanding Enron common stock and the right to receive up to 18.0 million shares of outstanding Enron common stock in March 2003 (subject to certain conditions) and (ii) transferred to the Entities assets valued at approximately $309 million, including a $50 million note payable and an investment in an entity that indirectly holds warrants convertible into common stock of an Enron equity method investee. In return, Enron received economic interests in the Entities, $309 million in notes receivable, of which $259 million is recorded at Enron's carryover basis of zero, and a special distribution from the Entities in the form of $1.2 billion in notes receivable, subject to changes in the principal for amounts payable by Enron in connection with the execution of additional derivative instruments. Cash in these Entities of $172.6 million is invested in Enron demand notes. In addition, Enron paid $123 million to purchase share-settled options from the Entities on 21.7 million shares of Enron common stock. The Entities paid Enron $10.7 million to terminate the share-settled options on 14.6 million shares of Enron common stock outstanding. In late 2000, Enron entered into share-settled collar arrangements with the Entities on 15.4 million shares of Enron common stock. Such arrangements will be accounted for as equity transactions when settled.

In 2000, Enron entered into derivative transactions with the Entities with a combined notional amount of approximately $2.1 billion to hedge certain merchant investments and other assets. Enron's notes receivable balance was reduced by $36 million as a result of premiums owed on derivative transactions. Enron recognized revenues of approximately $500 million related to the subsequent change in the market value of these derivatives, which offset market value changes of certain merchant investments and price risk management activities. In addition, Enron recognized $44.5 million and $14.1 million of interest income and interest expense, respectively, on the notes receivable from and payable to the Entities.

In 1999, Enron entered into a series of transactions involving a third party and the Related Party. The effect of the transactions was (i) Enron and the third party amended certain forward contracts to purchase shares of Enron common stock, resulting in Enron having forward contracts to purchase Enron common shares at the market price on that day, (ii) the Related Party received 6.8 million shares of Enron common stock subject to certain restrictions, and (iii) Enron received a note receivable, which was repaid in December 1999, and certain financial instruments hedging an investment held by Enron. Enron recorded the assets received and equity issued at estimated fair value. In connection with the transactions, the Related Party agreed that the senior officer of Enron would have no pecuniary interest in such Enron common shares and would be restricted from voting on matters related to such shares. In 2000, Enron and the Related Party entered into an agreement to terminate certain financial instruments that had been entered into during 1999. In connection with this agreement, Enron received approximately 3.1 million shares of Enron common stock held by the Related Party. A put option, which was originally entered into in the first quarter of 2000 and gave the Related Party the right to sell shares of Enron common stock to Enron at a strike price of $71.31 per share, was terminated under this agreement. In return, Enron paid approximately $26.8 million to the Related Party.

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.

In 2000, the Related Party acquired, through securitizations, approximately $35 million of merchant investments from Enron. In addition, Enron and the Related Party formed partnerships in which Enron contributed cash and assets and the Related Party contributed $17.5 million in cash. Subsequently, Enron sold a portion of its interests in the partnerships through securitizations. *See* Note 3. Also, Enron contributed a put option to a trust in which the Related Party and Whitewing hold equity and debt interests. At December 31, 2000, the fair value of the put option was a $36 million loss to Enron.

In 1999, the Related Party acquired approximately $371 million, merchant assets and investments and other assets from Enron. Enron recognized pre-tax gains of approximately $16 million related to these transactions. The Related Party also entered into an agreement to acquire Enron's interests in an unconsolidated equity affiliate for approximately $34 million.

○