THE ENRON COLLAPSE: IMPACT ON INVESTORS AND FINANCIAL MARKETS

JOINT HEARING

BEFORE THE

SUBCOMMITTEE ON
CAPITAL MARKETS, INSURANCE, AND
GOVERNMENT SPONSORED ENTERPRISES

AND THE

SUBCOMMITTEE ON
OVERSIGHT AND INVESTIGATIONS

OF THE

COMMITTEE ON
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JOINT HEARING: THE ENRON COLLAPSE: IMPACT ON INVESTORS AND FINANCIAL MARKETS

WEDNESDAY, DECEMBER 12, 2001

U.S. HOUSE OF REPRESENTATIVES,
SUBCOMMITTEE ON CAPITAL MARKETS, INSURANCE
AND GOVERNMENT SPONSORED ENTERPRISES,
JOINT WITH THE
SUBCOMMITTEE ON OVERSIGHT AND INVESTIGATIONS,
COMMITTEE ON FINANCIAL SERVICES,
Washington, DC.

The subcommittees met, pursuant to call, at 10:50 a.m., in room 2128, Rayburn House Office Building, Hon. Richard H. Baker, [chairman of the Subcommittee on Capital Markets, Insurance, and Government Sponsored Enterprises], and Hon. Sue W. Kelly, [chairwoman of the Subcommittee on Oversight and Investigations], presiding.

Present from Subcommittee on Capital Markets, Insurance, and Government Sponsored Enterprises: Chairman Baker; Representatives Shays, Paul, Bachus, Royce, Oxley, Shadegg, Weldon, Fossella, Miller, Ose, Toomey, Rogers, Kanjorski, Bentsen, Sandlin, J. Maloney of Connecticut, Hooley, Mascara, S. Jones of Ohio, LaFalce, Capuano, Sherman, Inslee, Moore, Ford, Lucas, Shows, Israel, Ross, and Hinojosa.

Present from Subcommittee on Oversight and Investigations: Chairwoman Kelly; Representatives Cantor, Gutierrez, Schakowsky, W. Jones of North Carolina, Tiberi, and Clay.

Also Present: Representatives C. Maloney of New York, Jackson-Lee, and Sanders.

Chairman BAKER. I would like to call this hearing to order.

To begin our proceedings this morning, there are a couple of matters of business, procedural matters to which I would like to attend. The first is that by prior agreement with Mr. LaFalce and Mr. Kanjorski, each Chair and Ranking Member of the subcommittees and Full Committee will be recognized for opening statements of 5 minutes. Then each side will be given an additional 10 minutes for a delegation of opening statement time for whichever Members each side so chooses. By utilizing this method, we will still consume at least 45 minutes of subcommittee time before we begin discussion with the witnesses, so I think it very important that the subcommittees will adopt, without objection, this plan for proceeding.

Any objection?

Without objection, so ordered.

In addition, we have two Members here present, Mr. Sanders, as well as Ms. Jackson-Lee from Texas, who will be recognized in regular order pursuant to recognition of all Members of the subcommittees for purposes of questions. Without objection, there is agreement on that matter.

We are here today to examine and begin the process of understanding the most stunning business reversal in recent history. At one moment, an international corporation with a diversified portfolio enjoying an incredible run-up of stock prices, the darling of the financial press and analysts which, by the way, contributed to the view that Enron had indeed become the new model for the business of the future, indeed a new paradigm. One edition of *Fortune Magazine* called it the "best place in America for an employee to work." Analysts gave increasingly creative praise while stock prices soared.

The corporate mission statement perhaps says it best, I take from page 53 of Enron Annual Report 2000: "We are satisfied with nothing less than the very best in everything we do. We continue to raise the bar for everyone. The great fun here will be for all of us to discover just how good we really can be."

Enron even redefined fun. The sad fact, while having too much fun, it was really all too good to be true. Not only were investors and creditors left with lawsuits as their only assets, lifelong employees lost their jobs, retirement and savings, virtually left to start completely over in the midst of a national recession.

While there were apparent indicators of potential difficulty to a few insiders, virtually all observers were shocked by a surprising statements of earnings expectations and then the incredibly fast demise of the huge enterprise. Now, in retrospect, it is clear, at least to me, that while Enron executives were having fun, it actually became a very large hedge fund, which just happened to own a power company. While that in itself does not warrant criticism, it was the extraordinary risk-taking by powerful executives which rarely added value, but simply accelerated the cash burn-off rate. Executives having Enron fun were apparently very costly.

All the while, they were aggressive in the exercise of their own stock options, flipping acquisitions for quick sale. One executive sold a total of $353 million in the 3-year period preceding the failure. What did he know? When did he know it? And why didn't we? Again, referring to the mission statement of the corporation's annual report 2000, on communication: "We have an obligation to communicate. Here we take time to talk with one another and to listen. We believe that information is meant to move and that information moves people."

Apparently so. It moved this executive to sell $353 million worth of stock.

Then we learned of the multiple special purpose enterprises, SPEs, as they are known, in which some executives apparently set up businesses which contracted with Enron, usually on exceptionally profitable terms. Everyone seemed to have their own place to go for self-dealing at great cost to employees and shareholders. Another concern, even though I must admit when times were good, single stock 401K seemed to be an advantageous thing to do when stock prices were soaring. Have you actually ever met a financial advisor who would tell you to have the most fun, be sure to put all your eggs in one basket?

Some things are too risky, even for the purpose of having fun. We are here today to begin to grapple with just how all of this could happen. A lot of smart people with no conflicts of interest just missed it. Our task is to establish the facts, change the rules where needed, and assist the SEC in the pursuit of those who apparently have violated the law. This will not be fun, and it won't happen as quickly as Enron's demise. We will do this the old fashioned way, with a lot of hard work and a lot of time.

In the end, our goal is to assure individual investors that there is real value in the marketplace, credibility and professional conduct and consequences for those who abuse the system. I wish to express my appreciation to Chairman Oxley and Ranking Member LaFalce for their significant interest in these matters, to Chairwoman Sue Kelly, who Chairs the Oversight and Investigation Subcommittee of Financial Services, who has graciously agreed to join with us in this hearing today, and use their subcommittee resources to take on important aspects of this inquiry, and to announce on our return in late January, and possibly early February, the subcommittees will continue a series of hearings to look at a number of elements.

One, this certainly rekindles prior subcommittee interest in the conduct of analysts and their role in this matter to evaluate the potential for an SRO for the CPA profession. A review of the 1933 and 1934 Securities Acts to determine where there are inadequacies, to examine Reg FD and its' failure to protect investors in this current debacle.

And a special word to Mr. Kenneth Lay, the CEO of Enron who, after numerous requests by the subcommittees, sent a letter, which I do not have in my possession at the moment, but will be entered into the record at a later time, indicating that his appearance before a bankruptcy proceeding today obviated his ability to respond to the subcommittees' request. On the record, I wish to make it clear the subcommittees will have additional meetings should Mr. Lay's social obligations preclude his participation, the subcommittees also have the power to subpoena. At such time as we deem it appropriate, the subcommittees will take action to get the appropriate information from Mr. Lay and other executives of Enron.

I do have a letter dated December 11th, which I will enter into the record at this time without objection.

When we're finished, I hope we will establish a methodology in which all participants will understand when a corporation is just having too much fun, it won't result in the loss of personal fortunes for innocent third parties, investors, shareholders, and most importantly, innocent employees.

At this time, I'd like to recognize Mr. Kanjorski for an opening statement.

Mr. KANJORSKI. Thank you, Mr. Chairman.

Today's hearing will help us understand at least some of the factors that contributed to the downfall of Enron, a once mighty international conglomerate that recently filed the largest corporate bankruptcy in American history. Our hearing will also help us to discern whether Congress needs to take steps to restore the faith and trust of investors in the American dynamic capital markets.

Although I have not yet arrived at any conclusions about the disturbing downfall of a corporate icon, I have already identified a number of concerns that I expect we will address during our investigations.

First, I would like to learn more about the serious financial harm done to thousands of Enron employees and the many others who owned Enron stock. Some press reports suggest that the company rules blocked rank-and-file employees from selling Enron stock in their 401K retirement plans in the days and weeks following the announcement that Enron had overstated its earnings by $583 million in the past 4 years. Those hardworking Americans had to watch helplessly as their savings shrank without any recourse while Enron's executives could apparently sell their stock options and avoid the financial pain. That is wrong.

Second, I have concerns about whether the accounting industry experiences any conflicts of interest in serving its customers. In recent years, many have noted that an accounting firms' consulting fees from one company may exceed its auditing receipts from the same company. This practice calls into question whether shareholders can rely on earnings reports and other indicators of the company's health and its future stock price. In order to provide transparency for investors, auditors should actively work to limit potential conflicts.

Third, we return today to the issue of analyst independence, a topic we have closely studied this last year. From our past hearings, we have learned that an analyst working for a firm that handles investment banking for a company the analyst covers could receive a more favorable rating to attract new business. I am therefore interested in learning why of the 15 analysts covering Enron on the day following the failed merger with Dynegy, only one had a "sell" rating on the company stock. These ratings misled investors.

Finally, in hindsight, it appears that the Enron board of directors failed to serve Enron's shareholders. Several news stories have detailed how gifts, contributions and other activities may have compromised some members of Enron's board. I expect that, as time goes on, we will learn that Enron is not the only company where these questions arise. Members of a corporate board must retain their independence and hold management accountable.

In closing, Mr. Chairman, I typically prefer private sector regulation to Federal regulation. But if the private sector fails in its responsibilities and creates a vacuum, then the Federal Government has a duty to protect its citizens by addressing the market failure. More Americans than ever have their savings invested in the stock market, and we have an obligation to protect them from the conflicts of interest we are investigating in the Enron collapse.

[The prepared statement of Hon. Paul E. Kanjorski can be found on page 85 in the appendix.]

Chairman BAKER. Thank you, Mr. Kanjorski.

At this time, I recognize the Chairwoman of the Oversight and Investigations Subcommittee, Mrs. Kelly.

Mrs. KELLY. I want to thank Chairman Baker and Ranking Members Kanjorski and Gutierrez for agreeing to hold this joint hearing on the recent collapse of Enron and its impact on investors and the financial markets. In this hearing, I hope we can all gain a better understanding of why Enron collapsed so quickly, and why Enron's public filings and Andersen's audit reviews failed until it was much too late to give any indication of the problems they were experiencing.

Transparency is the goal of the disclosures a company is required to make, and a fundamental necessity to a properly functioning open market. Unfortunately, the disclosures made by Enron did not give any indication of the problems they were experiencing until October 16th. News reports have had many different versions of what may or may not have happened.

I've read about a partnership that hid the level of leverage the company had incurred, mistakes and misstatements that may have occurred in the audits, certain Brazilian investments that also may have contributed to Enron's fall.

What is clear is that people have been hurt by the collapse of Enron, from the thousands of investors whose retirement and other investment savings have been devastated to the thousands of employees who now find themselves without a job and with a jeopardized pension plan.

We have on our hands what appears to be the largest bankruptcy ever, which could have far-reaching implications for our economy. We have the duty and the responsibility to ensure that safeguards are in place to prevent a disaster of this magnitude from ever being repeated. We must determine when the accountants, executives and regulators knew what was happening, what they did to rectify the problems. While it would be impossible to ever have in place a system that would prevent failures in the future, we always must try to improve on the current system of disclosures and enforcement that is the responsibility of the SEC.

Enron's collapse underscores how important it is for Congress to act immediately to pass the netting provisions of the bankruptcy bill which have already passed the House numerous times.

For the record, Mr. Chairman, I would like to ask unanimous consent to have a letter signed by seven financial regulators who support the netting provision made part of the record. This legislation would reduce the uncertainty for financial market participants about the disposition of their contracts in the event one of their counterparts becomes insolvent. In this letter, the financial regulators state that "failure to enact, these financial contract netting provisions would unnecessarily place the financial system at greater risk."

Chairman Oxley has been working on this. I want to add my strong support for enacting these needed provisions before we adjourn this year. I want to thank all the witnesses for taking time out of their busy schedules to share their views with us, and I look forward to discussing these issues with them.

I yield back the balance of my time, and I do thank those Members of my subcommittee who are here today.

[The prepared statement of Hon. Sue W. Kelly can be found on page 68 in the appendix.]

Chairman BAKER. Thank you very much, Mrs. Kelly. We certainly appreciate your cooperation and assistance in this important matter.

The Ranking Member, Mr. Gutierrez.

Mr. GUTIERREZ. Good morning Chairman Baker, Chairwoman Kelly and the Ranking Member Mr. Kanjorski, and I want to thank Mr. LaFalce for joining us also here this morning, and for holding this hearing.

We are gathered here today because of a series of unfortunate events that culminated on December 2nd with the filing for bankruptcy of Enron. In Houston alone, Enron has laid off more than 4,500 of its 7,500 employees as part of a corporate restructuring program. The victims of this catastrophe, Enron's employees, have been left wondering how bankruptcy will affect their severance pay, health insurance, and financial futures. For the vast majority of them, the spectacular collapse of their company causes a financial and personal tragedy. Many feel betrayed and angry. Sadly, many workers didn't even know they were about the lose their jobs. They just came in one day to work, and were simply given 30 minutes to pack up their belongings and leave.

In addition to the layoffs, a great number of Enron employees lost, in a matter of months, almost all the value of the stocks they owned, which plunged into levels below one dollar. Enron employees may have lost 70 to 90 percent of their retirement funds, which translates into more than $1 billion. Many of Enron's employees had invested all of their 401K funds into Enron stock. And why shouldn't they? Just months ago, Enron was the country's seventh-largest company in terms of reported revenue, I say reported revenue. Enron was a fast-rising star that had turned the dreary business of energy trading into one of the world's vastest corporate empires. It reported quarterly revenues of nearly $47 billion.

The Enron case brings to the fore an issue that has long worried pension and benefits experts: a retirement plan hugely dependent on the health of the company that provides it. Although the Employee Retirement Security Act of 1974 states that an employer with a traditional pension plan cannot invest more than 10 percent of the plan's assets in the employer's stocks, traditional pension plans are rapidly falling out of favor, with the newer 401Ks replacing them. Currently, there are no limits yet on how much an employee's pension plan may be comprised of the employer's stock, nor are there any caps on investments in employer stock with employer-contributed funds.

Enron's own stock accounted for more than 60 percent of the assets in the $2.1 billion defined benefit 401K plan several months ago. It is widely known that some companies have even higher levels, creating an even worse scenario should these companies fail. Indeed, these amounts are situated well beyond what would be described as prudent diversification.

The dangers of over-concentrating company stock in a 401K plan have been made vividly clear by Enron Corporation's debacle. But despite the perils, millions of American workers have little choice but to bet their retirement savings, as well as their jobs, on the fortunes of their employers.

However, Enron is hardly alone in its high exposure to its own stock. Almost 120 of the largest U.S. companies, as represented by the Committee on Investment of Employee Benefit Assets, have seen their own stock rise to an average one-third of plan assets.

Hardest hit will be Enron's 21,000 workers. For 3 weeks, starting in late October, all Enron retirement plan participants were locked into their current allocation when the firm decided to go ahead with a switch to new plan administrators. Enron's stock lost 35 percent of its value during the freeze, but the workers' pain was not shared by top executives. According to press reports, many of them cashed in millions of dollars worth of Enron stock while the employees were locked into those stocks.

For instance, Enron Chairman, Mr. Kenneth Lay, who refused to come before these subcommittees, alone took $23 million of Enron stock and sold it in the year 2001, a year in which the price of the stock plummeted from $82 to 26 cents a share, while the employees were stuck with the stock.

The only mistake these employees have committed was being loyal to their company and wanting their own small, but well-deserved, share of the riches Enron executives habitually pocketed during their years at the company. Of Enron's 21,000 employees, the approximate 12,000 who participated in the Enron 401K plan now have virtually nothing.

Another source of problems is the companies that make their own matching contributions in stocks, and usually place restrictions on the trading of these shares by the employees. Generally, workers cannot sell their shares until they are near the age of retirement, making them captive investors.

Enron prevented its workers from selling the shares they had accumulated until they reached the age of 50. Although this did not save the stock from collapse, it did major harm to the employees. It's alarming to consider that Enron is not alone in such a requirement. Other big companies lock workers into their 401K company shares until a certain age. We all know that you are not supposed to put all your eggs in one basket.

Mr. Chairman, to conclude, I would like to touch on an issue that I think is key to this affair. Under my perspective, transparency of information must be enforced in publicly-traded firms, such as Enron.

Transparency in financial reporting plays an essential role in making financial markets fundamentally efficient. This is absolutely necessary if we want to have healthy markets.

Last, Mr. Chairman, we should give them what Members of Congress have. I can pick up the phone and today I can change my 401K, we all can, as Members of Congress. All of our employees can make one simple phone call and we can change our investment strategy at an instant. The employees of America should have the same right and the same prerogatives that Members of Congress and Federal employees have.

Thank you very much, Mr. Chairman.

[The prepared statement of Hon. Luis V. Gutierrez can be found on page 81 in the appendix.]

Chairman BAKER. Thank you, Mr. Gutierrez.

The Chairman of the Full Financial Services Committee, Chairman Oxley.

Mr. OXLEY. Thank you, Mr. Chairman. Thank you for chairing this subcommittee hearing, as well as Chairwoman Kelly. Today, we'll begin the subcommittees' investigation of the facts and circumstances surrounding the largest corporate failure in history. Today, we will hear about the dramatic collapse of Enron Corporation, once the seventh largest company in the United States, riding high as recently as 6 months ago. The company has since lost more than 99 percent of its market capitalization, and now trades below $1.

Until all the facts are known, it is prudent for these subcommittees to avoid reaching sweeping conclusions about the causes and persons responsible for Enron's collapse. But that does not mean we should refrain from asking the difficult questions that demand answers.

We will ask the difficult questions. We will delve thoroughly into the facts and circumstances surrounding Enron's collapse. And we will get answers.

This subcommittee, and the Subcommittees on Capital Markets and Oversight, will vigorously pursue this matter to ensure that the Congress, and the American public, know who to hold accountable.

We need to learn whether millions of investors were intentionally misled by Enron's financial engineering and reluctance to disclose information.

We need to learn why financial statements that provided less than a complete picture of Enron's financial situation were certified.

We need to learn why almost all of the securities analysts following Enron failed to warn investors, and why exactly half of them continued to rate the company a "buy" or a "strong buy" even after it had plunged below $1.

We need to learn whether the current reporting and financial disclosure system needs to be overhauled.

We need to learn why the accounting rules permit companies to keep important information off their balance sheets.

Above all, we need to reduce the likelihood that this will happen again.

The effects have been devastating, as one might expect, when a $75 billion company files for bankruptcy. Hit hardest by the meltdown, of course, were Enron's employees. Thousands have already lost their jobs, and more will undoubtedly follow. And the 11,000 employees who participated in the company's 401K plan have seen their retirement savings practically eliminated.

In addition, beyond the impact on Enron employees themselves, Enron's collapse has drained the investment savings of investors across the country who put their retirement and other investments into mutual funds, pension funds, and other vehicles that invested in Enron. Thankfully, at this point, there does not seem to be a systemic threat to the financial markets as a result of Enron's collapse, but the damage the collapse has done to the financial position of thousands of Americans will be very difficult to quantify.

Some may use Enron's bankruptcy as a vehicle to make big Government arguments against electricity markets. But it wasn't the electricity consumer who was hurt by Enron's fall, it was their workers and investors.

Furthermore, Congress must pass the netting provisions of the bankruptcy reform legislation. Enron and its subsidiaries were party to tens, if not hundreds of thousands, of different financial contracts. The identification of these contracts and verification that they are eligible for netting will require vast expenditures of time and money and divert the attention of Enron and the court from the task of reorganizing. Meanwhile, creditors will remain uncertain as to the enforceability of their contracts and the ultimate status of their claims against Enron.

Let's eliminate the uncertainty, the waste of valuable court time and estate funds, and allow institutions to eliminate exposure more thoroughly.

We are pleased to welcome the distinguished Chief Accountant of the Securities & Exchange Commission, Bob Herdman, to discuss the reporting and financial disclosure system mandated by the Federal Securities laws. I'm particularly pleased that Mr. Herdman is here today, because the central issues that the Enron collapse raises are issues of investor protection and accounting rules, about which there are few better experts than the Chief Accountant of the Commission on which to opine.

Mr. Herdman, welcome to the subommittees for your first appearance since you've been appointed.

I would like to remind the Members of the subcommittees that Enron, as well as Arthur Andersen, are the subjects of a formal investigation by the SEC, so Mr. Herdman will not be able to provide any specific information about those investigations, and I'd ask the Members to please phrase your questions accordingly.

On the second panel, we will hear from the Chief Executive of Arthur Andersen, Joseph Berardino, who serves as Enron's auditor. We welcome back Chuck Hill to the subcommittees to discuss the performance of Wall Street research analysts in this matter. Finally, we will hear from the AFL-CIO on the impact to investors.

Unfortunately, Enron's Chief Executive, Kenneth Lay, was not able to testify before the subcommittees today. Mr. Chairman, you entered the letter into the record. He is participating in the first hearing of creditors in the bankruptcy proceeding.

I want to assure the Members of these subcommittees, as well as the public, that I am confident Mr. Lay, and Enron, will provide answers to us and to the public as the subcommittees continue their investigation into this matter.

Mr. Chairman, I yield back the balance of my time.

[The prepared statement of Hon. Michael G. Oxley can be found on page 72 in the appendix.]

Chairman BAKER. Thank you very much, Mr. Chairman.

Ranking Member of Financial Institutions, Mr. LaFalce.

Mr. LAFALCE. Thank you very much, Mr. Baker. Thank you also for acceding to my request to have a representative of the employees, Mr. Trumka, testify at today's hearing. He's also a 1974 graduate of Villanova Law School, and I had the pleasure of graduating from the same law school just a few years earlier.

Enron is a wake-up call. Enron gives us a very important glimpse of what is necessary to hold our markets together. The integrity, the adequacy, the clarity of information provided by public companies to the public. When the adequacy and accuracy of that information is compromised, devastation can and does occur, devastation to large and small investors alike. And how many more Enrons are out there? And what are the systemic factors that made this collapse and may make other future collapses possible?

Today, we will get but a small glimpse of that. But when our committee returns in January, we must, and I'm confident we will, conduct a comprehensive review of all of the policy issues this debacle raises, including at least the following:

First, earnings management or earnings manipulation. To what extent did Enron's management bend or break accounting conventions to distort their financial condition? And most important, is this practice widespread? And are there more Enrons out there?

Second, corporate governance. The board of directors, and particularly the audit committee and the compensation committee, have a fiduciary responsibility to the shareholders. Did they meet that responsibility in this case? Are audit committees in corporate America meeting their responsibilities to vigorously review the financial statements of companies and hold management accountable to the standards of the law, as well as sound business practices? And what reforms should the SEC, SROs, and this Congress consider?

Related party transactions: What was the nature of the related party transactions in what was basically a publicly-traded hedge fund? Were those transactions proper? Were they properly disclosed to investors and to the board of investors?

Accounting and auditing: Are the accounting standards, as they apply to a company of this type, too difficult to apply, and do such rules incentivize companies to exploit unintended loopholes? To what extent, if any, should we rely on the accounting industry to protect shareholders and assure that companies disclose the true nature of their financial conditions, or the desire to keep clients affect accountants' ability to conduct their audit objectively and their willingness to bring accounting irregularities to the attention of management, the board of directors, and the SEC?

Analysts and market expectations: It's clear that the Enron collapse was in large part due to a crisis in confidence throughout the market after Enron made material adjustments to the financial statements. Should financial analysts have known by their own critical analysis of the company's financial statements at their regular meetings with management that something was fundamentally wrong?

Data analysts, whose firms have significant business with Enron, maintained a favorable rating even after it became clear that the company was in serious trouble. It would be useful, in fact, I think imperative, for our subcommittees to hear testimony from independent research analysts not affiliated with investment banks, and then with research analysts from investment banks to compare their ratings on Enron at different points in time over the last several years.

For it is my understanding that there were some independent analysts issuing negative recommendations on Enron. What did they know that others did not and should have known? We need to understand the quality and objectivity of their research and how well such analysts communicated with investors.

Employee pension plans: People didn't have money in their 401Ks, they had their lives in the 401Ks. Were they encouraged to invest in those 401Ks by management to buttress the stock? Did management tell them what they knew, or did management tell them what they thought was necessary to stabilize the price of the stock? What laws exist under ERISA? Is it possible for a company to say "we will contribute matching moneys only if you invest in our stock," as opposed to others? If that's true, should the law be changed?

Lastly, the sufficiency of regulation. Has the SEC fulfilled its oversight obligation in this case? Is the current framework of self-regulation adequate? Does the SEC have sufficient resources to effectively fulfill its oversight responsibility, whatever it perceives its oversight responsibilities to be? There was a day when people had virtually all their money in a bank, in a thrift, in a credit union, and we mandated that the Federal Reserve, the FDIC, the OTS, the OCC basically live with those institutions examining the books. But today, people have most of their wealth in publicly-traded companies. And there is very little governmental oversight, if any at all. Should this change?

Mr. Chairman, I look forward to pursuing all these questions very aggressively in the future. Thank you.

Chairman BAKER. Thank you, Mr. LaFalce.

For the record, Mrs. Kelly had a letter that she wished to have introduced in the record relative to contract netting. Without objection, it is included.

[The information referred to can be found on page 70 in the appendix.]

Chairman BAKER. I have two charts distributed to Members. I just realized the charts are mine relative to Enron's stock value over time, and the trading record of those documents I've had distributed to the Members, and are also being made part of the record without objection.

[The information referred to can be found on page 88 in the appendix.]

Chairman BAKER. At this point, we will begin to recognize Members on each side for opening statements to be limited to no longer than 2 minutes with 5 Members per side. The first I have on my recognition list is Mr. Shays for 2 minutes.

Mr. Shays.

[No response.]

Chairman BAKER. The next I have is Mr. Paul. This is by time of arrival. Mr. Paul, no statement?

[No response.]

Mr. Fossella, we're on a roll here.

[No response.]

Chairman BAKER. Mr. Ose.

[No response.]

Chairman BAKER. Mr. Toomey.

Mr. TOOMEY. Thank you, Mr. Chairman. It appears that the complex nature of the large volume and some question reporting of numerous transactions introduced uncertainties, significant uncertainties as to the leverage and the nature of the risks, even the solvency of Enron, and the market responded. It responded severely, shutting off credit, allowing Enron to collapse with breathtaking speed. But I would remind my colleagues that we tolerate another kind of uncertainty, that is the legal uncertainty that credit exposures could be properly netted and resolved according to the documents under our Bankruptcy Code.

I want to join with some of my colleagues who have emphasized the importance of passing the netting bill. I introduced a bill that would make the necessary changes to the bankruptcy code, and we should do that this year.

I would just briefly like to make one other point. Several of my colleagues have strongly criticized the practices that cost employees of Enron to lose large sums of the money that they invested in Enron stock. I share that criticism generally. But I would remind all of us that we contribute to that very problem in some respects when you consider that last year, we passed a bill that forbids people of ordinary means from engaging in the very transactions which could have allowed them to hedge their exposure. Retail swaps would allow people to preserve the value of their retirement savings, and these subcommittees and the Federal Government should not continue to restrict the use of these vital risk management tools only to institutions and to the very rich, as we do today.

With that, I yield the balance of my time.

Chairman BAKER. Thank you, Mr. Toomey.

Mr. Bentsen.

Mr. BENTSEN. Thank you, Mr. Chairman. This hearing today will begin the process of unraveling the reasons for the collapse of the Enron Corporation. While the impact of Enron's collapse will be felt in many quarters, not the least of which is Houston, where thousands of employees have lost their jobs, and apparently their savings, this hearing will focus on the failure of the company's corporate governance structure to properly oversee management, along with serious questions regarding the performance of Enron's outside auditor. The subcommittees need to begin to understand whether the fall of Enron from its perch, as one of the largest public corporations in the United States, with its market capitalization at $75 billion, and stock trading at $84 a share a year ago, to bankruptcy and the stock at about 25 cents today was a failure wholly inside the company with its outside advisors within the financial market, or our regulatory and legal structure.

As a Houstonian, this is not just a failure within the marketplace, but also a tremendous loss to our community. Thousands of employees have been laid off just before Christmas into a down economy. Their savings and pensions wiped out. Our city has lost not just a corporate icon, but a corporate partner in civic affairs, a company which transformed the Nation's energy markets from a State-regulated structure into an innovative efficient marketplace, collapsed under its own weight, apparently due not to the new trading markets that it helped create and nurture, but apparently because of old economy corporate mistakes.

While it is doubtful in my mind that Enron will survive, the energy marketplace it helped to found will, and it is telling that throughout its fall, those markets still have remained steady and calm. The scope of our hearing today must determine whether Enron's management knowingly violated securities laws regarding disclosure or whether those laws allowed for the company to limit disclosure of certain financing structures which have the effect of understating liabilities and overstating assets and revenues. We must determine whether the corporate governance structure of Enron broke down or whether the laws providing for outside directors of public companies are flawed. We must determine whether Enron's auditors properly stated its financial condition or ignored warning signs to the detriment of investors and employees.

The increasing volume of corporate earnings restatements, not just Enron, should be alarming to the investing public, capital markets and the Congress. Are the disclosure laws lacking in providing investors and regulators with accurate data regarding a company's true financial condition?

Is Enron an anomaly or a preface of the things to come at the end of the roaring 1990s and its period of so-called "irrational exuberance," and I hope we have many more hearings on this and the pension effects of this. And I ask unanimous consent to present my whole statement for the record.

Chairman BAKER. And don't forget to yield back the balance of your time.

[Laughter.]

Chairman BAKER. Mr. Shays has returned. Mr. Shays.

Mr. SHAYS. Thank you, Mr. Chairman. I want to associate my remarks with the remarks of the Full Committee, your remarks and Mrs. Kelly's. They express my views quite well. I would then yield to my colleague, Mr. Ose.

Mr. OSE. Thank you, Mr. Shays.

Mr. Chairman, if I might, I do have a couple of questions before I make a statement. There was a comment about the defined benefit plan at Enron, which was another means by which people could protect their retirements. We've checked that out through the Pension Benefit Guarantee Corporation and those assets are guaranteed by the Pension Benefit Guarantee Corporation. That's the defined benefit plan.

I appreciate the gentleman from Connecticut yielding. My particular interest has to do with the special purpose entities and the rules that govern them. I read the various statements. As near as I can tell, that 3 percent threshold is considered on the basis of each separate transaction rather than in aggregate. I'm hopeful that in the course of these hearings, we'll get into that a little bit further.

I yield back the balance of Mr. Shays' time.

Chairman BAKER. Thank you very much, both you gentlemen.

Ms. JONES. Thank you, Mr. Chairman. Good morning to Chairmen Baker and Kelly, Ranking Members Kanjorski, Gutierrez, and LaFalce. I'm glad to have an opportunity to give a brief opening statement this morning. We are here to find out, as best we can, within the public view, what happened with Enron. I would suggest Chairpersons and Members that our efforts must run deeper than that, and that is to find out not just what happened, but how did it happen and where did our regulation policies and opportunities to oversee this particular public company went wrong. Never before in our recent memory has a company's stock fallen so quickly. I'm concerned about the loss of jobs and the possibility of pension loss that will come as a result of the loss of dollars from people's investments.

I'm as concerned about Enron as I am concerned about a company called LTV still in the City of Cleveland in bankruptcy with 3200 employees being laid off and the steel workers stand on Capitol Hill today saying to the Congress, "pass some legislation that would help us and save our industry and give us some legacy fees."

So today, as Members of Congress, we're asked to do a number of things, and one of those would be to look at some of the agencies and organizations that are responsible for providing oversight over the accounting methods of this company and what people have to rely upon when they make investments. I trust that at the end of the day, we will be able to move forward and say that we're doing all within our power as Members of Congress to provide oversight, to provide regulation, and give insight and protection to the American public that uses Enron and any other company to do their investments and save for the future.

I yield the balance of my time, Mr. Chairman.

Chairman BAKER. Thank you very much. I thank the gentlelady. Mr. Bachus.

Mr. BACHUS. I thank the Chairman. I commend you and Chairwoman Kelly for holding this important hearing. We have very transparent and strong capital markets so when a failure of this magnitude comes, it takes all of us by surprise. I think it's important that, as opposed to pointing fingers or rushing to judgment, that we take a hard look at this and study it, and not really rush to conclusions until we've done that. In studying what happened, I want to first commend Arthur Andersen for bringing their CEO today. I wish that Enron had done the same thing. The fact that Arthur Andersen's Mr. Berardino is here, I congratulate Arthur Andersen. I wish Enron had done the same thing. It would have made it easier for us.

I would like to focus on three real quick things. First of all, we know that Enron was at one time a very successful company. They were willing to take risks, they had creative business planning, aggressive expansion. That contributed to their growth. Obviously, on the flip side, that contributed to their demise because they grew too fast, got into areas they didn't understand.

Second, quite apart from the accounting, whether they complied with accounting rules, we know that this company, I think this is part of the bottom line, had a history of not being forthcoming about their business operations. I just want to give you one quote that I think shows this. This is from the former CFO of Enron, Andrew Fastow. He told *Fortune Magazine* in March, 7 months before he was forced out, "We don't want anyone to know what's on our books. We don't want to tell anyone where we're making money." Obviously, we didn't need to wait till today to find that out. Their lack of transparency was a significant contributor to what happened. We owe it to the shareholders, to the pension holders, to get to the bottom of this, and I feel under your leadership, Chairman and Mrs. Kelly, and with the help of our witnesses, we'll begin to do that.

Thank you.

Chairman BAKER. Thank you very much, Mr. Bachus.

Mr. Mascara.

Mr. MASCARA. Thank you, Mr. Chairman. Thank you for calling these hearings. What I'd like to say in my 2 minutes is to pose some questions that hopefully I'll have an opportunity to do later, but if not, they'll be on the record.

One is whether the SEC approves the prospecti filed by Enron on the various SPE filings in an attempt to ascertain whether complete financial disclosure was revealed. The other is, given that the SEC representative here, the CEO cannot disclose, according to his statement anyway, that I read—is that information that has to deal with this investigation? And if not, apparently we're not going to get many answers today—is whether a grand jury should be formed and empaneled to investigate this economic calamity.

Regarding the pensions, I'm looking for answers. Whether the large number of Enron employees who had 401K pension plans and Enron stock, why they could not sell their stock. We call it down here a thrift plan, open season. And at the same time, the management people were cashing in their 401Ks. And now that Enron has declared bankruptcy, does the bankruptcy law provide any special protection to employees in the pension plan. I understand that before Enron declared bankruptcy, the stocks in these 401Ks were traded, and whether the SEC required that the accounting firms involved complied with all of the FASB, Financial Accounting Board Standards.

Those are some of the questions that I need to have answered, and hopefully I'll have an opportunity to ask those questions. If not, I would hope that the respective firms and the SEC involved will provide those answers to me.

Thank you, Mr. Chairman, I yield back.

Chairman BAKER. Thank you, Mr. Mascara.

Mr. Miller.

Mr. MILLER. Thank you, Mr. Chairman.

To be honest, I'm less interested in what we have to say and more interested in listening to what the witnesses have to say. I'm personally going to focus on questions following that. I would yield back my time.

Chairman BAKER. Thank you very much, Mr. Miller.

Mr. Sherman.

Mr. SHERMAN. Thank you. I'm interested in the pension plan issues where workers invest their entire work life and their retirement savings in the same basket, but I would point out that we in this Congress are very much promoting the ESOP concept which encourages the same thing, but with an additional element, and that is worker control. And I think ERISA should require in a pension plan diversification or worker control, if the workers are over invested in the stock of their employer.

I am a CPA and I am particularly interested in the accounting issues. Fundamentally, responsibility rests with Enron management which engaged in highly complex and questionable transactions and then misstated them in their financial statements. But we need to see whether Generally Accepted Auditing Standards were sufficient to allow the accounts, the outside auditors to know what the facts were and whether the auditors applied those standards correctly. And if the auditors did know the facts, then we need to look at whether Generally Accepted Accounting Principles serve were employed, and if so, whether they need to be changed. I'm particularly interested in these special purpose entities which seem a wonderful way to enrich management through self-dealing and conflict of interest, plus a method of manipulating financial statements. The only legitimate use that I'm familiar with for SPEs is to shift risk from the public shareholders to a special purpose entity. But you hardly shift risk when the chief asset of the SPE is stock in the company that they are supposedly ensuring or protecting against risk.

Also, I have to wonder whether the 3 percent independent equity rule is sufficient. It seems to beg for manipulation with insufficient risk protection for the company. I think we have a bit of an analogy here—wrap it up?—and that is we may discover not only that the auditors did not apply the accounting standards correctly, but that the company actually came very close to complying with those standards and that it is the standards that need to be changed even more than making sure that we had adherence, what I think will worry us most as we discover that Enron, had they just been a little different, could have complied with all the technical rules and still gone down the drain.

I yield back.

Chairman BAKER. Thank you, Mr. Sherman.

Mr. Weldon.

Mr. WELDON. Thank you, Mr. Chairman. I want to thank you and the Ranking Member and all those involved in putting this very important hearing together. This failure of this company has shaken the American confidence in our investment system and I feel very strongly that we will need to, either through a self-regulating process or a legislative process, make changes in the way accounting practices and stock analysts operate in the United States. I would like to particularly associate myself with the remarks made by Mr. Gutierrez. I think we will seriously need to consider modifying ERISA legislation to prohibit the situation that we had with Enron. It's tragic enough that these employees had been laid off, but the fact that their entire retirement savings was wiped out, is totally unacceptable.

I yield back.

Chairman BAKER. Thank you, Mr. Weldon.

Our last participant opening statement is Mr. Sanders for 2 minutes.

Mr. SANDERS. Thank you, Mr. Chairman. Thank you for holding this hearing. It seems to me that Enron's collapse raises several very important issues, some of which have already been discussed by my colleagues. Clearly, we must protect employees from seeing their retirement funds ripped off and their life savings go down the tubes. We've got to look at this in terms of the implications on the privatization of Social Security as some would have us do, and also understand that other companies around this country in different ways are ripping off the retirement plans and the pensions of their workers.

Second of all, we want to examine the role of accounting firms like Arthur Andersen. As many know, Andersen recently settled a suit brought against them by the SEC for $7 million as a result of a failed audit at Waste Management Incorporated. The question arises, what was Arthur Andersen doing when Enron was cooking its books. How much confidence should the American people have in companies like Andersen?

But the third issue, Mr. Chairman, that has not yet been raised, it seems to me perhaps to be the most important. That is the role of big money in the political process and the need for real campaign finance reform. Since 1992, Enron has contributed over $5 million to Republicans and Democrats. During the last 2 years, Enron has spent $4 million lobbying Congress and the White House. The Chairman of Enron, Kenneth Lay, his wife contributed close to $800,000 to the Republican party since 1988. During the 2000 presidential campaign, Enron made available its fleet of corporate jets for political travel by candidate Bush.

What did Enron get in return for their campaign contributions from the Federal Government? Amazingly enough, as far as I understand, Mr. Chairman, they are still in line today for a $254 million tax rebate if the Republican House version of the Economic Stimulus Bill becomes law. Thank you Enron, for all the good work you are doing, and you're going to get a check for $254 million from the American people. Clearly, that's an outrage.

Several months ago, the Bush Administration refused to assist California and other States cope with severe energy crises.

Chairman BAKER. If you can begin to wrap up, Mr. Sanders.

Mr. SANDERS. Costing consumers tens of millions of dollars. There is no question but Enron, through their political contributions and influence, has had an enormous impact on energy policy and the way this Government does business. That's wrong and it's got to be changed.

Thank you, Mr. Chairman.

Chairman BAKER. Thank you, Mr. Sanders.

For the record, I have several documents relating to political contributions by the Enron Corporation to Republicans and Democrats. I will admit those for the record as well, just to keep balance in the hearing record. Thank you, Mr. Sanders.

At this time, I would like to finally turn to our esteemed witness on our first panel, Mr. Robert K. Herdman, Chief Accountant of the Securities & Exchange Commission, your first appearance before these subommittees, Mr. Herdman. I am very pleased to learn of your acceptance of this position. Your reputation for good work is outstanding, and we are pleased to hear your comments. Welcome.

STATEMENT OF ROBERT K. HERDMAN, CHIEF ACCOUNTANT, U.S. SECURITIES AND EXCHANGE COMMISSION

Mr. HERDMAN. Chairman Oxley, Chairman Baker, Chairwoman Kelly, Ranking Members LaFalce, Kanjorski and Gutierrez, Members of the subcommittees, thank you for the opportunity to testify today on behalf of the Commission regarding recent events relating to Enron. Your letter of invitation asked me to address the regulatory matters and accounting issues that have been publicly raised by Enron's collapse. My written testimony does address those matters. I ask that it be included in the record.

As you know, the SEC is investigating the Enron matter. The Commission appreciates the subcommittees' recognition of the nonpublic nature of its investigation, and as Chairman Oxley alluded to, the Commission also asks that in light of its ongoing investigation, the subcommittees understand our reluctance to address specific issues relating to compliance with the Federal Securities Laws at this time.

If I might add, the reason for this, as I understand it from my General Counsel, Mr. Becker, behind me, is that if there is public disclosure about the particulars of an investigation, while it's still in process, that runs the risk of appearing to prejudice the outcome and it might, in fact, jeopardize the investigation. But let me assure you that at the conclusion of this investigation, we will deal swiftly and completely with any wrongdoing and wrongdoers to ensure full protection of investor interests. I want to assure the subcommittees that the Commission shares your grave concern over these events.

The sudden collapse of a Fortune Ten company gives pause to all of us who care about financial reporting and the tragic consequences of these events for Enron investors, including the many Enron employees whose retirement savings have been decimated, simultaneously with losing their jobs, is a sober reminder to all of us of the importance of reliable and transparent financial reporting. It is axiomatic that confidence in our markets begins with the quality and transparency of the financial information available to help investors decide whether, when and where to invest their hard-earned dollars. The goal of the Federal Securities Laws is to promote honest, efficient markets and informed investment decisions through full and fair disclosure of all material facts.

The SEC is tasked with ensuring that markets are transparent and hospitable to all investors. Congress wisely, in the Federal Securities Laws, adopted the philosophy that investors have the right to be fully informed of all material facts, and choose markets that are free from fraudulent, deceptive and manipulative conduct.

Transparency in financial reporting, that is the extent to which financial information about a company is visible and understandable to investors and other market participants, plays a fundamental role in making our markets the most efficient, liquid and resilient in the world. Transparency enables investors, creditors, and the markets to evaluate any publicly owned entity. Transparency helps investors make better decisions and by doing so, it increases confidence in the fairness of markets. It is critical that all public companies provide an understandable, comprehensive, and reliable portrayal of their financial condition and performance. If the information in financial reports is transparent, then no one is surprised by unknown transactions or events.

It also is critical that auditors, standard setters, audit committee members and the SEC perform our respective roles with respect to financial statements. My written statement includes information on the accounting standards setting process that exists in our country, the self-regulatory process in the accounting profession, and the role of the SEC in reviewing filings.

As you know, last month Enron disclosed several errors in its' previously issued financial statements and announced its intention to restate its financial statements dating back to 1997. As the subcommittees have requested, my written statement provides an explanation of the accounting and auditing literature and several of the issues discussed in Enron's recent filing. Specifically these deal with restating previously issued financial statements account for special purpose entities or SPEs, and the $1.2 billion reduction in shareholders' equity.

Also at the request of Members of the subcommittees, my written statement explains the mark-to-market accounting applied to contracts for the purchase or sale of energy contracts. As I said at the outset, the Commission will move expeditiously in its investigation in the Enron matter and will take appropriate actions.

Regardless of the outcome of the issues surrounding the Enron situation, the SEC is working to improve and modernize our financial disclosure system. Our goals are to make financial statements more transparent, easier to understand, to foster private sector standard setting that deals appropriately with current and immediate needs, and to work with the accounting profession to ensure comprehensive and effective self-regulation.

Chairman Pitt's op-ed piece in the *Wall Street Journal* yesterday outlined these and other of the Commission's planned improvements to our current reporting and financial disclosure system. We believe these are extremely important initiatives that will constitute much of the Commission's work in the coming weeks and months. And I am pleased to advise you that today the Commission is issuing cautionary advice regarding the need for corporations to make full and fair disclosure about what we're calling "critical accounting policies." As we continue to move forward, the Commission looks forward to working closely with the Congress on these and other issues of importance to the investing public.

Thank you for the opportunity to appear today. I'm happy to try to respond to any questions Members of the subcommittees may have.

[The prepared statement of Robert K. Herdman can be found on page 90 in the appendix.]

Chairman BAKER. Thank you, Mr. Herdman.

The Committee will return next month to review practices which have been initiated in the last session. There has been ongoing staff work and research effort and efforts to come to closure with my staff on recommendations which should be forthcoming early next year. I hope we will be initiating a similar process with regard to at least consideration of the SRO approach with regard to the CPA industry, or whatever might be the appropriate recommendation from the SEC to consider.

Although the current body of law, in my view, would seem to be adequate, I think the complexity of modern business structures may have surpassed the rules we currently have in place, which would then lead us to a discussion of a rewrite of the 33–34 codes, which would be a long-term, obviously extensive process. The short term issue for me, though, is without regard to a fact finding in the matter of Enron, does current law provide sufficient penalty and what is the nature of the penalty for self-dealing either inaccurate disclosure or withholding disclosure or violation of meeting the duty of care standard or your fiduciary responsibility.

Can you tell us without making a statement as to a finding relative to the performance of Enron officials not related to the question. If someone were found to violate those standards, what would be the penalties available to the Commission today in pursuit of bringing someone to responsible justice?

Mr. HERDMAN. Mr. Baker, I'm aware that the Commission has a wide range of sanctions that it can impose against companies, and in certain cases against individuals. I really have to defer the discussion of the specifics, because that is not my area of expertise.

Chairman BAKER. We've got a couple more and we may get back to this, but let me just save that for the record, and at an appropriate time, to keep us moving, perhaps a response pursuant to the hearing would be helpful.

With regard to regulation in the current environment, it seems an element that works for compliance is simply not to disclose if there is a question in your mind if you can do it properly as opposed to an affirmative responsibility in the law to make disclosure of material elements without having to make the judgment. If it's material, you disclose it. Had we had that standard, in fact, would that have helped with the transparency concerns and the current concern.

Mr. HERDMAN. I really can't speculate about how things might have affected the particular matters with respect to Enron. The entire question of moving to a system of current disclosure with affirmative obligations to disclose is one of the important parts of our program to improve financial reporting coming up——

Chairman BAKER. Let me characterize it this way. A statutory or regulatory requirement for affirmative disclosure certainly would not have made the matter more difficult. It possibly could have helped.

Mr. HERDMAN. Certainly.

Chairman BAKER. With regard to the adequacy of current disclosures, and they are extraordinarily sophisticated, in trying to wade through the financial statement of Enron, well, it put me in my place. I don't know—is there anybody within the SEC that really goes through, from A to Z, the entire document on their own without outside help who can read these things and understand what business risks are presented? Or have we gotten information that's so convoluted that a person in good faith, who is reasonably educated still is rather lost. Make me feel better, please.

[Laughter.]

Mr. HERDMAN. I assure you that we have on the staff of the Commission people who are quite expert in these matters and do go through documents filed with us from A to Z. Having said that, I won't deny that at times that can be a daunting task, because financial statements today are very complicated.

Chairman BAKER. Let me ask it this way. If you had had the time and the staff available and someone in the casual review of the data currently required under law to be disclosed, could they have determined that financial reversals were in the future from the current disclosure format, or do we need to be looking at a different way of making relevant information more understandable?

Mr. HERDMAN. Without commenting on Enron here, Mr. Chairman, I think most financial statements today are not designed to provide information about the future. However, our rules for disclosure and management's discussion and analysis does require a certain forward looking focus particularly with respect to matters that have occurred in the past that might not be reasonably expected to occur in the future.

Chairman BAKER. For example, we're going to buy a waterworks company in England—I'm just making up something here—and we don't know much about waterworks and we're going to spend a lot of money, that's a material thing, it doesn't necessarily mean it's adverse, but disclosures of where you might be going in business judgment could have been helpful to people trying to understand the scope of business which a hedge fund-like business might engage in.

Mr. HERDMAN. Disclosure is designed to provide transparency.

Chairman BAKER. Lastly, because I've exhausted my time, with regard to pro forma reporting, as opposed to cap standards, will there be recommendations, further recommendations with regard to revision of the pro forma methods of accounting or reporting as opposed to the current Generally Accepted Accounting Principles?

Mr. HERDMAN. At the present time, I'm hopeful and expect that the cautionary advice that the Commission issued just several weeks ago will take care of any abusive practices that have existed in the past.

Chairman BAKER. Let's assume we're going forward without looking historically. There would be pro forma reporting, which would have led to a misunderstanding in the marketplace. Under current rule, given your recent advisory, what would be the consequences for a corporation or a CFO issuing those pro forma advisories that were found to be inappropriate?

Mr. HERDMAN. I can't generalize, but if such disclosures are made in a way that violates the anti-fraud provisions of the Securities Laws, then I expect that there will be vigorous enforcement action taken.

Chairman BAKER. I can surmise, given the sensitivity of the response to the current environment, you feel adequately armed to respond to inappropriate conduct in current circumstance once you have made a factual determination of wrongdoing?

Mr. HERDMAN. I believe that that's correct. I'm not sure that I can speak for the entire Commission.

Chairman BAKER. We want to make sure you have the tools you need to do the job that's ahead of you. If that is not the case on further reflection, please advise the subcommittees as to areas of concern that you can identify that may warrant the subcommittees' assistance.

Mr. HERDMAN. We will certainly do that.

Chairman BAKER. Thank you very much, Mr. Herdman.

Mr. Kanjorski.

Mr. KANJORSKI. Mr. Herdman, looking over the overall policy, is it your belief, as a professional accountant of the SEC, that we have sufficient transparency or as the sophistication and possible manipulation of disclosure statements by corporations becomes so fuzzy as to really not constitute true transparency.

Mr. HERDMAN. Congressman, I think that our capital markets are clearly the best in the world, and our accounting and financial reporting are widely acclaimed as the best in the world as well.

Mr. KANJORSKI. So is it your interpretation that this is a singular occurrence that occurred because of economic situations, or did this occur because of stock being artificially bid up and played because of an over accentuation of revenues and the hiding of debt?

Mr. HERDMAN. I really can't say at this point what has led to Enron's demise with any certainty. That's something that we certainly hope to learn as part of our investigation. As that progresses, as we learn things, we'll be looking to see whether there are indications that there may be other problems out there.

Mr. KANJORSKI. Are there other Enrons out there or do you feel this is a unique situation?

Mr. HERDMAN. I think at this point, it is premature for me to answer that question one way or the other.

Mr. KANJORSKI. I may assume there may be other Enrons out there?

Mr. HERDMAN. There may be.

Mr. KANJORSKI. What is the SEC doing to determine whether that's the case, and how will you disclose that to the public or to the Congress?

Mr. HERDMAN. Well, when problems are found in a particular industry, the staff of the Division of Corporation Finance, which does review filings, makes it a practice to take a look at the filings made by other companies in that industry and proceeds, if there are indications of non-compliance with Generally Accepted Accounting Principles, unclear disclosures, and so forth, enters into a common process back and forth with the registrant. If there's not a satisfactory resolution of those matters, and if the staff of the Division of Corporation Finance believes that it's warranted, there are instances where a referral is made to the Division of Enforcement for follow-up by them.

Mr. KANJORSKI. With regard to the special purpose entities, is this a widely used methodology in large corporations, specifically to avoid disclosure of the true nature and condition of the main corporation?

Mr. HERDMAN. It's not an uncommon practice, Congressman, for special purpose entities to be engaged. While special purpose entity transactions have the effect of excluding certain things from a corporation's financial statements, there are a number of very valid reasons why corporations do enter into them, including the fact that they often offer the potential for reduced interest costs as well as certain tax advantages in some instances.

Mr. KANJORSKI. So from your general overall view of the occurrence here at Enron, you would say that the investing public doesn't have to have a fear that this may be endemic to the system, but this is just a unique, separate situation that just happened?

Mr. HERDMAN. I don't think any of us can say that at this point, Congressman. I think that the Enron situation raises questions about an entire system of financial reporting and confidence in that system.

Mr. KANJORSKI. I notice, as I looked at the Chairman's chart of Enron Insider Trading, you can almost see a picture that the insiders were getting out at the absolute top point, and they did it in several instances. They took their life rafts and got out about 6 months ahead of when the ship was finally going down. Are you looking at insider trading to be an indicator that there may be something that the insiders are aware of that the investing public isn't aware of?

Mr. HERDMAN. With respect to Enron, I can't comment obviously. With respect to whether that's a procedure that might be useful, that's something that we would consider. I don't have any personal knowledge of whether that's an accepted practice today among the staff of the commission.

Mr. KANJORSKI. I'm just trying to see what we can do as a Committee in the Congress to make sure there aren't other innocent investors out there in the public. Should they be somewhat alarmed when they start seeing the insiders getting out in large bulk? They may not want to go in. Obviously, the analysts didn't bring this to anybody's attention. The accountants didn't bring this to anybody's attention and the SEC didn't bring it to anybody's attention. So there are a lot of babes in the woods out there that own stock, and they are trading in these securities thinking that they were a very secure corporation, and all the insiders are handing out life jackets.

Mr. HERDMAN. I think the question of whether shareholders should pay particular attention to trading by insiders is an interesting one, but frankly, Congressman, that's outside of my area of expertise, really to comment.

Mr. KANJORSKI. Do you clearly by the disclosures made on insider dealing disperse that information to the general public sufficiently?

Mr. HERDMAN. I can't answer your question.

Mr. KANJORSKI. If I were on a boat and I saw some water on the floorboards and I saw the captain and the crew jump off the boat real fast, normally at sea I think I'd grab a life jacket and jump too, because they must know something I don't know. It seems to me in stock transactions it's somewhat similar. And if it isn't, if we're not getting that disclosure out there, the fact that the captain and crew are jumping overboard, then we've got to find a vehicle to alert people.

Mr. HERDMAN. I am aware that there are requirements for disclosure determined by insiders, and that information is made public.

Mr. KANJORSKI. I yield back my time.

Chairman BAKER. Thank you, Mr. Kanjorski. I'm sure those dispositions were purely coincidental and in time will prove there was no relationship.

Mrs. Kelly.

Mrs. KELLY. Thank you, Mr. Chairman.

Mr. Herdman, I'm interested in the mark-to-market accounting standards that energy traders are given. It's a sophisticated kind of thing. A lot of people who invest are not really, I think, aware of what's going on there. I wonder, given the difficulties in ascribing a value to some of these transactions with this policy, don't you think it's led to some misleading information that's been provided to investors? I'm not asking specifically about this, but investors in general?

Mr. HERDMAN. I don't know that there's any evidence to indicate that mark-to-market accounting has led to misleading information to investors. The broker-dealers in this country have used mark-to-market accounting to account for their activities for many, many years. They have sophisticated financial instruments that aren't quoted on exchanges that need to be accounted for at market value. And so estimates need to be made of value in order to accomplish the mark-to-market process. Energy trading contracts can be and are very, very complicated and they sometimes go on for periods of time as I understand it that go beyond the period of time where there are quotes, either for purposes of forward contracts, or broker-dealer type contracts, and therefore they require that a model be developed that takes into account recency of other transactions and mechanics such as that, leading to an estimate of fair value.

That really is the difficult part of it. It's fairly easy to mark-to-market a financial instrument that is traded on the New York Stock Exchange. Even I can calculate that. But the calculation of the market value of a third year contract to supply electricity requires a great deal of specialized expertise.

Mrs. KELLY. Is the SEC looking into changing any of these rules with regard to the energy policies, the energy companies?

Mr. HERDMAN. As I said at this time, Chairwoman, we haven't seen any indication that the mark-to-market accounting has caused problems for companies within the energy industry. If we do, we would certainly expect that there might be a need to tighten up the accounting rules here.

Mrs. KELLY. Do you think that the investors and transparency would be helped if the SEC and the FASB clarified the principles of mark-to-market accounting?

Mr. HERDMAN. I think the principles of mark-to-market accounting are quite clear in the accounting literature that exists today, and the circumstances under which it should be done.

Mrs. KELLY. Yes, you said earlier that this was a bit murky with regard to energy.

Mr. HERDMAN. What's not rigid in the accounting rules today is a specified methodology for how to calculate the market values.

Mrs. KELLY. And perhaps you might be looking into that.

Mr. HERDMAN. That's a possibility.

Mrs. KELLY. I also understand that FASB has been reviewing standards related to the consolidation of the financial statements by parents and the SPEs for 10 years. Do you find it a little troubling that FASB still is looking and has taken that long to address this?

Mr. HERDMAN. The policy FASB has had on consolidations includes considerations of the treatment of special purpose entities. We are encouraged at this point that the FASB announced just recently that it is refocusing its project on consolidations to address a number of issues that really are at the heart of the SPE question, and we're very hopeful that they will proceed apace with that and get it done, however, subject to all of the due process procedures.

Mrs. KELLY. Perhaps, sir, you could at the SEC make sure that it's sooner rather than later. It has been. We need to see a little sooner on this, I think. If I understood your testimony correctly, you said you've issued new cautionary advice with regard to critical accounting policies today. Could you describe that for us?

Mr. HERDMAN. Certainly. What we're doing is getting something out for this year end to encourage companies to make disclosures of a type that really have not been made before. We're doing this with a view toward accomplishing better disclosure in the 2001 annual reports, as well as facilitating work that we're going to be doing in 2002 to move to very definitive rulemaking in this area. But what these particular disclosures would relate to, critical accounting policies, which we are characterizing as those that really make a difference in a company's financial statements, but also require extremely complex and subjective judgments to be made by management in their application. And often the complexity and subjectivity is due to the fact that there needs to be very sophisticated estimation processes in order to take into account the fact that a lot of accounting has to grapple today with the uncertain effects of the future. So better disclosure about those kinds of things we think will help to mitigate the potential for surprises in the future.

Mrs. KELLY. My time is up. Thank you very much.

Chairman BAKER. Thank you, Mrs. Kelly.

Mr. Gutierrez.

Mr. GUTIERREZ. Thank you very much. Thank you for participating this afternoon with us. Some in the accounting industry have argued that the accounting rules have become too complicated for companies to apply rationally and for auditors to apply in connection with their audit. Do you believe this is true?

Mr. HERDMAN. Congressman, accounting rules have become very, very complicated, but let me also point out that the world is very, very complicated in terms of the types of transactions that are engaged in today which are also very complicated. At the same time, I think that the fact that the FASB is in the process of studying a project that they want to put on their agenda to deal with complexity in the accounting rules is very encouraging. I think that's terrific, because the accounting literature we have today rivals—in fact, exceeds—the size of the Internal Revenue Code and all the various regulations that pertain to that. Ultimately the accounting rules have to be applied by people. Simplification would be a good thing.

Mr. GUTIERREZ. Is the goal of a meaningful disclosure to provide investors with an accurate and complete picture of a company's financial condition? And has the SEC considered a top down review of accounting disclosure rules? You talked about them a little bit earlier on today.

Mr. HERDMAN. One of the critical projects we're going to be working on in the coming months is a real look at the nature of financial information that is conveyed to shareholders. Certainly at this point, we are considering things in addition to the current system of periodic disclosure, and we'll be working with many, many people that are interested in this and are providing and will provide input to us about things like disclosure by companies of trend information on a more current basis than just quarterly disclosure about changes in those types, those kinds of trends that might give earlier warnings about the company's prospects of going up or going down, and all those kinds of things.

Mr. GUTIERREZ. I think that's excellent. I look forward to working with your team, and obviously, the Members of these subcommittees on doing that, because an accurate picture might have helped a lot of people at Enron, because given what we know today, we didn't get an accurate picture.

I would just suggest that maybe—and this is a humble suggestion on my part, Mr. Herdman—as you look at the situation, the specific situation with Enron, that you look at the relationship—it's simply a suggestion on my part that you simply look at the relationship between insiders and selling their stock options. The Chairman has been very, very kind to share with us this form, this graph. I mean, January of 2001, you've got the insiders at Enron selling over $160 million worth of stock. Maybe you should look at that, and maybe we could find a way so that, as Mr. Kanjorski said, because it sounds to me that's kind of like the captain jumping off the ship, when the insiders are selling all their stock options, they are obviously not keeping them. And as we look at the sheet, they sold it at the highest point and then they went in May is the next time, and it seems that they sell things at the highest point. They know what's going on, they're inside obviously. That's why we call them insiders. Those are the executives.

And if you have a CEO, as in the case of Enron, that's going to sell $100 million worth of his own stock, and it would be good and prudent, in my humble opinion, it would be good and prudent and advisable for the public to know, hey, the CEO is selling all the stock, selling $100 million and we know about it in January so that everybody knows, at least to that extent, what he knows. We can't put him there like his wife wanted a new yacht or his college kid's tuition came up, although I don't know what college you would send someone to for $100 million, but you never know.

We don't have to know why they did it, but at least know that they did it and when they did it. It's a simple suggestion, because I think that way we would all know.

Mr. OSE. Would the gentleman yield?

Mr. GUTIERREZ. Sure, I would.

Mr. OSE. The insider trading by the Board of Directors of a Fortune 500 who are members of the management team are in fact tracked by the SEC. You can read them in the *Wall Street Journal* on a regular basis.

Mr. GUTIERREZ. I would yield, but you know something, if you can read them, then it's interesting that nobody knew about it, and nobody read about it and nobody made a note about it, and maybe our friends here should take a note about it and what kinds of action they can take when somebody's doing specifically that. I know there are Members of these subcommittees that want capitalism to thrive at any extent. I'm certainly a capitalist, but when you have tens of thousands of employees losing their jobs, I think it's a regrettable situation and we should look at ways to correct that situation.

Chairman BAKER. Thank you, Mr. Gutierrez. You will note on the form that the document made reference to in the left hand corner, this source is the insider and Form 144 filings, so to support Mr. Ose, there are mechanisms by which this information is publicly available. The real question is as to timing and understanding and I think that perhaps is the bigger concern.

Mr. HERDMAN. Congressman Ose is correct. It's published in the *Wall Street Journal* periodically, but certainly I'll follow up on your suggestion, Congressman.

Chairman BAKER. Chairman Oxley.

Mr. OXLEY. Thank you, Mr. Chairman.

Mr. Herdman, the Enron collapse clearly points out the need for Congress to act on netting legislation. Our good friend from Pennsylvania, Mr. Toomey, has that legislation ready to go. Does the SEC have a position on that issue, and if so, what is it?

Mr. HERDMAN. The Commission is in favor of the netting provisions of the Bankruptcy Bill. Chairman Pitt did sign that letter in November that was also signed by the Chairmen, I believe, of six other regulatory agencies. He signed it on behalf of the SEC and the Commission is very much in favor of that legislation.

Mr. OXLEY. Mr. Herdman, is it your understanding that if we're able to pass the Toomey legislation before Congress adjourns for the year, that the court would be able to use the netting provisions in the law in the Enron case specifically?

Mr. HERDMAN. I can't answer that question, Mr. Chairman. I'm not an expert on that in bankruptcy law.

Mr. OXLEY. We'll follow up. Thank you very much.

Mr. Herdman, as you know, there have been a series of accounting shortfalls. Waste Management, ZZ, Sunbeam, and now, of course, Enron—the grandaddy of them all. Does this suggest a systemic problem? If it may, what is the SEC planning to do to alleviate that systemic problem?

Mr. HERDMAN. I think it's premature, Mr. Chairman, to conclude about whether there are systemic issues here. I also believe that it would be premature to look to only one potential source of whether there might be a systemic issue. Instead, there's work that needs to be done by all concerned in these processes.

Like Chairman Pitt's op-ed piece in the *Journal* the other day points out that things need to be done with respect to faster standard setting. Things need to be done with respect to the analyst community, the Big Five accounting firms and the NCPA have already stepped up and said they're going to take a look at self-regulation, the self-regulatory structure that exists today to determine what types of improvements might be needed so there are issues here. The SEC can and will work hard to improve our review process for the review of filings with us, so there are lessons to be learned here for everyone.

But, I think it's premature to say that that translates into a particular, or a series of particular, systemic issues.

Mr. OXLEY. I too read the op-ed piece in the *Wall Street Journal* by Chairman Pitt. I was most impressed with the breadth and scope of what recommendation that he gave. Obviously we will be pursuing that as a committee, particularly when we take up SEC reauthorization early next year. But indeed, it's fair to say that even before all of the bad news came out of Houston, that the Chairman had already put on the table numerous modernization efforts, and indeed, as you know, many of the regulations date back to the 1934 Act in a modern world of instant communications. In many ways, we still rely on the quarterly report, and I think one of the best ideas he had was more timely disclosure. And obviously the technology and the infrastructure is there today to do that. Maybe even Mr. Gutierrez will be able to pick up some insider trading information electronically instead of having to leaf through the *Wall Street Journal*.

My friend from California here is apparently flogging the *Wall Street Journal* for whatever reason, but I think it does point out that the new Chairman has recognized that we are in a new environment here, and that modernization of our structural regulation is clearly called for. And for that end, we thank you and the Chairman for their aggressive work in that area, and I yield back.

Chairman BAKER. Mr. Chairman, I would just point out that if it is not a systemic regulatory problem in the matter of Enron, then one would not have a large leap to assume that there's at least significant fraud or criminal conduct. I can't imagine that every person in Enron engaged in that activity. It's got to be one or the other. I would hopefully land on the systemic side for necessary reform and review, and then assume than everybody engaged in activities there was not aboveboard.

Mr. LaFalce.

Mr. LAFALCE. With respect to netting, this is not a new issue. The House of Representatives has passed netting legislation not only in this Congress, but in the Congress before this and in the Congress before that, and so has this Senate. But the leadership of the House and Senate has put this in a bankruptcy bill that is destined to go down to defeat. We need to extricate the netting provisions that have passed three successive Congresses and simply pass it independently if there's such bipartisanship in support of netting. And I was a co-author of all the bills. Let's do it.

Mr. Herdman, you recently came from the private world of accounting from Ernst & Young, and you are the Chief Accountant now for the SEC. My first question is, very briefly, what are your responsibilities as opposed to the Chief Accountant within the Enforcement Bureau?

Mr. HERDMAN. The chief accountant in the Enforcement Division works strictly on enforcement matters. As the Chief Accountant of the Commission, I am the principal advisor to the Commission on accounting and auditing matters and——

Mr. LAFALCE. Would you be more involved with policies, procedures, and general practices, and your counterpart would be more involved with the specifics of individual situations?

Mr. HERDMAN. That's a fair generalization, Congressman.

Mr. LAFALCE. Let's go back to your days at Ernst & Young. There are basically five big accounting firms worldwide I believe. You vie with each other. You want to represent clients because that's the only way you make money, so you have to be competitive. But there's a tension that exists, because you have certain fiduciary responsibilities as members of the accounting profession, and you have other fiduciary responsibilities either to your clients or to the public at large. Tell me a little bit about what you do when a CFO is engaging in practices that are not black and white, but are very grey and make you feel ill at ease. And how could the system be improved to make sure that the grey comes out white rather than black?

Mr. HERDMAN. First of all, Congressman, auditors have a code of ethics that they follow. As part of doing that——

Mr. LAFALCE. Accountants do, lawyers do, and doctors do, and virtually every professional organization does. One of the difficulties is sometimes that the code is not too clear or it's not enforced too well.

Mr. HERDMAN. The code in this case is quite clear, Congressman. Accountants and auditors owe a duty and care and professionalism to their client, and also a duty to make sure that the financial statements that they certify are according to Generally Accepted Accounting Principles and that their audits are performed in accordance——

Mr. LAFALCE. The CFO is about to do something or is doing something and the audit committee is either unaware of it or goes along with it. And you really don't think they should, although you suppose they could push the envelope that far. What do you do under those circumstances?

Mr. HERDMAN. You should keep in mind that recently the accounting profession, as part of its part to implement the recommendations of a blue ribbon panel on audit committees from several years ago, implemented a requirement that auditors meet and discuss with audit committees and management the audit partner's assessment of the quality, not just the acceptability of the accounting principles that companies are following.

Recently in a speech that I gave last week——

Mr. LAFALCE. You know, sometimes there's a tendency to say what you think they want to hear, especially if you want to keep them as clients. I'm not saying that it's never once done, but when you're dealing with a firm, and Arthur Andersen I believe is the smallest of the big five, 85,000 employees, how many employees worldwide does Ernst & Young have?

Mr. HERDMAN. One-hundred-and-fifty-thousand.

Mr. LAFALCE. I would imagine it's difficult to monitor the activities of 150,000 people, try as hard and best as you can. I'm just wondering how we could improve the system. I know Mr. Pitt wants to improve the system. I'm just wondering if self-regulation is going to be good enough.

Mr. HERDMAN. Congressman, that certainly is a topic that has to be considered at this point. I also would encourage you to think about the fact that big public accounting firms do have numerous controls and procedures to ensure that their people do follow the firm's policies and positions.

Mr. LAFALCE. But every now and then, there's a little bit of a slip that amounts to $90 billion, and an awful lot of people get hurt. And I'm not sure how many more $90 billion blips are out there. I do know that your predecessor, Mr. Lynn Turner, referred to the restatements that existed thus far as the tip of the iceberg, and I'm wondering whether Enron is the tip of the iceberg.

Mr. HERDMAN. I think it's premature to come to that conclusion.

Mr. LAFALCE. I think it might not be.

Mr. HERDMAN. I think it's very important at this point that we recognize the seriousness of the Enron matter, but at the same time we should neither under react to it, nor should we overreact to it.

Mr. LAFALCE. We ought to react to it very aggressively.

Chairman BAKER. Thank you, Mr. LaFalce.

Mr. Shays.

Mr. SHAYS. Thank you, Mr. Chairman.

Enron's collapse is obviously heartbreaking for the investors and the employees and the retirees who are dependent on it. I don't invest in these individual stocks if I'm not going to do due diligence, but it amazes me that the people who do due diligence—I'm interested in Enron, but I'm also interested in the implications for other investments in other companies. I'm particularly interested in the special purpose entity and I'm new at this and I'm trying to understand it.

I gather that if you have more than 3 percent ownership, you have to consolidate and I gather that one of the values of these funds is that it enables you to apply assets.

What I want to understand first is basically the 3 percent rule was established by the SEC. FASB declared it, but it was SEC generated. And the issue of the controlling test or the risks versus rewards your people in the SEC have been over the last 10 years trying to describe different tests with qualitative factors as well as quantitative factors. I'm looking at one speech that was delivered to the 28th Annual Convention of the current SEC Development by Dominick Ragone, I guess who works for you, a professional accounting fellow. And he went through all of these, which seems to me to almost set up a confusing process for the accounting firms and others.

And one is I want to know why the SEC doesn't just step in and get this resolved and why it doesn't do it sooner. And I carry with me the basic view that it used to be "the large ate the small," but now it's "the fast eat the slow." And it seems to me you can't have a system that takes so darn long to resolve.

Mr. HERDMAN. I think, Congressman, actually the first statements that were made by the SEC staff with respect to special purpose entities were directed particularly toward certain leasing transactions.

Mr. SHAYS. Towards what?

Mr. HERDMAN. Towards leasing transactions. Those statements were made in the late 1980s. The Emerging Issues Task Force of the FASB put together a working group which I chaired.

Mr. SHAYS. So what's your point?

Mr. HERDMAN. We got rules that were pretty quick with respect to special purpose entities back in 1990. There have been some ongoing comments by the staff with respect to that, but on balance, I think that the special purpose entity accounting is working as well as could be expected right now, but it does cry out for the FASB to finish their project and conclude whether a different set of rules should be enacted.

Mr. SHAYS. I'm a little confused. What confuses me is my sense is the SEC has been injecting itself in this debate and looking at a standard different than the 3 percent. Isn't that accurate?

Mr. HERDMAN. Congressman, I'll have to look into that. I've been on board for 2 months. In the time that I've been here we have not been injecting ourselves particularly in that debate.

Mr. SHAYS. In his speech he said the staff believes that the registrant should not apply any specific factor to determine the sponsor of an SPE and believes that all the facts and circumstances of each transaction should be considered carefully. In this regard, the staff believes registrants should consider the following qualitative and quantitative factors in evaluating who was the sponsor, who the sponsor is of an SPE. And then basically it has a number of qualitative factors and then you have a few quantitative factors.

Bottom line, do you think we're going to be able to continue to exist with FASB and the SEC not resolving issues more quickly?

Mr. HERDMAN. We do need to and it's one of the major points that was made the other day in Chairman Pitt's op-ed article. We need to foster an environment where private sector standard setting moves quickly and decisively to deal with the important issues.

Mr. SHAYS. Tell me to someone like myself who isn't an investor, tell me what the purpose is of a special purpose entity. I mean, I look at it and I think, why does it exist?

Mr. HERDMAN. Special purpose entities exist in order to finance—this is a generalization. There are many types of special purpose entities that engage in different types of things. As you may be aware, the banking industry, the credit card aspect of the banking industry relies extensively on securitization, thus providing for the bank a source of liquidity to carry on their ongoing operations.

This is a huge market. It's done with a great deal of transparency, and there are other types of special purpose entities that are created perhaps to finance particular investments. There are special purpose entities that are created to provide leasing facilities to a company. It's a way to achieve financing, and oftentimes there are some tax advantages associated with the use of these types of entities.

Chairman BAKER. Would the gentleman yield?

Mr. SHAYS. Yes.

Chairman BAKER. I think there are structural reasons why SPEs have a legitimate purpose, but I think the analysis should be, and I don't know that it has been, does the creation of the SPE create real value for the underlying shareholder of the principal corporation, or in this case, were the SPEs used for self-dealing of the official to profit at the expense of the taxpayer? That's what hasn't been determined.

Mr. SHAYS. And then the question would be does this happen in other companies and in other areas? I thank the gentleman.

Thank you, Mr. Chairman.

Chairman BAKER. I thank the gentleman for yielding.

Mr. Bentsen.

Mr. BENTSEN. Thank you, Mr. Chairman, Mr. Herdman. I want to follow up on what Mr. Shays was talking about. But I also want to say, a moment ago—and I can't remember who was asking the question—on the issue of restatements—and I think you're trying to be sincere of just being there for 2 months and looking at this, I think the increasing—it may have been the Chairman's question—I think the increasing volume of restatements is somewhat alarming. And I hope that the SEC is taking a harder look at that.

Now I don't know if it's systemic or not, and the more you look at the Enron case, it really does seem to me this is not—it's not certainly not—they didn't fail because of a cyclical reason or a recessionary reason or an economic reason. It certainly appears to me that they failed because of some severe structural reasons in their corporate governance.

And I think the Chairman is right about the SPEs, and your comments are as well. They can be an attractive, an efficient financing vehicle. But in this case, isn't it a problem or shouldn't it be a problem for the SEC or the auditors, which the auditors did apparently find at one point, when on the one hand you're calling debt an increase in equity and you're really swapping what you're doing. They were double counting notes receivable and double counting equity when it was going the opposite direction. And the restatements were quite severe.

And isn't it also a problem in having a restatement of a billion dollars plus of equity that's not just going back to the beginning of the quarter that you were filing the 10-Q for, but going back not just 4 quarters, but 4 years? And does it appear—and I know you have to be circumspect on your comments with respect to Enron because it's under investigation. But it seems to me to have every appearance of either using the SPEs as an artifice or self-dealing of some sorts. Even your own chronology in your statement.

Mr. HERDMAN. I think, Congressman, you referred to the double counting of the notes receivable in the stockholders' equity. What has been disclosed with respect to that indicates that it does not go back 4 years. About $170 million of it arose in 2000 and the other $830 million arose in 2001.

Mr. BENTSEN. But they reduced their net income going back 4 years as it related to——

Mr. HERDMAN. Reduction of that income——

Mr. BENTSEN. ——as it related to—I think as it related to both Jedi and Chewco. Right. In those they restated it going back to 1997——

Mr. HERDMAN. That's correct.

Mr. BENTSEN. ——to the point where they would have, instead of having net income, they would have had a net loss, which is somewhat substantial to the investing public.

Let me ask you this. When they went through the transition, the CFO was out, the CEO was out. The chairman of the board resumed the role of CEO. In a conference call with analysts, the issue sort of came up, if I understand the chronology correct, that $1.2 billion of equity basically had washed away, no longer existed.

The chairman and now CEO states in response to a question from analysts, "Well, that's over my head. I'm not sure I know the details of that and the special purpose entities." Isn't it a problem when you have the chairman of the board of a Fortune 500 company, publicly-traded company, and not a penny stock company. It is today. But it certainly wasn't a penny stock company then—who doesn't understand the financing mechanisms of the company as it's operating?

Is there a question here of corporate governance and is the SEC looking at that issue? Was the audit committee functioning properly? Are we through the 1933 and 1934 Acts or through the tools you have, are we sure that the boards of public companies are operating efficiently for the benefit of shareholders and the investing public and the pensioners, for that matter?

Mr. HERDMAN. Congressman, your question carefully weaved in and out of Enron, and to the extent that it pertains to Enron, as you understand, I can't address that.

Mr. BENTSEN. Well, address it as a hypothetical.

Mr. HERDMAN. As to a generality, of course chairmen of boards and audit committees should understand the important elements, the material elements of financing for the entities with which they're associated.

Mr. BENTSEN. Is the SEC doing enough? I mean, obviously, you can't sit and review every company's board minutes and all of that. But, I mean, do you think that the SEC is providing enough oversight in that area? I mean, if everything that has been said turns out—or if half of everything that's been said turns out to be true, the collapse of Enron is going to be one hell of a story and what happened and a huge miss on the part of the board and potentially its auditors.

I mean, I can see where certain things can be missed and certain, you know, the contract with the copying machine company maybe wasn't the best deal you could get——

Chairman BAKER. Could you begin to wrap up, Mr. Bentsen?

Mr. BENTSEN. But this is a pretty big deal.

Mr. HERDMAN. The processes that the SEC uses to review filings have been basically based on a selective review process now for 20 years. And we don't talk about the particulars of that process in public, because we don't want companies to know, frankly, when they'll be subject to review and when they won't be subject to review.

I can assure you, Congressman, that continuous improvement has been the hallmark of working with that review process. And I can certainly assure that going forward, we will continue to do that. We will learn the lessons that are out there to be learned from what we might discern from the Enron matter, and we'll apply those to improving our processes.

Mr. BENTSEN. Thank you. Thank you, Mr. Chairman.

Chairman BAKER. Thank you, Mr. Bentsen.

Mr. Toomey.

Mr. TOOMEY. Thank you, Mr. Chairman.

A question on the SPEs if I could. First of all, maybe you could correct me if I have this wrong. But my understanding is that if you own 2.9 percent of the equity, you as some corporate entity own 2.9 percent of the equity of an SPE and you meet the other criteria regarding the control of the SPE, then your balance sheet is essentially silent on that fact. It doesn't reflect it in any way. Is that incorrect?

Mr. HERDMAN. No. Congressman, the 3 percent doesn't have to do with what the company that enters into a transaction with the SPE owns. It has to do with the fact that many SPEs could be formed and providers of capital would be quite comfortable to provide 100 percent of the financing of an SPE in the form of debt securities. Let's say that that SPE was formed to carry out a sophisticated leasing program for a major program. This SPE could be formed. It's a legal entity. It could borrow 100 percent of the money from banks or private.

What these rules say that in order for there to be enough substance to the SPE, in order for it to be viewed as an entity independent from the sponsor, somebody has to put in some common equity to it.

Mr. TOOMEY. Right.

Mr. HERDMAN. And that common equity has to be at least equal to 3 percent of the total capitalization of the SPE.

Mr. TOOMEY. OK. That's an important clarification. Thank you. If the corporate entity that wants to create the SPE provides a certain amount of that 3 percent equity and other entities provide the rest, then is there a requirement that the be represented on the balance sheet at all?

Mr. HERDMAN. Yes. That would have to be on the balance sheet.

Mr. TOOMEY. That would have to be?

Mr. HERDMAN. If the 3 percent isn't owned by independent entities, and the other conditions are met, of course, then the SPE would have to be consolidated on the balance sheet.

Mr. TOOMEY. It would have to be consolidated when the sort of sponsoring corporation has less than 3 percent?

Mr. HERDMAN. No. It has to be consolidated if the SPE doesn't have at least 3 percent of its total capital owned by outsiders.

Mr. TOOMEY. I understand.

Mr. HERDMAN. Independent third parties who have common equity-type capital.

Mr. TOOMEY. Right. I understand that. I guess what I'm getting at is there is a set of criteria, there are rules that allow for someone to create an SPE. They follow all the rules and they are allowed to change not to consolidate that SPE or in fact they're required not to consolidate it, right? And my question is, if the contribution, if you've made some kind of contribution, say you've contributed your own equity to part of the capitalization, but not so much that you would consolidate, but if you do it in a fashion that has the additional proviso that you'll top up that contribution in the event that the value of your stock declines, then that creates a contingent liability on the part of the sponsoring company, correct? Would you consider that?

Mr. HERDMAN. In the rare event when a sponsoring company would be part of the capital structure of an SPE, that's potentially—you could view it as a contingency. I don't think that it would consider it to be a contingent liability.

Mr. TOOMEY. Do you think it should be?

Mr. HERDMAN. It would have to be recognized on the financials.

Mr. TOOMEY. Right. Well, it seems to me it certainly is a contingent liability. It's equivalent to having sold a put option on your own stock, and therefore it would be required to be reported. Is that correct?

Mr. HERDMAN. They're really very complicated rules on the accounting for put options and call options on your own stock. And I'd be glad to get back to you on these issues if you'd like to explore this further.

Mr. TOOMEY. Yes, I think I would, because it seems to me——

Mr. HERDMAN. There's a lot of detail here.

Mr. TOOMEY. And it seems to me that this was part of what was going on with at least one of the SPEs that Enron had created. And I'm just wondering whether that had contributed to a larger exposure than perhaps was evident.

Mr. HERDMAN. I can't comment on the Enron aspect of it.

Mr. TOOMEY. I'll yield the balance of my time to my colleague, Mr. Ose.

Mr. OSE. Thank the gentleman from Pennsylvania. Mr. Chairman, I do want—it's ironic. I was reading through the *Wall Street Journal* as I listened to some of the comments about the insider trading spotlight, and in fact today, Wednesday, December 12th, there's the most recent report on insider trading listing the top eight or ten individuals, both on the buy and the sell side and the top six or eight companies, both on the buy and sell side. And there's a little footnote down here. It's a *Wall Street Journal* link. "See a list of companies with the highest number of insiders filing Form 144 with the SEC disclosing their intention to sell restricted stock."

So it would seem to me that the information is being collected at the present. It's in the public domain. There may be some people who perhaps aren't aware of that fact. But as it relates to any directorships or managerial positions liquidating stock, it's a matter of public record by rule, if I understand, that has to be disclosed.

Mr. HERDMAN. That's correct, Congressman.

Mr. OSE. Now there's also a secondary cut, if you will, and that is that—correct me if I'm wrong, Mr. Herdman—that members of the board of directors or members of a management team only have specific windows during which they can sell stock that they receive. Is that correct?

Mr. HERDMAN. I understand that to be true. But I couldn't give you the particulars on that, because that is a matter of law.

Mr. OSE. The reason I asked that is somebody put together a very red document here that highlights the sales seemingly on a—for some purpose, but I wonder whether the windows correspond with the dates showing the large amounts of sales. I think that's worthy of being checked out.

Chairman BAKER. I can help you, Mr. Ose, because if you look down at the left-hand corner it says "Source: Insider and Form 144 filings." That's all the corporate records. And what happened is there were two different types of actors here, a Mr. Lay who sold—I don't have the correct pronunciation—who sold in large blocks. Mr. Lay, however, sold in \$10- to \$100,000 blocks virtually every week, some every day. So if there were windows that were closing, they took a long time to close in the case of this particular matter.

Mr. OSE. But there are windows during which they——

Chairman BAKER. Apparently so. There were a goodly number of them in this case.

Mr. OSE. Are there different types of stock? This is where I get beyond my level of knowledge. And that is, with respect to senior management, do they hold restricted stock and unrestricted stock? Is that what you're saying?

Chairman BAKER. They were exercising stock options. Normally they would be in an acquisition on the morning of the day and the disposition of that same stock that afternoon, and there were various classes of stock being exercised, I'm assuming in accordance with their contractual relationship with Enron, whatever their employment agreement guaranteed them, they were entitled to receive and therefore make disposition of.

Mr. OSE. And they were eligible to do that because they met certain minimum financial requirements on a personal basis?

Chairman BAKER. I'm certain that was——

Mr. OSE. Which are not necessarily available to someone working lower down in the company?

Chairman BAKER. It was clearly a benefit of their contractual relationship as an employee of Enron, as an officer.

Mr. OSE. OK. I understand I'm on Mr. Toomey's time. I want to come back to that question. Because the issue of why certain people are eligible to hedge their exposures and others aren't has been the substance of significant debate in these subcommittees and over in the Agriculture Committee on which I sit, relative to the minimum financial standards a participant must meet.

And coincidentally and quite interestingly, there's been a lot of argument that people who are going to participate in hedging of exposures must meet certain minimum financial requirements. And in fact, that has been a demand from one side of the aisle in particular. And I think that merits investigation, because it's at the heart of people participating in the 401Ks getting stuck, if you will, when stock collapses. And I'm hopeful you'll come back to me, because I know I'm on Mr. Toomey's time. So thank you, Mr. Chairman.

Chairman BAKER. And Mr. Toomey's exhausted time. Thank you, Mr. Ose.

Mr. Sandlin.

Mr. SANDLIN. Thank you, Mr. Chairman. Just briefly. And thank you, Mr. Herdman, for being here today. The goal of meaningful disclosure is to provide the investors and the market with an accurate and complete picture of the financial condition of the company. Is that correct?

Mr. HERDMAN. That's correct.

Mr. SANDLIN. And the public is protected at least in part by an independent audit and by SEC oversight. Is that correct?

Mr. HERDMAN. That's correct.

Mr. SANDLIN. It's already been brought out today the issue about the partnerships with SPEs. But it's not been brought out—it's my understanding in this particular case, the partnerships were run by the officers of the company. Is that correct? Of Enron.

Mr. HERDMAN. That's what's been reported, yes.

Mr. SANDLIN. And it's my understanding that these partnerships also were unnamed partnerships. Is that correct?

Mr. HERDMAN. What kind of partnerships?

Mr. SANDLIN. Unnamed. That they were not identified by name.

Mr. HERDMAN. I believe that's correct from the disclosure I've seen, yes.

Mr. SANDLIN. Would this not cause—that's not in accordance with normal business practice or generally accepted accounting principles, is it?

Mr. HERDMAN. Congressman, I don't believe that there's a generally accepted accounting principle requirement with respect to related party transactions that specifically calls to name the names of the partnerships.

Mr. SANDLIN. So, you think it's fine, then, just to list partnerships, but not by name and not to indicate that the partnership is run by an officer of the company?

Mr. HERDMAN. No, that's not what I said.

Mr. SANDLIN. That's what I'm asking.

Mr. HERDMAN. If that is the related party, is the officer, and generally accepted accounting principles does require disclosure of certain things with respect to——

Mr. SANDLIN. That's what I thought. Disclosure of——

Mr. HERDMAN. ——the transactions.

Mr. SANDLIN. Now these partnerships were treated in this particular case as a separate entity, correct, from Enron?

Mr. HERDMAN. We're now starting to get far too specific.

Mr. SANDLIN. OK. In the event that a SPE is set up or a partnership is set up in this sort of situation, then that partnership is considered as a separate entity from the original company. Is that correct?

Mr. HERDMAN. An SPE or a partnership that meetings the applicable accounting rules to be considered is separate.

Mr. SANDLIN. And that allows debt to be moved away from the original company. Is that correct?

Mr. HERDMAN. What that does, Congressman, is it says that the debt that's incurred by the SPE doesn't have to be consolidated in the financial statements of the company that does business with the SPE.

Mr. SANDLIN. But in the event that the company or SPEs are set up properly or do not meet accounting principles, then you're allowing the liabilities and equities of the company and ultimately the stockholder be distorted. Is that correct?

Mr. HERDMAN. Could you repeat that question?

Mr. SANDLIN. My point is, you're allowing debt of an original company to be spun off into an SPE that's run by an officer of the original company in order to move debt away from the original company so that the stockholder equity appears much higher than it is. Is that correct?

Mr. HERDMAN. My experience, Congressman, with respect to SPEs is that they normally do their own borrowing.

Mr. SANDLIN. Should auditors be involved in auditing partnerships or SPEs that they have a part in setting up?

Mr. HERDMAN. I don't know what auditors would be doing in terms of setting up partnerships. They're not lawyers.

Mr. SANDLIN. If an auditor that's a part of an accounting firm or a law firm is a member of that same firm and helps set up an SPE or a partnership, should that same firm then regardless of your artificial restrictions within the firm, should that same firm be involved in auditing that setup?

Mr. HERDMAN. I don't think there would be any prohibition against doing that.

Mr. SANDLIN. You don't see a problem in the fact that an accounting firm or a law firm would set up a partnership and then turn around and audit its own work? You think that's fine?

Mr. HERDMAN. Accounting firms don't practice law, so they don't set up partnerships.

Mr. SANDLIN. I'm very aware of that. Well, let me ask you this. Should it raise a red flag for an auditor, if a firm is setting up a special purpose entity transactions in the firm's own stock? Is that a red flag?

Mr. HERDMAN. If the transactions are material to the company's financial statements and if the auditor is aware of them, I would expect that that would be something that the auditors would pursue diligently.

Mr. SANDLIN. Now the press reported that the enforcement division of the SEC sent a letter in October to Enron about having questions about their disclosure. Could you tell us what disclosures raised the red flags for you?

Mr. HERDMAN. The disclosures that prompted the letter were those that were made in an October 16th press release in which Enron released the results of its operations for its third quarter of 2001.

Mr. SANDLIN. What factors does the SEC consider to determine what filings it's going to review?

Mr. HERDMAN. Congressman, as I said earlier, the selective review process that's used by the staff of the Commission to determine filings for review is not a topic that we discuss publicly, because it would take what element of surprise is in it out of it, and companies might know better when they might expect to be reviewed.

Mr. SANDLIN. I'm being tapped, and I think that means I'm done. Thank you for your response.

Chairman BAKER. Thank you, Mr. Sandlin.

Just make a brief announcement for the subcommittees. I have to step out for a moment. Mr. Bachus will assume the chair. We'll proceed with questions of Mr. Herdman until—I understand there's a likely vote on the floor about 1:30. It's my hope that all Members could get their questions in before that vote.

And I'm making this announcement for our second panelists. Pending that vote, we would take a few minutes for a lunch break and probably try to come back around 2:15 if the vote occurs around 1:30, which is a guess at this point. But to let our panelists know they will have a few minutes from whenever that vote occurs, and Members, a little time to grab a sandwich and come back. Let's just make it 45 minutes from whenever the bells first sound so we can get a vote in, get some lunch, and then come back for the second panel.

Mr. BACHUS. [Presiding.]

Mr. Royce.

Mr. ROYCE. Thank you, Mr. Chairman.

Mr. Herdman, are you troubled by Enron's use of partnerships to keep significant liabilities off of the balance sheet?

Mr. HERDMAN. Congressman, I can't comment about any of the particulars of the Enron matter because of the pendency of our investigation.

Mr. ROYCE. OK. Well, let me ask you then in a broader scope here. Do you see ways in which the SEC can encourage or maybe compel companies to provide financial information that's useful to investors on more of a real time basis? Let's say for large corporations monthly rather than quarterly financial statements. Would that be helpful in your view?

Mr. HERDMAN. I don't necessarily think that a requirement for monthly financial statements would be helpful. But the things that we're going to be considering with respect to improving the totality of financial reporting could very well lead to disclosures of financial and other types of performance indicator information on a more frequent basis than quarterly.

Mr. ROYCE. Well, we've had accounting problems now that are almost systemic. Waste Management. We've had Sunbeam. We've now had Enron. It would seem to me that there would be need to move quickly on developing such changes.

Let me ask you a question about the ongoing investigation. Let us say that fraud is discovered in this investigation with respect to Enron in terms of insider trading. What is the likelihood that the profits made through fraud through insider trading would then be compelled to be paid back to Enron so that the assets held by the employees of Enron and shareholders of Enron who did not have access to this insider information could then be at least partially benefited?

Mr. HERDMAN. That's beyond my personal expertise, Congressman. I just don't know all of the particulars about the specific remedies the SEC has available, including the potential for disgorgement.

Mr. ROYCE. Well, let me just close by saying it seems to me that investors need current information that is, in fact, true on a real time basis, and we have not developed to date apparently an effective system to make sure that it's delivered on a timely basis to them, and I would suggest that the SEC look at changing its procedures in a way that effectively does that, because the Congress is certainly going to look at finding ways to prod just such changes.

Mr. HERDMAN. Congressman, Chairman Pitt, since the time he's assumed office, has been talking about modernization of the financial reporting system, including more current information. Congressman, if you'd like, I could ask our general counsel, David Becker, to respond to your question about remedies and recoveries.

Mr. ROYCE. Certainly I'd be happy to hear from the general counsel. Thank you, Mr. Herdman.

Mr. BECKER. Congressman, on remedies, we do have a variety of remedies in cases in which we can go to court and get disgorgement of ill-gotten gains. If the folks who misbehave still have the proceeds of the fraud, we'll get them and we'll——

Mr. BACHUS. If you could lean a little closer to the microphone.

Mr. BECKER. Sure. If the folks who violated our anti-fraud rules still have the proceeds of the fraud, we'll get them, and we'll make them give it up.

Mr. ROYCE. Well, I would suggest that besides changing the ground rules so that we can get this information to investors on a more timely basis, that the other part of the equation is to aggressively pursue just such actions so that there will be a deterrent effect in the future. And I thank the gentleman for his answer.

Mr. HERDMAN. I agree with you very much, Congressman.

Mr. BACHUS. I thank the gentleman.

The lady from Ohio.

Mrs. JONES. Thank you, Mr. Chairman. Lots of questions, not enough time. You stated earlier that we should not overreact to a situation such as Enron. What would be an overreaction, sir?

Mr. HERDMAN. An overreaction might be to say that financial reporting is not trustworthy in this country. I think that would be an overreaction.

Mrs. JONES. What should we say, then, if based on Enron, financial reporting in this country is?

Mr. HERDMAN. I think we should say that financial reporting in this country is challenged and appropriate steps need to be taken to learn what needs to be done to improve it, and that should be done quickly.

Mrs. JONES. OK. The filings that we're talking about on the chart over there on insider trading, these insider and Form 144 filings. How often are they filed, sir?

Mr. HERDMAN. I'm not an expert. I believe that they're filed on a transaction basis. In other words, if an insider sells——

Mrs. JONES. Can your general counsel answer that question for me?

Mr. BECKER. I hope so. On the Section 144(a) transactions, they have to be filed fundamentally contemporaneously on general sales of stock they have to be filed, I believe, monthly or within 10 days.

Mrs. JONES. Say that again, please. I didn't hear you.

Mr. BECKER. Fundamentally, they all have to be filed within 30 days.

Mrs. JONES. Is there a level of insider trading that would cause the SEC to say hello?

Mr. BECKER. Well, the short answer is depending on what else is going on, yes. If there's an extraordinary transaction and folks have traded and we want to know why.

Mrs. JONES. OK. I'm Company Outwalk, so you don't have to talk about Enron. And in January I had $180 billion million worth of insider trading. Would that make you go "Wooo"?

Mr. BECKER. I suspect that that's something that we would look at. I will tell you, though, that the fundamental philosophy of the Federal securities laws is get the information out and have investors evaluate the wisdom of their investment decisions. We do look at a variety of sources, including visual patterns of trading, to see if there is any fraudulent conduct going on.

Mrs. JONES. But, the goal and purpose, Mr. Herdman, the Chief Accountant, U.S. Securities and Exchange Commission, is you have an oversight obligation over all these different accounting firms and auditing firms and the OAB, which was the office of—the POB, excuse me, the Public Oversight Board, to sit with them and give advice and counsel on the standards of what becomes appropriate accounting procedures. Wouldn't something like that be part and parcel of something that you would say to the world? Well?

Mr. BECKER. This information—our fundamental mission is to see to it that information relevant to investors is out in the public and that financial statements and disclosures are fully transparent to the public. And this type of information is information——

Mrs. JONES. You know what? You could sit down if you'd like.

Mr. BECKER. Oh, thank you. Mr. Herdman's got his briefcase here, so I wouldn't. So, in fact, this type of information is information that's pushed out to the public quickly. One of the paradoxes—not talking about Enron in particular—one of the paradoxes, and this is where the role of analyst comes in, is that often that there is information out in the public, but people don't necessarily focus on it and take it as seriously as in hindsight they should.

Mrs. JONES. Let me ask this, then. We've got a company—I called myself Outwalk. And Outwalk, my company, not only is showing $180 million worth of insider trading, but is—let me back up. Is there an obligation to also show how many subsidiaries or partners that you have as they become partnerships under your or become what do you all call them? The SPEs or something?

Mr. BECKER. I think this is one for Mr. Herdman.

Mrs. JONES. OK. I'll take him.

Mr. BECKER. But, the basic answer is, sometimes yes, sometimes no.

Mr. HERDMAN. SPEs sometimes are accounted for as subsidiaries, in which case there would be information about them, and sometimes if they meet the appropriate standards, they're not accounted for as subsidiaries, in which case there wouldn't be information about them.

Mrs. JONES. Based on what we know about my company—Outwalk—and perhaps it would not be an overreaction for us to look how do we let the public know that there are a number of FPEs or SBEs operating within a company that could, in fact, camouflage the economic condition of a company such that poor little me, who doesn't know anything about this area that I'm investing in, might think twice before I would invest my money in Outwalk Company?

Mr. BACHUS. The lady's time has expired.

Mrs. JONES. Thank you, Mr. Chairman. Can I get a quick yes or no on that question? Can I get quick yes or no on that question?

Mr. HERDMAN. I'm sure that's something that the FASB, when they finalize their rules on SBEs, will take into consideration.

Mr. BACHUS. Thank you.

Mr. Herdman, there's been some disturbing allegations with respect to the failure of the board of Enron to monitor the activities of management, in particular related to the special purpose entities, the SPEs, as you've referred to them, and the related party transactions. What would you recommend to increase board oversight for these kinds of transactions and entities?

Mr. HERDMAN. Congressman, there have been significant developments in the various structures about audit committees, about boards in recent years, particularly about audit committees. And the Commission really has no plans to do anything further with respect to rulemaking in that regard. And once again, this is an area where I believe that if we learn something as a result of our investigation that should be applied more broadly, we'll move ahead aggressively with that.

But at this point, there have been significant changes in what audit committees do, in the amount of their interaction with auditors, and so forth. And those are all fairly recent within the last year or two. And right now there's no indication that that's an area that needs something to be done with it.

Mr. BACHUS. OK. How should a board react when they think that generally accepted accounting principles or GAAP-compliant disclosures are inadequate?

Mr. HERDMAN. Well, under the conditions today to be a member of an audit committee—and these are encompassed in rules—as I say, they were not that long ago enacted by both the New York Stock Exchange and Nasdaq, is that members of audit committees have to be quote/unquote: "financially literate" and each understand enough about accounting and about financial reporting and financial statements to be able to critically engage management and the auditors in discussions about the accounting principles that are used, the disclosures that are made, and so forth.

That being the case, when these discussions occur, if there are instances where the financial statements or where management doesn't intend to follow generally accepted accounting principles for some reason or it doesn't want to make a disclosure that is required by generally accepted accounting principles, the discussion has to be with the members of the audit committee if discussions just between management and the auditors haven't yet resolved the problem. That's not to say that if the right accounting doesn't get used and the right disclosures don't get made that the accountants would give a clean opinion in dialogues that occur, these sometimes are iterative, and the audit committees do have an important role in those types of matters.

Mr. BACHUS. Thank you.

Yesterday, Chairman Pitt called for a self-regulatory organization for CPAs. Does the commission intend to issue a rule proposal for public comment on this? Or do you know what the timeline is?

Mr. HERDMAN. Actually, Congressman, the article today that indicated that Chairman Pitt called for a self-regulatory organization, I think, misspoke. And where the Chairman and where the Commission are at this point is we've begun a dialogue with the accounting profession, with the major firms in the AICPA. They've indicated that they're going to take a look at what changes are needed to the self-regulatory process. We're eager to continue to work with them on that, and we're not predisposed at this point to either a continuation of the current system of self-regulation or to a statutory self-regulatory organization.

Mr. BACHUS. OK.

Mr. HERDMAN. If that were to go in the direction of an SRO, I believe that in order to be enacted it would have to be a matter that was put out for notice and public comment.

Mr. BACHUS. Now are you also considering something like an enhanced FASB or an enhanced AICPA or something like that? Or are you talking about just an entirely new body?

Mr. HERDMAN. What we're talking about is the self-regulatory structure that currently is housed within the AICPA in its Division for Firms and is overseen by the Public Oversight Board, which is comprised of individuals of high integrity that are not practitioners of accounting and what have you. That's the structure that exists today. It does certain activities. They're outlined in my testimony. And the questions have to do with are those activities sufficient? Does more need to be done? Does discipline need to be more transparent, and so forth. Those kinds of issues.

Mr. BACHUS. OK. Thank you.

Mr. Mascara.

Mr. MASCARA. Thank you, Mr. Chairman.

Mr. Herdman, when did the SEC suspect there was a problem at Enron? And what action did the SEC take? And how soon afterwards? I heard you mention in an earlier question the third quarter, October of 2001, was it?

Mr. HERDMAN. The first letter Congressman, was a letter that was sent to Enron on October 17th of 2001.

Mr. MASCARA. And what action did you take?

Mr. HERDMAN. We sent them a letter requesting that they provide more information about the losses that had been reported in their earnings press release the prior day.

Mr. MASCARA. What role does the SEC play in SPE filings? I would imagine there is some kind of a filing someplace that someone's required to file. Did you say earlier that these liabilities do not appear if they have 3 percent invested in the total offering? On a consolidated statement, do these numbers appear there?

Mr. HERDMAN. What I said earlier was they do not appear on the consolidated financial statements if the owner of the special purpose entity has invested in equity capital of that entity in an amount that's equal to 3 percent or more of its total capitalization, and its total capitalization would include the amounts that the entity borrowed from various sources.

Mr. MASCARA. It's my understanding that Enron had a plethora of SPE filings. So if they invested a minimum of 3 percent, they would not be required to place that liability on their balance sheet? I think that's outrageous if the answer is yes.

Mr. HERDMAN. It's not, as I said earlier, Congressman, this is complicated, but it's not how much Enron has invested in the SPE or another sponsor of it. Let's not talk about Enron. When a sponsor of an SPE invests it's—because they can't invest anything. It's how much is invested in by independent third party investors.

Mr. MASCARA. So if any independent investor invests at least 3 percent, Enron or any other company would not be required to list the liability on their balance sheet on a consolidated balance sheet?

Mr. HERDMAN. That's correct, Congressman. The sponsor before the 3 percent requirement was put in place was quite willing to lend 100 percent of the capitalization of SPEs in order to effect these transactions.

Mr. MASCARA. How is your staffing at SEC? Is it sufficient to oversee the financial world of risk that's many times out there? Do you have enough employees to oversee those activities?

Mr. HERDMAN. I'm certain we have enough employees in the Office of the Chief Accountant. With respect to the other divisions, we're constantly looking to see where and how we can use our resources better and to redeploy resources to particular issues that—you know, radiate attention at a particular point in time.

Mr. MASCARA. I have an accounting license. I'm asking you this question because I can't answer it. Does any of this have to do with what went on recently in the dot.coms where people were looking at anticipated revenues rather than anticipated earnings? Is there any similarity between the——

Mr. HERDMAN. Based on what, Congressman, I don't see any similarity at all to the dot.coms. The dot.coms were speculative entities that generally didn't have much history in their business. They frequently have enough cash to carry out their money-losing activities as a result of the public investing the cash. Notwithstanding the fact that there was clear and transparent disclosure that these companies were vulnerable, that they didn't have any, and so forth. That was all out there on the table, and yet a lot people bought those stocks and I guess today wished that they hadn't.

Mr. MASCARA. Thank you, Mr. Herdman. I think we've just touched the tip of the iceberg. I'm afraid what's coming. But I thank you and I thank you, Mr. Chairman.

Mr. BACHUS. Thank you, Mr. Mascara.

We intend to recognize Mr. Inslee and then Ms. Jackson-Lee. There's probably about 7 minutes left on the floor, so for such time as we have, I'm going to recognize Mr. Inslee first and then Ms. Jackson-Lee.

Mr. INSLEE. Thank you, Mr. Chair. I represent a district up in the State of Washington. I can tell you that my constituents have a lot of real hard questions here. And the reason is is that they think of Enron as sort of a financial octopus with tentacles not only just into the investor community, but that touches Americans in a lot of different kinds of ways.

And one of those kinds of ways is in the energy field, the energy prices and the like. And I heard one of my colleagues say something I guess I'll take a little issue with to say that somehow Congress should not get to the bottom of the question of how this company hijacked America's energy policy. Because it appears from the press reports that I'm reading that there's good reason to believe that Enron's fingerprints are all over the American energy policy that exposed my constituents in the State of Washington to millions of dollars of overcharges last year in the electrical market and have led us into the situation where the country has huge failures in our energy policy.

And there are questions that I think—and I hope you and others help us answer—like, is the reason that we're giving Enron $254 million in tax relief instead of investing in clean energy is the answer Enron? We'd like an answer to that question. Is the reason that the Administration is doing nothing about global climate change, is the answer Enron? Is the reason the Federal Government is not taking action to improve automobile mileage standards, is the answer Enron? Because there's a lot of evidence that at least we've been hearing about, about the ability of Enron to affect our Government's policy, and we're very concerned about that.

And there's a relationship between this financial world and the energy world. I was just reading, I think it's in the *Los Angeles Times*, it's talking about Mr. Lay's role in the replacement of one of the FERC commissioners. And it says, as the *New York Times* reported, "Ebert [phonetic] had barely settled into his new job this year when an unsettling telephone conversation with Kenneth Lay prodded him to back a faster pace in opening up access to electricity transmission grid to companies like Enron." Lay admits making the call, but in an unctuous defense of his influence peddling said: "the final decision on Abrams [phonetic] job was going to be the President's, certainly not ours." Soon after, Ebert [phonetic] was replaced by Texan Pat Wood, who was favored by Lay.

I think that there are a lot of questions here that are going to be related to the abuse of stockholders to also the abuse of energy payers, consumers, and those who care about our whole energy world. And we encourage you and others to engage in trying to answer those questions that Americans have.

And I want to ask you one specific question about abuse of stockholders and employees. And I know you can't comment on the investigation, so I'll ask you in a hypothetical form. If a company on October 17th, the very same day the SEC announced it was investigating that company, chose to change plan administrators of their 401K, which thereby automatically locked in their employees so they couldn't sell their product. And then the insiders, including some of the executives that were partially, in my view, responsible for the pathetic energy policy we have in this country, to go on this binge of selling their stocks to jump ship and leave their employees in a sinking ship, is that, number one, legal? And number two, is there disclosure required for that activity?

Mr. HERDMAN. Congressman, I think what happened to the employees with that 401K plan is just one of the most terrible things I can imagine. However, nothing about 401K plans comes under the jurisdiction of the Securities and Exchange Commission. Those are matters that have to do with the Department of Labor. And as to whether there would be a need for disclosure in SEC documents, I don't believe that there would be.

Mr. INSLEE. Well, should we consider requiring disclosure that if executives are going to treat their employees, of essentially getting into the lifeboat and leaving them on a sinking ship, should we consider requiring disclosure on that in some regard?

Mr. HERDMAN. I don't know whether there was disclosure made to the employees in advance about the fact that the change in administrator was going to prevent them from changing their investment elections for a period of time. I just don't know.

Mr. INSLEE. Let me ask a little broader question.

Mr. BACHUS. I thank the gentlemen for his questions.

Mr. INSLEE. Thank you, Mr. Chairman.

Mr. BACHUS. Thank you.

Ms. Jackson-Lee. And at the end of her questioning, we're going to recess for 45 minutes.

Ms. JACKSON-LEE. Thank you very much, Mr. Chairman. I'm a guest in this hearing and I want to thank the Chairman. I want to thank the Chairman of the Full Committee, Mr. Oxley, the Ranking Member, the Chairman and Ranking Members of the subcommittees as well.

I am here because Enron is in the 8th Congressional District of Texas, my District in Houston. The eyes of the Nation, Mr. Herdman, are on these particular hearings, and more specifically the eyes of Houston are on this particular hearing because, of course, Enron was a very good civic and corporate anguish in Houston, Texas now and I believe as it moves across the Nation, in the Nation. As the SEC's responsibilities, if, for example, in 2000 December a stock price of $84 and then around October of 2001 it had a stock price of $33, why did the SEC do more to that particular company—and particularly if there was a loss of about $600 million?

Mr. HERDMAN. As I understand it, the loss that you may be referring to wasn't reported until November when Enron announced that it planned to restate its financial statements back to 1997. Once again, as Mr. Becker pointed out earlier, the purpose of the securities laws is to require disclosure, to provide disclosure to investors so that they can make informed decisions about whether to invest, when to invest, when to sell, and so forth. And the fact that a stock price changes—we'll look into this, but I'm not persuaded that that would be an effective means for the SEC to screen filings and determine whether a particular company's filings should be looked at as contrasted to some other procedures that are applied in our selective review process. But we'll certainly look into that.

Ms. JACKSON-LEE. I appreciate your assessment on that. I would think with the overwhelming—you just answered my question. Wouldn't you think it's now time to reassess or to look into what might be additional resources, regulations and laws that might assist in that review on behalf of the SEC?

Mr. HERDMAN. We'll be taking a look at ways to improve our processes as well.

Ms. JACKSON-LEE. Let me close on this question because my other duty is to cast my vote on the floor of the House, and I will return for the second panel. I thank the Chair. With respect to the law, the difficulty that they provide in camouflaging the acts of a particular company. How do we address that and treat that? I'm not using the correct terminology, but truth in information. That is not truthful.

Mr. HERDMAN. Ma'am, I don't think you can conclude that it's always not truthful. This is why we have the Financial Accounting Standards Board to develop the appropriate criteria as to when those assets and liabilities should be part of the consolidated financial statements and when they should not be part of their consolidated financial statements, and we will urge them on to the swift completion of that task.

Ms. JACKSON-LEE. Let me leave you just with this. Maybe we will heighten the standards on the utilization or the proctoring of those kinds of companies. It may not be a question of truth in information, but maybe there needs to be a higher bar.

Mr. HERDMAN. Perhaps.

Ms. JACKSON-LEE. Thank you very much.

Chairman BAKER. Thank you, Congresswoman Sheila Jackson-Lee. We are now going to dismiss this panel. We want to thank the witness for testifying today, and we also want to give the Members of the Congress 30 days in which to put together any additional questions that they might want to ask you. So I'd like to acknowledge that for the record.

We are going to reconvene with the second panel at 2:15 after this vote is over. So, thank you again for your testimony here today.

Mr. HERDMAN. Thank you.

[Recess.]

Chairman BAKER. By way of advisory, Members will be returning momentarily. I thought it would be helpful to proceed with the receipt of testimony so that by the time we have a full complement and get to our questions there will be sufficient Members here to engage our panel.

Our first participant this afternoon is Mr. Joseph Berardino, Chief Executive Officer, Arthur Andersen.

Before I recognize you for your comments, Mr. Berardino, I just want to, by way of personal acknowledgment, express my appreciation to you in the manner in which you have responded to the subcommittees in this difficult manner.

I wish all officials who had similar participation in the issues before the subcommittees had exercised your judgment and expressed your willingness to cooperate with the subcommittees in seeking a commonly beneficial resolution to this matter. So I do appreciate your openness and your willingness to be here today.

Thank you, sir.

STATEMENT OF JOSEPH F. BERARDINO, CHIEF EXECUTIVE OFFICER, ARTHUR ANDERSEN, LLP

Mr. BERARDINO. That is very kind of you, Mr. Chairman.

Good afternoon. Thank you for inviting me to appear before you today. I am here because faith in our firm and the integrity of the capital market system has been shaken. What happened at Enron is a tragedy on many levels. We are very aware of the impact this has had on investors and the pain this business failure has caused for Enron's employees and others.

Many questions need to be answered, some involve accounting and auditing. I will do my best today to address these.

I ask you to keep in mind that the auditing and accounting issues are very complex and are part of a bigger picture. None of us yet know all the facts. Today's hearing is an important step in enlightening all of us.

If there is one thing you can take away from my testimony, I hope it is this: Andersen will not hide from its responsibilities. That is why I am here today.

The public's confidence is of paramount importance. If my firm has made errors in judgment, we will acknowledge them. We will make the changes needed to restore confidence.

In my written testimony, I have addressed two issues that go to the heart of concerns about our role as Enron's auditor: did we do our job, did we act with integrity?

To aid the subcommittees in their inquiry, I have provided detailed answers to these questions in my written statement and I would like to touch on a few of the key points.

On the accounting issues, Enron has said it will restate its financial statements back to 1997 as a result of issues with two special purpose entities or SPEs. These are sophisticated financing vehicles used by many companies. They are well known to the investment community.

On the larger of these which was responsible for 80 percent of the SPE-related restatement, it appears important information was not revealed to our team. We have notified the audit committee of possible illegal acts within the company.

On the smaller of the SPEs responsible for 20 percent, we now believe, based on a second look, that our team has made an error in judgment. An honest error, but an error nonetheless. But I do believe we did a professional job overall and that this error did not cause Enron's collapse.

There have been questions about the sufficiency of Enron's disclosures. It is true that Enron did not disclose every transaction or every contingency. It was not required to. Accounting rules also do not require a company to disclose losses, such as the sudden rapid decline we witnesses in Enron's stock price and credit ratings.

Finally, let me spend a minute on fees. We were paid $59 million by Enron, including $25 million for our audit. There is a perception that the remaining $27 million was for traditional management consulting work such as installation of computer systems. In fact, the bulk of that $27 million was for audit-related work, tax work and work that could only be done by auditors; $13 million was for consulting work done by Arthur Andersen.

Some may assert that even $13 million in consulting work is too much, that it weakens the backbone of the auditor. There is a fundamental issue here. Whether it is consulting work or audit work, the reality is that auditors are paid by their clients.

For a system to work, you and the investing public must have confidence that the fees we are paid, regardless of the nature of our work, will not weaken our resolve to do what is right and in the best interests of investors. I do not believe the fees we received compromised our independence. Some will disagree and I have to deal with the reality of that perception.

I am very aware that our firm must restore the public's trust. I do not have all the answers today, but I can assure you we are carefully assessing this issue and will take the steps necessary to reassure you and the public that our backbone is firm and our judgment clear.

Andersen will have to change to restore the public's interest and confidence and we are working hard to identify the changes we need to make. The accounting profession will also have to reform itself. Our system of regulation and discipline has to be improved and others will have to do things differently as well: companies, boards, audit committees, analysts, investment bankers, credit analysts among others.

I believe we can work together to give investors a more meaningful, relevant and timely information. My firm, and I personally as CEO, will do our part.

Thank you, Mr. Chairman.

[The prepared statement of Joseph F. Berardino can be found on page 113 in the appendix.]

Chairman BAKER. Thank you very much.

Our next participant is Mr. Charles Hill, Director of Research, Thomas Edison Financial/First Call.

Welcome, Mr. Hill.

Mr. HILL. Thank you.

Chairman BAKER. And grab that microphone and yank it around toward you there. It needs to be pretty close.

STATEMENT OF CHARLES L. HILL, DIRECTOR OF RESEARCH, THOMSON FINANCIAL/FIRST CALL

Mr. HILL. Chairman Oxley, Chairman Baker, Chairwoman Kelly, Ranking Members LaFalce, Kanjorski and Guttierez, and Members of the subcommittees, I welcome the opportunity to again testify in front of the House Financial Services Committee. I believe these subcommittees have been addressing substantive issues that are important not only to the future health of the investment community, but important to the general public's perception of and confidence in the overall capitalist system.

The excesses associated with Enron that led to its bankruptcy are more far-reaching than just their impact on Enron. There is plenty of blame to go around in the mistakes made in the Enron situation. I am here today to focus on the role of the broker analysts in the debacle.

In my previous testimony before these subcommittees, I did not tread lightly on what I thought were some serious problems in analyst behavior that needed to be remedied. I am here this afternoon, however, to say that analysts to some degree were more victims rather than culprits in the Enron situation. Not that they were without blame, particularly in the late stages of the Enron collapse, but they were not the underlying cause of the excessive rise in Enron's stock that later proved to be irrational.

The performance of the analysts should be judged on two fronts. The first is their analysis of Enron's fundamentals, particularly in regard to earnings. The second is their valuation assessment and recommendations of Enron stock.

The thing that stands out most visibly about the analysts' analyses of Enron is over the 3 years up to October 2001, their estimates at the beginning of each year for that year had minimal changes. The few changes that did occur were always upward and usually followed the guidance given by the company when they reported quarterly earnings.

The narrowness of the spread of estimates among analysts was remarkable, especially for an energy company. The coefficient of variance for Enron estimates was consistently below the average for the S&P 500 during the same period.

This pattern is highly suggestive that the analysts were being spoon fed as to what Enron expected earnings to be. The analysts might have been willing to accept company guidance, be it overt or inferred, as long as the company kept meeting expectations each quarter. Since at least the beginning of 1998, Enron has met or exceeded analysts' estimates every quarter.

One reason that analysts may have been more willing than normal to accept company guidance for Enron was that it was becoming increasingly difficult to understand how Enron was achieving its revenue growth and profitability. Extensive use of derivatives, particularly when the company is using mark-to-market accounting, is extremely difficult in the best of situations.

We now know that a big additional reason for the difficulties in analyzing Enron's financials was that there were significant parts of Enron's business that were hidden from the balance sheet.

Often, the way out for analysts when faced with difficult-to-analyze situations like Enron is to drop coverage. Why take the risk when there are plenty of companies that are transparent enough to do meaningful analysis with confidence?

The problem with dropping Enron was that it had become the giant in the industry. If you were an analyst covering that industry, you essentially had to cover Enron. That was further reinforced if your firm was one of Enron's investment bankers or investment banker wannabees.

The real problem, though, was having sufficient information about the off balance sheet items. Whether the accounting for each of these items was within FASB rules or not is not yet clear, although the announced restatement of prior periods earnings is a strong signal that at least not all was kosher.

But what is clear is that Enron was not providing what could even be considered minimum transparency in its financials and that the analysts did not have all the tools necessary to make a reasonable analysis.

In evaluating the analysts' performance on recommending Enron stock, one first has to understand how the brokerage community's recommendation system really works.

As I have testified before to these subcommittees, the investor needs a two-level decoder. The first level of the decoder gets all the brokers on a common recommendation scale. The most common scale is a five-tiered one, where the top category is a "strong buy"; the second is a "buy"; the third is "hold"; fourth, "sell"; fifth, "strong sell." Most brokers have a five-tiered scale, some have a four-tierd one, and a few have a three-tierd scale.

In addition, many have very different terminology. The term "buy" may be the term used for the top category at some brokers, or for the second-best category at many brokers, or, in at least one case, for the middle category. There are more than a dozen different terms used for each of the top three categories and almost as many for the bottom two.

Unfortunately, getting all the firms on a common scale is not the end of the decoding. Analysts are overly biased on the positive side in their recommendations. The typical distribution is about 33 percent of all recommendations are in the top or "strong buy" category, about 33 percent in the second or "buy" category, about 33 percent in the middle or "hold" category, and only about 1 percent in the remaining "sell" and "strong sell" categories combined.

If the recommendations are put in numeric terms where 1 is a "strong buy"—or whatever the broker's term is for that top category—2 a "buy," and so forth, using this numerical scale consensus recommendations can be calculated for each company.

Most of the time, the average consensus recommendation for either the companies in the S&P 500, or for the roughly 5,000 companies that analysts cover, is a 2.1. Occasionally, the average may be a 2.0 or 2.2.

Therefore, the second level of the decoder would move the recommendations into three more meaningful categories—those in the 1 or "strong buy" category would really be saying "buy," at least in relative terms. Those in the 2 or "buy" category would really be saying they were neutral on the stock, and those in the 3 or "hold," the 4 or "sell," and the 5 or "strong sell" categories all would be saying sell the stock.

For Enron, the consensus recommendation, as shown on a graph that is in the handout, was about a 1.5 from May 2000 until the end of September 2001. Even if we had our decoder to compensate for analyst optimism, it is clear that the analysts covering Enron were very positive with their recommendations.

But, during that same period, the analysts had similar or higher consensus recommendations on competitors like Calpine and Dynegy. While a consensus recommendation for Enron was much better than the average for S&P 500 companies, their enthusiasm was not limited to Enron.

In early October 2001, the consensus recommendation spiked up from a 1.5 to a 1.3 as several analysts raised their recommendations ahead of Enron's reporting its third quarter earnings on 16 October.

On the day of the earnings announcement, one analyst raised their recommendation, pushing the consensus to a remarkable 1.2. But as the Enron story began to unravel over the next few days, the recommendation downgrades exploded, plus six of the 17 analysts dropped coverage.

In these kinds of situations, it is easy to point a finger at the analysts for mistakes made. In my prior testimony, and in other forums, I have taken the analysts to task for not performing to an acceptable standard in certain situations. While the analysts are certainly not without blame on Enron, they are not the real culprits in this situation.

I am not an expert in doing the actual accounting at a company, or in auditing a company's accounting, but having been an analyst for 22 years, as well as closely observing analysts' behavior at First Call for the last 10, I can say without reservation that this was a situation where either the company or its auditors or both were at fault in not providing investors, especially including the analysts, with the tools necessary to understand Enron's business.

Whether the letter of the accounting rules were met or not, it is patently obvious that the spirit of the rules were violated in that Enron's financial statements did not fairly convey enough information for investors to reasonably analyze the company's operations.

In that climate, it is hard to be too critical of the analysts' optimism. Enron had a long history of showing consistent and substantive earnings growth. If it had been up to me, if I was in that situation, I would have dropped coverage long before October 2001. The financial reports and details of operations had become more and more inscrutable well before then. But, as I mentioned earlier, most, if not all, analysts did not have that option. All things considered, they probably did as well as could be expected until October 2001, although in hindsight it is easy to say that they could have at least tempered their bullish recommendations to some degree.

However, once the issues of the off balance sheet items became an unexplained issue on the 16 October 2001 conference call on third quarter results, it does seem that the analysts could have moved quicker to either suspend their recommendation or dramatically drop the level of their recommendation. The unexplained $1.2 billion balance sheet writedown was not a caution flag, it was a red flag.

But Enron is not the situation on which to challenge analysts' performance. There are far more significant situations where analysts' conflicts and performance are at issue.

The lessons to be learned here is how to ensure that companies and their auditors can be relied on to openly provide the necessary tools for investors to meaningfully analyze the company's business.

Thank you.

[The prepared statement of Charles L. Hill can be found on page 125 in the appendix.]

Chairman BAKER. Thank you very much, Mr. Hill.

Our final participant is Mr. Richard Trumka, Secretary-Treasurer, AFL-CIO.

Welcome, sir.

STATEMENT OF RICHARD L. TRUMKA, SECRETARY-TREASURER, AFL-CIO

Mr. TRUMKA. Thank you, Mr. Chairman.

Good afternoon, Chairman Baker and Chairwoman Kelly and Ranking Members of the committee and subcommittees. My name is Richard Trumka and I am Secretary-Treasurer of the AFL-CIO.

On behalf of the AFL-CIO and our 13 million members, I would like to commend these subcommittees, and Chairman Baker in particular, for his leadership in calling this hearing and his foresight in looking at the issue of analyst independence last summer.

I am here today first and foremost to make clear who the victims were in the Enron catastrophe. Let us start with those hurt worst by the conduct of the board and officers at Enron. More than 12,000 Enron employees participated in Enron's 401K plan. On October 17th, the same day that the SEC announced it was investigating Enron, the company implemented a plan to switch 401K administrators, knowing that their decision would freeze employees' accounts and that freezing took three times longer than is normal in these situations.

Meanwhile, Enron executives continued to sell their stock, continuing a pattern of inside sales that netted a handful of executives over a billion dollars.

Now, 5,000 of these same employees have been laid off and Enron has tried to extract waivers of liability from these laid off workers in exchange for their severance. Many of the 1,000 members of the International Brotherhood of Electrical Workers at Enron's subsidiary, Portland Gas and Electric, suffered catastrophic losses. Members like Roy Rinard, who watched helplessly, his accounts frozen, as 22 years of retirement savings dwindled from $472,000 to less then $3,500. Or Tim Ramsey, a 33-year veteran, who lost $995,000 from his retirement account.

Most pension funds and institutional investors held some Enron stocks or bonds. The AFL-CIO's pension fund held Enron bonds and watched them lose 75 percent of their value.

Much of this money was going to fund pension benefits for working families, for the public employees we are counting on to protect us during this period of national crisis, for the pensions of the ironworkers, for instance, now clearing the rubble at Ground Zero.

All of us who have S&P 500 index funds in our 401Ks or mutual fund portfolios lost money in Enron, probably about one-half a percent of the total assets in those type of funds.

Much of what happened at Enron, as has been stated earlier, remains murky, but from what we know, this is a story first and foremost about conflicts of interest, about a long list of people and institutions that were supposed to look out for workers' retirement savings and instead looked out for themselves.

Now, what do I mean by a conflict of interest?

Let us begin with the first line of defense, when management goes sour. That is the board of directors. At Enron, most of the board was independent of the company, according to the SEC filings. But look another layer deeper and you find some of these "independent" directors were actually investing in Enron-sponsored limited partnerships.

Then there were the auditors. Arthur Andersen, who testified earlier, was the company's long-time auditor, but management was funneling lucrative consulting contracts to Andersen, as was stated, $59 million in fees.

Then we come to the Wall Street analysts. Practically every Wall Street firm and post-Glass-Steagall commercial bank had an interest in courting Enron. Out of the 13 Wall Street analysts that covered Enron in October, according to *Forbes Magazine*, 11 were bullish, while the majority of independent investment newsletters were bearish.

Finally, there were money managers. Alliance Capital, a major money manager for pension funds, shared a director with Enron. Alliance kept buying Enron shares this summer and this fall, so many shares that Alliance ended up as Enron's largest holder. Enron was a company that talked about a future of transparent markets, but whose CFO openly bragged that, and I quote: "We don't want anyone to know what's on those books. We don't want to tell anyone where we're making money."

Enron's mantra was deregulation and privatization and now Enron itself is a demonstration of why workers need both defined benefit pension plans and a Social Security system safe from the conflicts of interest that appear rampant in the capital markets.

In response to these causes of the Enron fiasco, the AFL-CIO is today submitting two rulemaking petitions to the SEC. These proposals have the support of the Council of Institutional Investors whose members have nearly $2 trillion in assets. We ask in these petitions that the Commission act to ensure independent directors are really independent.

In the accounting area, our proposals are aimed to keep auditors independent and include a prohibition on accountants reviewing transaction they themselves structured, direct audit committee approval of any audit consulting arrangement, as well as the audit engagement itself.

These proposals follow efforts in early November by the AFL-CIO and the Amalgamated Bank, a large index manager of union pension fund assets, to reach out to Enron's outside directors.

Mr. Chairman, we did that immediately upon the announcement of their losses. We wrote to those independent directors and cc'd all the boards of directors.

We asked for more independent directors and more extensive disclosure immediately, but we never received a substantive reply. In fact, the independent directors never wrote back. The company itself wrote back saying thanks for your letter.

In the wake of the Enron bankruptcy, the Amalgamated Bank took the last step remaining open to investors, bringing suit last week in Federal court on behalf of Enron shareholders.

Our funds will fight as hard as we can to get our money back, but the truth is, only strong Government action, led by the SEC and the Department of Labor, and the support of these subcommittees, and Congress can ensure that investors are not victimized again in this way.

Mr. Chairman, I and the AFL-CIO look forward to working with you and these subcommittees in the coming days on these very, very important tasks.

Thank you very much.

[The prepared statement of Richard L. Trumka can be found on page 135 in the appendix.]

Chairman BAKER. Thank you, sir, for your good testimony.

I just want to make a brief comment before asking my first question and that is I can assure all of you that every Member of the subcommittees, regardless of the philosophic perspective, finds no comfort in the fact that thousands of people are unemployed, their retirement benefits gone, their 401Ks vanished. Regardless of the circumstance and how it came to be, this is a most unfortunate event over which there is no happiness anywhere.

From here forward is the issue. How do we preclude it from reoccurring? In order to do that, we must understand how this came to be.

I happen to believe that within the capital markets most people, as in politics, get up every morning and try to do the best they can to do the job they are assigned to do. It appears to me without knowing all the facts yet today that there were a few individuals engaged at very high levels within the corporate structure that did not provide the disclosures that are required perhaps by law, but certainly by good moral judgment, either to the accountants, to the analyst community, to the journalists or to anybody else and that it appears from the disposition of assets over the time preceding the bankruptcy filing that their profiteering coincided with the lockout of the employees' access to their own funds. If these facts turn out to be the case, this is a travesty.

Now, could a change in our structural law have precluded it?

I do not know, but that is what we are about.

To that end, Mr. Hill, you were making the comment that some analysts, because of enthusiasm and the pressure of prominence, take an LTCM, they were making hand over fist great sums of money, very bright people, never had a back-to-back trading loss, banks were throwing money at them, investors were throwing money at them. It was almost as if you had a question about their methodology, there must be something wrong with you, because you did not understand the business model.

It would seem from what I know now that to a great extent the Enron story is not too dissimilar. The principal difference, however, is that in the closing days of LTCM the principals believed in their own philosophy, they were putting money in. In this case, the principals were taking money out. That is a tremendous difference of great public policy consequence which troubles me greatly.

But to your point about the independence of the analysts, as of 2:40 today, December 12th, checking by Yahoo! finance page, we have 13 analysts listed covering Enron, we have two "strong buys," we have one "buy," we have eight "holds," one "sell" and one "strong sell."

How do you respond to that today? Is there something of value that these subcommittees are missing? How could anybody look at these events and come to the conclusion that this is a "strong buy" opportunity?

Mr. HILL. I have a problem with the "strong buys." Again, if you have your decoder, you know that the holds are really meaning sell, so the majority of them are saying sell now to those that—as we said last time——

Chairman BAKER. But given these circumstances and the public discussion and the pending investigations and all the other matters that are out there, why not for the first time break the code and say, for goodness sakes, to the American public, "sell this stuff"?

Mr. HILL. I agree.

Chairman BAKER. If you can.

Mr. HILL. I agree. But this is not new, you know, this whole thing. I mean, you brought up Long-Term Capital Management, and I have in my notes here that when we got into the questions to mention it, so you beat me to it on that one.

Not long after I got in the business, there was a company that I was covering called Memorex. It was selling back then at over 100 times earnings. I do not remember the exact date, but it was some time in the early 1970s. Larry Spitters, the Chairman of Memorex, came to Boston to explain to the financial community their lease accounting and we have talked this morning about the similarities between off-balance lease accounting and off-balance derivatives, but same idea, there was no transparency. Part way through the presentation—he was using flip charts in those days—he got to the point where he threw up his hands and said, "I can't explain it, I can't answer your questions."

I think a lot of us either dropped coverage or went to "sell" on Memorex.

Chairman BAKER. And let me ask on that point, what is the significance in the market if someone drops coverage? What is the decoding of that activity?

Mr. HILL. Well, assuming it is not because an analyst is leaving or whatever, it is interpreted as there is a problem here.

Chairman BAKER. So what we also need——

Mr. HILL. And to me, that was the easy out, would be at that point certainly once that restatement——

Chairman BAKER. Well, are all these actions, the drop coverage, the hold comment, is this the prominence problem? Is that we do not want to downgrade someone because of the consequences of that to the firm?

Mr. HILL. Absolutely. And the conflicts are threefold. First is the obvious one that most everyone is aware of, is the investment banking problem. And until we change the compensation situation for the analyst, which means we have got to find some way to go back, for the firms to get paid for research.

When I was an analyst, my bonus was incentivized to do good fundamental research, but that was when the commissions were high enough that the firm was getting paid for research.

Chairman BAKER. Well, let me interrupt you, if I may. I want to get one question in to Mr. Berardino. My time is expiring. If we have a chance for a second round, I really want to come back.

Mr. Berardino, I think what troubles me, I am standing on the presumption that the in-the-field auditor has no direct benefit from a lucrative contract with the larger firm and that in my view of the operative auditor function, he has a contractual relationship with the company, certainly he wants the company to be profitable. But, in the case of Arthur Andersen, whose gross income per year is in the millions and millions and millions of dollars, the relationship with Enron I do not view as being a significant factor in the judgment of an in-the-field auditor looking at the books.

What troubles me, I believe, is in this case it appears that individuals who were responsible for disclosing the books or the activities to the in-the-field personnel in most cases may have not been providing you with the appropriate information or insight.

If that is the case, what do we do about changing the system to correct for that problem? How do you know the data that the auditor is looking at is the real set of books?

Mr. BERARDINO. That is a very complicated question and a very fundamental question, Mr. Chairman.

As you probably know, Enron was an extremely complex company. They had over 20,000 employees. In fact, I recently found out they had 600 CPAs. So they spent a lot of time trying to keep their books. They had 3,000 subsidiaries all over the world.

And as auditors, you know, we do not live there. We do test checks, we do statistical samples to inspect the transactions as the company presents us the information. And the company does have a legal obligation to present us information that we require.

Chairman BAKER. Let me do this, because I do not want to run inordinately time since I am trying to keep other folks on the clock.

To put a simple point to it, must we make the consequences of failing to properly disclose, to provide transparency so severe that it ain't worth the risk?

Mr. BERARDINO. I think that would be very helpful. It will add, though, and I made this comment in my testimony, it is an illegal act to withhold information from an auditor.

Chairman BAKER. Well, I understand that and, believe me, in my experience in Louisiana political life, having something be illegal is not necessarily a prohibition. I think we need to have something a little more strenuous than just the fact that you get written up in the books. And I do not know what that is in this case, but it ought to be pretty significant.

Mr. BERARDINO. Well, that is worth investigating, sir.

Chairman BAKER. Mr. Kanjorski.

Mr. KANJORSKI. Yes. I was just thinking to myself as we heard the dialogue between yourself and the Chairman, if this were 1942, Nazi Germany, and people were talking about the death camps, it seems like a tremendous establishment of plausible deniability. If you do not know, you do not have to answer and you are all home free, other than Mr. Trumka.

I do not quite sense——

I will give you a chance, Mr. Hill, are you not outraged? Are you not outraged? Do you two gentlemen just not think this is horrendous, what happened to the shareholders, what happened to the investors, what happened to the employees?

I mean, do we not have to say something to the system?

If this system is so broken that the seventh largest corporation in the United States can play these silly games and everybody comes and just says, "Well, I did not know," or "we did not understand," or "we have these complications," are we any different than any other nations in the world that are having problems with transparency?

Mr. HILL. I think when you get into this derivatives issue, we are in a whole new world and I do not know what the answer is. I do not know whether we need another class of security or whatever for people whose business is essentially driven by derivatives. I do not know what the answer is, but I agree with you, that we have to have some kind of different system because the normal fundamental analysis really does not apply to these kind of companies. I just do not know how you could really do it.

Mr. KANJORSKI. Let me ask something. You know, I thought corporate statements were required to give an understanding of what is going on and these special purpose entities, I have to confess, I know very little about them as to how they operate or derivatives. We have had hearings on it, everybody has come in here and said they are so important, they balance and hedge the market and do not worry about it and they get into the trillions and trillions, it is all OK. But why not just disclose it?

If there is a special purpose entity, why should it not be disclosed? Unless it is constructed, and I think you gave an indication to me yesterday when we talked about this, it is particularly constructed so that it does not hurt the disclosure in the company?

So here you are.

Mr. BERARDINO. Well, Congressman, you are obviously getting right to the heart of the matter, which I appreciate. There is no great answer to your question right now. These special purpose entities have been in business for years.

Mr. KANJORSKI. And I understand that. But, by God, did not the accounting profession say, hey, by having these things, we are not really giving transparency here and disclosure?

Mr. BERARDINO. Well, you know, there have been great debates and there is a great irony, unfortunately, in all of this. There is been a great debate within the accounting profession as to what goes on off balance sheet and there are two schools of thought, if I could just do a little accounting 101, maybe.

One school of thought is if you lose control, if you are an Enron and somebody else has control over these SPEs, simplistically defined as more than a 51 percent vote, these transactions go off your balance sheet, assuming these other tests, 3 percent, and so forth, are passed.

Mr. KANJORSKI. In spite of the fact that by doing that you lose transparency of what is really occurring in the company?

Mr. BERARDINO. If you will just bear with me for a second, Congressman.

The second school of thought, which is the school of thought Andersen has always been in, is that one ought to look at risks and rewards. So even though these transactions went off balance sheet, Enron could maintain 97 percent of the risks and rewards.

Mr. KANJORSKI. And we are arguing that in the accounting.

Mr. BERARDINO. We lost that debate within the accounting profession.

Mr. KANJORSKI. And it has been going on for years?

Mr. BERARDINO. Things go off balance sheet, it has been going on for years, people know about it.

Mr. KANJORSKI. Ten years, I think you told me yesterday. And as a result of that not coming to some conclusion, we are now faced with somebody lost $80 billion, I think a hell of a lot of somebodies who Mr. Trumka was talking about that are important, and innocent investors and a lot of bad guys who were inside traders made billions while this thing was going to hell in a basket.

And now you are putting Congress as representatives of the people in the position that if we have had enough and we are fed up, you are telling us the Government better come in and regulate your profession, the corporations, disclosure, the business interests of this country seem to me to make the most compelling case in the world of we need heavy regulation.

And that sort of offends me, because I felt that we could rely on the decency, the honesty and the professionalism that the professions aiding these corporations and the corporate executives would be using the highest moral and ethical standards and I just—somebody was in the hen-house. And I think it is up to you guys to tell us who that was. And then let us find out—are we going to slap them on the wrist with a $1,000 fine and put them in jail for a year so they can take their billion dollars in jail and speculate and make two or three billion? Or maybe set up some more special purpose entities out there?

Mr. BERARDINO. Congressman, I am here voluntarily because I want to be part of the solution. The points you raise are valid. I understand them. I do not feel good about where we all are. But I think the Chairman set the right tone here by saying we have to learn from this. We are prepared to shed whatever facts we can on the accounting and auditing side of this because I think we can get it better.

Mr. KANJORSKI. And I appreciate that and I want to tell you I appreciate you having the—I am trying to use the right word here—nerve to be here today. I think my patience at this point is fully tested. I applaud the petitions for regulations filed by the

AFL-CIO. I think America is going to go back to a lot of instances of re-regulation where it will be counterproductive to the market if we do that, but it is going to happen because people are not going to take it, $80 billion, what that means to America, where we could go with it, and to allow——

I do not know whether this is a Ponzi scheme or what the hell it is, but when the best analysts from the best investment banking in the country are, at a time when everything is gone, still recommending heavily that people buy and put their pensions, their savings—I think we have to do something and I think that is very unfortunate, that the business community here is forcing the Congress on behalf of representing the people to get involved with the accounting profession on conflicts of interest, with the analysts and the way they get paid. That should not even be an issue, as you indicated.

We have so many compromises out there it is amazing that anything is working in this system.

I know I have had my time. Thank you, Mr. Chairman.

Chairman BAKER. Thank you, Mr. Kanjorski.

Mrs. Kelly.

Mrs. KELLY. Thanks, Mr. Chairman.

First of all, I want to say thank you, Mr. Trumka, because you represent a lot of people, not only in AFL-CIO, but by your words today you represent a lot of other people out there in the United States who also got involved, not because they were in the union, but because they trusted. And I think it is important that your testimony was heard.

I want to turn to you, Mr. Berardino. I want to follow up on the mark-to-market situation.

Do you think that the mark-to-market accounting system has yielded a situation where we have misleading information being provided to investors?

I was not real happy with what I heard this morning. I would like to hear it from your standpoint.

Mr. BERARDINO. I think it is an extremely important issue and I will hide behind theory to start and then I will get real life for you, if you do not mind.

Theoretically, it is a very appropriate way to account for transactions. You get a more current valuation. I think what you heard this morning is some of the difficulties in the methodologies that go into evaluating something. It is easy to evaluate something that might be due tomorrow than something due 30 years from now.

We share your concern, and by "we" I mean the accounting profession. We issued a statement, the five CEOs of the major firms, just 1 week ago, where we called to the SEC and said we need more disclosure so people know what is going on this mark-to-market stuff. It is hard, it is complex and there are different interpretations as to how to get there.

We think it is a real issue, we think it is an important issue. It is on the agenda. We have put it on the SEC's agenda and we are fully prepared as a profession to try to get some guidance out before this year end as companies are ending their years December 31 so that there will be more clarity this year than there might have been last year.

Mrs. KELLY. Well, bear with me for a minute. How would you really do that?

What are we talking about? How can you get a type of transparency in that type of transaction so that people understand why decisions were made to do the projections that they have done and that they can evaluate the sensibility of those projections?

Mr. BERARDINO. This is very difficult, very difficult, because these are highly sophisticated transactions that require a number of estimates and in some cases where there are not active markets day to day that one can refer to. So it is not going to be easy. But I do think it is an area worth exploring and we are fully prepared to help in real time to come up with some more clarity.

Mrs. KELLY. Did you ever ask the SEC for guidance on the Enron audits?

Mr. BERARDINO. I do not remember.

Mrs. KELLY. Would there be somebody here who could advise you about that?

Mr. BERARDINO. I was not directly involved. Perhaps. If you do not mind, let me just check with my friends here.

Mrs. KELLY. Feel free.

Mr. BERARDINO. Thank you.

[Pause.]

Mr. BERARDINO. The answer is yes. On mark-to-market, we were heavily involved with Enron back in the early 1990s and working through with the SEC how they might do mark-to-market on their portfolio. Very open conversations to try to get to the best answer. And there have been consultations on many different items, not just mark-to-market, since then.

Mrs. KELLY. Did you find them forthcoming? Maybe you want to consult on that one, too.

Mr. BERARDINO. Did I find who forthcoming?

Mrs. KELLY. The SEC. Were they helpful? Did they have guidelines? Were they able to give you what you needed in order to do something that is complicated and bringing the mark-to-market——

Mr. BERARDINO. Oh, again, these are hard issues that you need a lot of smart people in a room to try to figure out what is right, and in the early 1990s this was new, and the SEC was very helpful in that conversation.

Mrs. KELLY. Do you think the kind of environment exists at the SEC to encourage public companies to seek their advice?

Mr. BERARDINO. Well, I think that that has varied over the years, quite frankly, and in the past, there has been unfortunately more of an adversarial relationship and less of a let us work this all out together relationship, which I think the current chairman is trying to change and which, frankly, we welcome because it is—you know, many people think accounting is a science, where one number, namely earnings per share, is the number and it is such a precise number that it could not be two pennies higher or two pennies lower.

And I come from the school that says it really is much of an art, that a company like Enron, $500 million transactions going through Enron online, highly complex organizations where there is no one number, and one of the challenges we have and one of the reasons I think we have the opportunity for reform here is the accounting model has traditionally been historic. You know, we told you what happened 90 days ago or a year ago. Most analysts, most investors are really interested in predicting the future. And we do not have an ability in our present financial reporting model, mark-to-market is an attempt to get there, to give investors more current information on a more timely, real time basis.

I think this is a time for change and I think some of the stresses in the system we have seen at Enron, not to understate them, will provoke all of us to be thinking outside the box. So I think your questions are incredible. And I will tell you we are prepared to be part of the solution.

Mrs. KELLY. Thank you very much. I appreciate your being here.

Chairman BAKER. Thank you, Mrs. Kelly.

Mr. LaFalce.

Mr. LAFALCE. Thank you very much, Mr. Chairman. And I thank all the panelists for coming here, especially you, Mr. Berardino, for stepping up to the plate. It is not an easy task to be the number one person at the accounting firm that is being looked at right now, but I commend you for the integrity of your comments and the approach you are taking.

Let me just ask a few questions. First of all, any of you, what percentage of the CEOs, CFOs, and members of audit committees have their compensation in large part based upon the market valuation of their stock?

Mr. BERARDINO. Quite a few.

Mr. LAFALCE. A very high percentage?

Mr. BERARDINO. Yes, sir.

Mr. LAFALCE. I would think that that creates a tremendous incentive on their part, both the officers and the directors, especially the audit committee, to have a good market valuation and therefore to report good earnings. Is that correct?

Mr. BERARDINO. Well, Congressman, this is a paradox, is it not? The shareholders——

Mr. LAFALCE. Well, it is a fact, I think.

Mr. BERARDINO. Well, but——

Mr. LAFALCE. There may be a subsequent paradox that is coming, but——

Mr. BERARDINO. Well, it is a fact to some, but to others as shareholders, do you not want your CEO to help the stock price go up? I hope you do not want him to have it go down.

Mr. LAFALCE. So long as it is real rather than imaginary.

Mr. BERARDINO. Of course.

Mr. LAFALCE. And that is the difficulty. So my point is simply that there really is a need, it seems to me, for improvement in the system and you have called for improvements. The question is where do we start?

And it seems to me we have to start first with the issue of corporate governance. And what do we—independence?

I do not think you could bring it into the management itself, but what do we do to bring independence into the audit committee of the board? Or can there be some audit committee outside of the board? But some committee that does not have a vested interest in doctoring earnings because of the market valuation that will determine what their compensation is.

I mean, it is an outrageous conflict. And then my first question is how do we deal with it?

Let me ask you to come back to that, but I do think that is a very threshold question.

The second question or point is you made the statement, Mr. Berardino, that it is a violation of the law to withhold information from the accountant auditor, correct?

Mr. BERARDINO. Yes.

Mr. LAFALCE. Is that a criminal or a civil violation?

Mr. BERARDINO. I am not sure. Probably criminal.

Mr. LAFALCE. Well, in your prepared testimony, you said with respect to the one SPE, the one that accounted for approximately 80 percent, the one with the far larger impact, our audit team was not provided critical information.

Now, applying the logic and syllogisms that I learned in my Jesuit days, it would seem to me that you are therefore saying and that therefore Enron violated the law in their relationship with you.

Mr. BERARDINO. Congressman, I also have a Jesuit education.

Mr. LAFALCE. That is why I am referring to it.

Mr. BERARDINO. I am also taught to believe that we need to have all the facts. And if I could shed some——

Mr. LAFALCE. But you did say it would appear.

Mr. BERARDINO. Yes. I mean, to shed some color commentary, what had happened was that the requirement for 3 percent equity from an outsider was met in one end of the Enron house and in a completely distinct other part of the house a compensating balance was offered to that same investor and when you look at the two together it flunks the test.

Now, we do not know if that was willful or not, but once we had all the facts and the company had all the facts, we had to restate the financial statements.

Mr. LAFALCE. OK. Mr. Hill, because my time is about to expire, most companies who are doing an analysis of stocks, the strong buy, buy, hold, accumulate, sell or what have you, it is my understanding that in the year 2000, only 1 percent of all the recommendations made by all the research firms were sell recommendations and that if you go back a half-a-dozen years or so, it was more like 6 percent. That is a considerable decline.

I have recommended to the SEC and others that every recommendation be accompanied with at least one thing and that is the number of recommendations a firm makes, if they make 200, and a statement, "we are recommending a strong buy" and 150 of our recommendations are "strong buys," 25 are "buys," 20 are "hold," and 5 are "sells," or whatever it might be.

I think that would be a good idea. I would like to know your thoughts on that.

Second, it took Mr. Baker two seconds to go to Yahoo! finance and tell you that there are approximately 20 firms analyzing the stock right now, of which two are "strong buys," and one is a "buy" or what-have-you.

What about if we required that any written recommendation of an analyst's firm give you the number of firms covering it, at least as of close of business yesterday, according to some criteria, whether it is an SEC or First Call or what have you, and if they are issuing a strong buy, it would be interesting to know that there are 12 others that are recommending sells and we would like to know who they are.

What are your thoughts on that?

Chairman BAKER. Mr. LaFalce, let me suggest this, if I may. I am trying to help Members get on the record on this issue, particularly Mr. Bentsen and Ms. Jackson-Lee, before the recess.

We have six votes and I am afraid we are going to be on the floor for about an hour and I feel very badly about having kept our witnesses here all morning and then keeping them here another hour into the evening. And I understand perhaps one has another appearance which cannot be missed anyway at 4:00.

With the subcommittees' understanding, Mr. Shays has waived his time.

Mr. SHAYS. Well, just one quick question.

Chairman BAKER. Yes, Mr. Shays.

Mr. SHAYS. I want to thank our witnesses. I understand that we are going to have more hearings, so it makes sense to close this hearing, but I just want to say to you, Mr. Trumka, that I believe that you are going to take your retirement funds and not invest them all in Treasury bills, thank God, and I just have to say I hope with Social Security funds that we also do the same.

Chairman BAKER. Thank you, Mr. Shays.

I would like to suggest to the subcommittees 2 minutes to Mr. Bentsen, 2 minutes to Ms. Jackson-Lee, call the meeting to a conclusion and let our witnesses go, but with this caveat, we have to have participation in future hearings. This matter is too complex to have covered it even in a day. This has been just a very light introduction to the subject.

Mr. Bentsen.

Mr. BENTSEN. Thank you, Mr. Chairman. I appreciate the panel being here and I have comments with Mr. Hill and Mr. Trumka, but I am going to have to do those another time.

Mr. Berardino, in your testimony, there are two things that stick out. One, when you talk about the SPEs and particularly the Jedi and Chewco SPE, you talk about no prohibition against company employees being involved as investors.

That seems to me to be pretty closely related parties and if the law does not address that now, it sure as hell ought to address that in the future.

And, second of all, it would appear to me on the issue of the international financial institution that—and you may not want to answer this—that looks a lot like a pretty contrived deal to create an off balance sheet financing vehicle that really was not one. And if they did not disclose that you as their auditor, then I think they have some real problems on their hands and I think that may be a crux. And you may not want to address that.

The other thing which I think is a serious issue is on page 6, where you talk about some people say we should have required the company to make more disclosures about contingencies such as accelerated debt payments, which did in part bring the company down, associated with the possible decline in the value of Enron's stock or changes in the company's credit rating. They ran some very high octane structured deals that were—and the credit consideration, the credit covenants were critical to that company going because they were extremely highly leveraged.

How that could not be a material item for disclosure, I do not know and, again, you may not want to answer it. I assume this issue will come up in other forums, but——

Mr. BERARDINO. Well, I will partially answer it and then there is some disclosure. I will not say it is in neon lights, but there is some disclosure in the derivatives area about the fact that this company relied on the confidence of its trading parties and, frankly, one of the issues was what happens when your trading parties do not want to trade with you? Do you have a business?

And there is no requirement to anticipate every possible contingency in terms of where a company's stock price might go and we obviously understand your point. I think it is one worth further exploration.

Mr. BENTSEN. Well, my time is up, but let me say this. Stock is a pretty volatile instrument and to not treat it as such in disclosure, disclosure is only as good as in the eye of the beholder and so I would hope that the industry would look at that.

Thank you, Mr. Chairman.

Chairman BAKER. Thank you, Mr. Bentsen.

Ms. Jackson-Lee.

Ms. JACKSON-LEE. Mr. Chairman, I cannot thank you and the Ranking Members and the Full Committee chairs and Ranking Member enough for your extreme courtesies to me and to the colleagues on this committee for their extreme courtesy. Very briefly, because we all are learning and I mentioned earlier that the eyes of the Nation are on us, and Houston, and particularly the pain and anguish that is experienced by those in Houston.

Mr. Berardino, thank you for your presence. Very quickly, I just want to know as it relates to the information that you thought you got incorrectly or made a mistake on the SPEs, what could have been done differently? Why did you probe further when you thought you had the information or are you just finding out you had incorrect information in your testimony?

Mr. BERARDINO. Well, thank you for your question. These are not easy issues. On the 80 percent where we did not have all the facts, this is a very complex company. They do lots of these deals. It is not like there is one a year that everyone looks at. There are, you know, scores and scores of them. And unfortunately, we just did not have the information. And once we and the company, the accounting department, had all the information, we all knew what the right answer was and unfortunately it resulted in a restatement.

On the other issue, where we made a mistake in judgment, at the time, our team made a very good faith, reasonable decision in terms of looking at these transactions and in hindsight they made an error in judgment. And let me be clear, you know, in no way do we think that this caused the collapse, but it is unfortunate that with the thousands and thousands of hours of work——

Chairman BAKER. Twenty seconds, Ms. Lee, because we are running out of time to make the floor vote.

Ms. JACKSON-LEE. Thank you very much.

Let me just say, Mr. Trumka, I thank you very much for being here. One quick word. How catastrophic is this to working people?

Mr. TRUMKA. We do not know the entire answer, but we can tell you that as far as Taft-Hartleys are concerned, the Taft-Hartley pension funds have probably lost a minimum of $250 million in stock and another $250 million in bonds. When you put all of the pension funds together, we are talking about tens of billions of dollars. When you look at individuals, many individuals have had their entire 401K retirement benefit wiped out. They are penniless.

Ms. JACKSON-LEE. Thank you, Mr. Chairman. We just have a lot of work to do.

Thank you so very much.

Chairman BAKER. Thank you. We will return after the Christmas recess to this topic, the analyst topic, transparency questions, a long litany of issues.

I wish to keep the hearing record open an unusually long period, 30 days, for all Members not only to formulate further questions, but for interested parties to make comment. I do appreciate your courtesies in being here and your longstanding patience throughout the day. We have to run. We have less than 2 minutes to make this vote.

Thank you.

[Whereupon, at 3:20 p.m., the hearing was adjourned.]

A P P E N D I X

December 12, 2001

Statement of Chairwoman Sue Kelly; Capital Markets, Insurance, and Government Sponsored Enterprises and Oversight and Investigations Subcommittees Joint Hearing on The Enron Collapse: Impact on Investors and Financial Markets

Wednesday, December 12, 2001

I want to thank Chairman Baker and Ranking Members Kanjorski and Gutierrez for agreeing to hold this joint hearing on the recent collapse of Enron and its impact on investors and the financial markets. In this hearing I hope we can all gain a better understanding of why Enron collapsed so quickly and why Enron's public filings and Anderson's audit reviews failed, until it was much too late, to give any indication of the problems they were experiencing.

Transparency is the goal of the disclosures a company is required to make and a fundamental necessity to a properly functioning open market. Unfortunately, the disclosures made by Enron did not give any indication to the problems they were experiencing until October 16. News reports have had many different versions of what may or may not have happened. I have read about a partnership that hid the level of leverage the company had incurred -- mistakes and misstatements that may have occurred in audits -- certain Brazilian investments that also may have contributed to Enron's fall.

What is clear is that people have been hurt by the collapse of Enron, from the thousands of investors whose retirement and other investment savings have been devastated to the thousands of employees who now find themselves without a job. We have on our hands what appears to be the largest bankruptcy ever, which could have far-reaching implications for our economy. We have the duty and responsibility to ensure that safeguards are in place to prevent a disaster of this magnitude from being repeated. We must determine when the accountants, executives and regulators knew what was happening and what they did or did not do to rectify the problems. While it would be impossible to ever have in place a system that would prevent failures in the future we must always try to improve upon the current system of disclosures and enforcement that is the responsibility of the SEC.

Enron's collapse underscores how important it is for Congress to act immediately to pass the netting provisions of the bankruptcy bill which have already passed the house numerous times. For the record, Mr. Chairman, I would like to as unanimous consent to have a letter signed by seven financial regulators who support the netting provision made part of the record. This legislation would reduce uncertainty for financial market participants about the disposition of their contracts in the event one of their counterparts becomes insolvent. In this letter the financial regulators state that "failure to enact these financial contract netting provisions would unnecessarily place the financial system at greater risk."

Chairman Oxley has been working on this and I just want to add my strong support for enacting these needed provisions before we adjourn this year.

I want to thank all the witnesses for taking the time out of their busy schedules to share there views with us and look forward to discussing these issues with them.

Board of Governors of the Federal Reserve System
Department of the Treasury
Securities and Exchange Commission
Federal Deposit Insurance Corporation
Commodity Futures Trading Commission
Office of the Comptroller of the Currency
Office of Thrift Supervision

October 31, 2001

The Honorable J. Dennis Hastert
Speaker of the House of Representatives
Washington, D.C. 20515

Dear Mr. Speaker:

We are writing to ask you to ensure passage this year of legislation to facilitate the termination and netting of financial contracts that has been proposed by the President's Working Group on Financial Markets.

This legislation would reduce uncertainty for financial market participants about the disposition of their contracts in the event one of their counterparties becomes insolvent. This reduced uncertainty should limit market disruptions in the event of an insolvency, limit risk to federally supervised market participants, and limit risk to the financial system generally.

We believe that failure to enact these financial contract netting provisions would unnecessarily place the financial system at greater risk. We have been working with the financial industry and the Congress for several years to craft this legislation. The relevant provisions are a noncontroversial portion of broader legislation to revise the bankruptcy laws that is currently before a Conference Committee. We are concerned, however, that the controversial issues in the broader legislation may not be resolved soon enough to allow its passage this year.

With the final days of this session of Congress approaching, we urge you to remove the netting legislation from the broader legislation and enact it separately.

Sincerely,

Alan Greenspan
Chairman
Board of Governors of the
Federal Reserve System

Paul H. O'Neill
Secretary
Department of the Treasury

Harvey L. Pitt
Chairman
Securities and Exchange Commission

Donald E. Powell
Chairman
Federal Deposit Insurance Corporation

James E. Newsome
Acting Chairman
Commodity Futures Trading Commission

John D. Hawke, Jr.
Comptroller
Office of the Comptroller of the Currency

Ellen S. Seidman
Director
Office of Thrift Supervision

Opening Statement

Chairman Michael G. Oxley

Committee on Financial Services

Subcommittee on Oversight and Investigations
Subcommittee on Capital Markets, Insurance and Government Sponsored Enterprises

"The Enron Collapse: Impact on Investors and Financial Markets"

December 12, 2001

Good morning and thank you, Subcommittee Chairs Baker and Kelly, for holding this important hearing. Today we will begin the Committee's investigation of the facts and circumstances surrounding the largest corporate failure in history. Today we will hear about the dramatic collapse of Enron Corporation, the seventh largest company in the United States. Riding high as recently as six months ago, the company has since lost more than 99% of its market capitalization, and now trades below $1.

Until all the facts are known, it is prudent for this Committee to avoid reaching sweeping conclusions about the causes and persons responsible for Enron's collapse. But that does not mean we should refrain from asking the difficult questions that demand answers.

We will ask the difficult questions. We will delve thoroughly into the facts and circumstances surrounding Enron's collapse. And we will get answers.

This Committee, and the Subcommittees on Capital Markets and Oversight, will vigorously pursue this matter to ensure that the Congress, and the American public, know who to hold accountable.

We need to learn whether millions of investors were intentionally misled by Enron's financial engineering and reluctance to disclose information.

We need to learn why financial statements that provided less than a complete picture of Enron's financial situation were certified.

We need to learn why almost all of the securities analysts following Enron failed to warn investors, and why exactly half of them continued to rate the company a "buy" or "strong buy", even after it had plunged below one dollar.

We need to learn whether the current reporting and financial disclosure system needs to be overhauled.

We need to learn why the accounting rules permit companies to keep important information off their balance sheets.

Above all, we need to reduce the likelihood that this will happen again.
The effects have been devastating - as one might expect when a $75 billion company files for bankruptcy. Hit hardest by the meltdown, of course, were Enron's employees. Thousands have already lost their jobs, and more will undoubtedly follow. And the 11,000 employees who participated in the company's 401(k) plan have seen their retirement savings practically eliminated.

In addition, beyond the impact on Enron employees themselves, Enron's collapse has drained the investment savings of investors across the country who put their retirement and other investments into mutual funds, pension funds, and other vehicles that invested in Enron. Thankfully, at this point there does not seem to be a systemic threat to the financial markets as a result of Enron's collapse, but the damage the collapse has done to the financial position of thousands of Americans will be very difficult to quantify.

Some may use Enron's bankruptcy as a vehicle to make big-government arguments against electricity markets. But it wasn't the electricity consumer who was hurt by Enron's fall, it was the workers and investors.

Furthermore, Congress must pass the netting provisions of the bankruptcy reform legislation. Enron and its subsidiaries were party to tens if not hundreds of thousands of different financial contracts. The identification of these contracts and verification that they are eligible for netting will require vast expenditures of time and money and divert the attention of Enron and the court from the task of reorganizing. Meanwhile, creditors will remain uncertain as to the enforceability of their contracts and the ultimate status of their claims against Enron. Let's eliminate the uncertainty, the waste of valuable court time and estate funds, and allow institutions to eliminate exposure more efficiently.

We are pleased to welcome the distinguished Chief Accountant of the Securities and Exchange Commission, Bob Herdman, to the Committee to discuss the reporting and financial disclosure system mandated by the Federal securities laws. I am particularly pleased that Mr. Herdman is here today, as the central issues that the Enron collapse raises are issues of investor protection and accounting rules, about which there are few better experts than the Chief Accountant of the Commission on which to opine.

I would like to remind the members of the Committee that Enron, as well as Andersen, are the subjects of a formal investigation by the SEC, so Mr. Herdman will not be able to provide any specific information about those investigations. Please phrase your questions accordingly.

On the third panel, we will hear from the chief executive of Arthur Andersen, which serves as Enron's auditor. We welcome back Chuck Hill to the Committee, to discuss the performance of Wall Street research analysts in this matter. And finally, we will hear from the AFL-CIO on the impact to investors.

Unfortunately, Enron's CEO, Kenneth Lay, was not able to testify before the Committee here today. I want to assure the members of the Committee, as well as the public, that I am confident that Mr. Lay, and Enron, will provide answers to us and to the public as the Committee continues its investigation into this matter.

I look forward to the testimony.

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Statement of the Honorable Kenneth E. Bentsen, Jr
Subcommittee on Capital Markets, Insurance and Government Sponsored Enterprises
"The Enron Collapse: Impact on Investors and Financial Markets "
December 12, 2001

The joint hearing before the Financial Services Subcommittees on Capital Markets, Insurance and Government Sponsored Enterprises and Oversight and Investigations will begin the process of unraveling the reasons for the collapse of the Enron Corporation. While the impanct of Enron's collapse will be felt in many quarters, not the least of which is Houston where thousands of employees have lost their jobs and apparently their savings, this hearing will focus on the failure of the company's corporate governance structure to properly oversee management along with serious questions regarding the performance of Enron's outside auditor. The Committee needs to begin to understand whether the fall of Enron, from its perch as one of the largest public corporations in the United States with its market capitalization at $75 billion and stock trading at $84 a share one year ago to bankruptcy and stock at 25 cents today was a failure wholly inside the company, with its outside advisors, within the financial market or our regulatory and legal structure. As a Houstonian, this is not just a failure within the marketplace, but also a tremendous loss to our community. Thousands of employees have been laid off just before Christmas into a down economy. Their savings and pensions wiped out. Our city has lost not just a corporate icon, but a corporate partner in civic affairs. A company which transformed the nation's energy markets from a staid, regulated structure to an innovative, efficient market place collapsed under its own weight, apparently due not to the new trading markets it helped to create and nurture, but apparently because of "old economy" corporate mistakes. While it is doubtful in my mind that Enron will survive, the energy market place it helped to found will and it is telling that throughout its fall, those markets have remained steady and calm.

The scope of our hearing today must determine whether Enron's management knowingly violated securities laws regarding disclosure or whether those laws allowed for the company to limit disclosure of certain financing structures which had the effect of understating liabilities and overstating assets and revenues. We must determine whether the corporate governance structure of Enron brokedown or whether the laws providing for outside directors of public companies is flawed. We must determine whether Enron's auditors properly stated its financial condition or ignored warning signs to the detriment of investors and employees. The increasing volume of corporate earnings restatements, not just Enron, should be alarming to the investing public, capital markets and the Congress. Are the disclosure laws lacking in providing investors and regulators with accurate data regarding a companies true financial condition? Is Enron an anomaly or a preface of things to come at the end of the roaring 1990's and its period of so-called 'irrational exuberance'?

Our task today is not to determine guilt and exact remedy with respect to the collapse of Enron, that is the role of the regulators and the Courts. Rather, our role is to determine what went wrong within the context of the nation's securities and disclosure laws and what is the appropriate remedy in that regard. Further, though beyond our committee's sole jurisdiction, I believe Congress must seriously review the existing body of law governing employee pension and thrift savings plans. The continuing revelations of long time Enron employees losing virtually all of their retirement savings because of excessive concentration of company stock is unnerving. It turns the well grounded concepts of profit sharing and ESOPS on their head and should sound alarm bells in Congress. That being said, Congress should avoid knee-jerk responses to an otherwise sound concept which has gone terribly wrong in the case of Enron and its former employees.

Finally, our task is to take whatever steps necessary to protect against a repeat of Enron, while the regulators and Courts resolve the collapse of Enron itself.

Statement of Rep. John Boehner

Chairman, Committee on Education and the Workforce

Hearing on:

"The Enron Collapse: Impact on Investors and Financial Markets"

before the

Subcommittee on Capital Markets, Insurance and Government Sponsored Enterprises, and the Subcommittee on Oversight and Investigations, Committee on Financial Services,

U.S. House of Representatives

December 12, 2001

I want to thank the Committee on Financial Services for inviting me to make a statement today on this very important issue of the Enron bankruptcy. I would also like to acknowledge the very important contribution to this effort of Mr. Baker, Ms. Kelly, Mr. Gutierrez, Mr. Kanjorski, and the full committee chairman, Mr. Oxley and ranking member, Mr. LaFalce.

Let me congratulate the committee on your quick action and hard work on behalf of America's investors, who now include more than half of all American families. I submit this statement to raise concerns as they relate to another segment of investors – Enron employees and retirees who have invested a substantial portion of their retirement assets in Enron stock. Employer-sponsored pension plans are regulated by the Employee Retirement Income Security Act, more commonly known as "ERISA," which is within the jurisdiction of the Committee on Education and the Workforce. Many of the issues raised by the Enron bankruptcy involve not only the participants in the Enron pension plan but also potentially the millions of Americans who participate in their employers' pension plans and depend upon these plans to provide them with financial security in their retirement. ERISA's cornerstone is a series of strict fiduciary standards of conduct imposed on individuals or entities that manage employees' assets in company pension plans.

ERISA allows employees to invest in equities offered by their pension plan. Investing in equities offers opportunities for rewards in growth, but it also offers risks. This is certainly true of company stock. Enron's employees who held Enron stock in their 401(k) accounts appear to have lost substantial amounts of money. On the other hand, employees at many other companies have made substantial amounts and therefore have significantly enhanced their retirement security. Furthermore, on a bipartisan basis over the last 20 years, Congress has encouraged the sale of employer stock to employees both individually and in their pension plans as a means to provide an extra incentive for enhanced job performance and direct participation of an employee in the future of their company. We should continue to protect these gains and not adversely affect the holdings of employees by unduly restricting this opportunity.

At the present time there are a number of formal investigations and inquires taking place as a result of the Enron bankruptcy. Today's hearing, the action of the Securities and Exchange Commission, and the investigation of the Department of Labor's Pension and Welfare Benefit Administration will bring the relevant facts to light. Once the facts are known, careful consideration should be given as to whether Congress should amend the law regarding company stock ownership in pension plans. If the facts demonstrate that the conduct in the Enron case was in violation of existing law then the appropriate parties will be held accountable. It may also be the case that the Enron matter demonstrates that Congress needs to make legislative changes to protect employees. If that is the case, we should move quickly and thoughtfully to make those changes.

As the chairman of the Committee with jurisdiction over ERISA, I assure you that in the next session the Committee will be carefully considering the Enron situation and its implications. The Committee will be examining the issues surrounding the Enron benefits plan and its compliance with ERISA. Specifically, the Committee will seek to understand the facts and circumstances surrounding the problems with Enron and will use this information to assess how well ERISA protects plan participants.

Our consideration of these issues will be thorough, fair and deliberate. I intend to work with the Committee's ranking member Mr. Miller, Employer Employee Relations Subcommittee Chairman Mr. Sam Johnson and ranking member Mr. Andrews to achieve this goal.

Congressman Harold Ford, Jr.
Committee on Financial Services
"The Enron Collapse: Impact on Investors and Financial Markets"
December 12, 2001

Thank you Mr. Chairman, Ms. Chairman.

The largest bankruptcy in American business history raises a wide range of questions whose answers cannot be found without a careful scrutiny by this Committee, by the other relevant congressional committees, the SEC, the Department of Labor, and the courts.

Our primary task must be finding out what went wrong with Enron -- how did the seventh largest corporation in the U.S. fail so abruptly, with barely any warning signs from the regulators, from Wall Street, or from Enron's board of directors, audit committee, or outside auditors?

How was a public company allowed to keep so much of its financial activity off of its own balance sheets? I commend Arthur Andersen's CEO, Mr. Berardino, for coming before this committee today. He has pledged to assist our investigations into the failure of our financial system to prevent such a large-scale bankruptcy, and the failures of his own firm to identify Enron's financial problems.

Tough questions must be answered -- not only about the shortcomings of our accounting standards, but about the independence and of accounting firms which generate substantial revenue from consulting and other services.

I thank Mr. Trumka for appearing here today -- the Enron collapse raises serious questions about our system of protections for workers and their retirement security. How were 4,000 employees laid off, some of whom with no more than 30 minutes notice? How were so many of their retirement accounts heavily exposed to the fluctuations, and ultimate death spiral, of Enron's stock? Again, all the answers cannot be known, but they must be asked and answered candidly.

Finally, the Enron debacle highlights the need for better oversight and enforcement by the SEC of corporate financial reporting and of accounting standards. I want to thank Mr. Herdman for appearing here today. This is no time for the SEC to ease up on the vigilance with which it oversees the financial markets. Our financial markets have suffered a series of tremendous shocks, and never before has maintaining investor confidence been more important.

We are not here to scapegoat -- there will be plenty of blame to go around once all the facts are known. We are here to gain a better understanding of this financial calamity, and to ask what Congress can do to prevent another Enron. Thank you.

OPENING STATEMENT OF LUIS V. GUTIERREZ RANKING DEMOCRAT SUBCOMMITTEE ON OVERSIGHT & INVESTIGATIONS "THE ENRON COLLAPSE: IMPACT ON INVESTORS AND FINANCIAL MARKETS"

December 12, 2001

Good morning Chairman Baker, Chairwoman Kelly, Ranking Member LaFalce, Ranking Member Kanjorski and thank you for holding this hearing.

We are gathered here today because of a series of unfortunate events that culminated on December 2 with the filing for bankruptcy of Enron.

In Houston alone, Enron has laid off more than 4,500 of its 7,500 employees as part of a corporate restructuring program to drastically cut costs. The victims of this catastrophe -- Enron's employees--have been left wondering how bankruptcy would affect their severance pay, health insurance and financial futures. For a vast majority of them, the spectacular collapse of their company causes a financial and personal tragedy. Many feel betrayed and angry. Sadly, many workers did not even know that they were about to lose their jobs. They just came in one day to work and were simply given 30 minutes to pack their belongings and leave.

In addition to the lay-offs, a great number of Enron employees lost in a matter of months almost all the value of the stock they owned, which plunged into levels below one dollar. The Labor Department stated that Enron employees have lost between 70 to 90 percent of their retirement funds–which translates to more than $1 billion. Many of Enron's employees had invested all of their 401(k) funds into Enron's stock. And why wouldn't they? Just months ago Enron was the country's seventh-largest company in terms of reported revenue. Enron was the fast-rising star that had turned the dreary business of energy trading into one of the world's vastest corporate fortunes. It reported quarterly revenues of nearly $47 billion. Its stock has fallen from nearly $90 to some pennies.

The Enron case brings to the fore an issue that has long worried pension and benefits experts: a retirement plan hugely dependent on the health of a company that provides it. Although the Employee Retirement Security Act of 1974 states that an employer with a traditional pension plan cannot invest more than 10 percent of the plan's assets in the employer's stock, traditional pension plans are rapidly falling out of favor, with the newer 401(k) replacing them. Currently, there are no limits yet on how much of an employees's pension plan may be comprised of the employer's stock, nor are there any caps on investments in employer stock with employer-contributed funds.

Enron's own-stock accounted for more than 60 percent of the assets in the $2.1 billion defined benefit 401(k) plan several months ago. It is widely known that some companies have even higher levels, creating an even worse scenario should these companies fail. Indeed, these amounts are situated well beyond what would be described as prudent diversification, because if there is one lesson to be learned from this tragedy that is explained by the term Diversification. Diversification should be made the very first and most important rule in investing in 401(k).

The dangers of over-concentrating company stock in a 401(k) plan have been made vividly clear by the Enron Corp. debacle. But despite the perils, millions of American workers have little choice but to bet their retirement savings, as well as their jobs, on the fortunes of their employers.

However, Enron is hardly alone in its high exposure to its own stock. About 120 of the largest U.S. companies, as represented by the Committee on the Investment of Employee Benefit Assets, have seen their own stock rise to an average one-third of plan assets.

Hardest hit will be Enron's 21,000 workers. For three weeks, starting in late October, all Enron retirement plan participants were locked into their current allocations when the firm decided to go ahead with a switch to new plan administrators. Enron stock lost 35 percent of its value during the freeze, but the workers' pain was not shared by top executives, many of whom had already cashed in millions of dollars worth of Enron stock earlier this year. For instance, Enron Chairman, Kenneth Lay, was able to sell at least $23 million worth of his company's stock this year –a year in which its price has gone from $82 to just 26 cents per share.

The only mistake these employees have committed were being loyal to their company and wanting their own small but well-deserved share of the riches Enron executives habitually pocketed during their years at the company. Of Enron's 21,000 employees, the approximate 12,000 who participated in the Enron 401(k) plan now have virtually nothing.

Another source of problems is that companies that make their matching contributions in stock usually place restrictions on the trading of those shares by the employees. Generally, workers cannot sell their shares until they are near the retirement age, making them captive investors.

Enron prevented its workers from selling the shares they had accumulated until they reached the age of 50. Although this did not save the stock from collapse, it did major harm to its employees. It is alarming to consider that Enron is not alone in such a requirement. Other big companies lock workers into their 401(k) company shares until a certain age. We all know that you are not supposed put all eggs in one basket. Yet nationwide we have an average of 30 percent company stock held in these plans.

Apart from the financial problems caused to thousands of people nationwide by the precipitous fall of Enron, probably I should say even internationally, there are other source of serious issues that also need to be discussed.

To that list of people affected by the economy, we also have to add the immigrants that are being laid off across the country and even being forced to leave the country due to immigration regulations. In the case of Enron, several hundred foreign nationals were working with H-1B visas in Houston alone and a significant number of them have been laid off, shattering in seconds years of hard work and lifetime ambitions.

As if losing your retirement savings and your job wasn't enough, indeed there is the case of these hundreds of immigrants that have come to the U.S. with an employer-specific visa and through their work have contributed to the betterment of our economy, especially during these difficult times. The workers, all of the sudden, find themselves desperate to find a job in about 30 days, so that they and their families, are not forced to leave the country.

Mr. Chairman, to conclude I would like to touch on an issue that I consider key on this affair. Under my perspective, transparency of information must be enforced in publicly traded firms, such as Enron.

Transparency in financial reporting plays an essential role in making the financial markets fundamentally efficient. This is absolutely necessary if we want to have healthy markets.

Although the internal controls within Enron as well as the independent oversight by the board and auditors will be investigated in detail, what answers can be given to (ex) employees, pension holders, shareholders, and creditors who have lost lifetime savings, retirement income, and jobs due to the actions of two dozen people?

Also, we should not forget that Enron distributed an additional $55 million to 500 key employees two days before filing for bankruptcy protection as an incentive for them to remain with the company while Enron works to emerge from Chapter 11.

If it is not a felony for executives to cash out their millions before their failures are revealed and then block employees from salvaging their 401(k) plans afterward, it certainly represents the height of arrogance and indecency.

Thank you.

<u>OPENING STATEMENT</u> of Rep. Stephanie Tubbs Jones

The Enron Collapse
December 12, 2001

Good Morning, Chairman Baker and Kelly, to the Ranking Member Kanjorski and Gutierrez and Members of the Capital Markets and Oversight Committees.

We are here this morning to find out more about what happened to Enron, just last year, one of the world's most admired companies, and today, a bankrupt corporation. However, Mr. Chairman, our efforts must run deeper than that. It is to find out about not just what happened, but how it happened and if additional questions or flares should have been sent up.

This is not our first snapshot at a large and one-time prosperous corporation taking a dramatic downturn. However, as the days unfold, there will be lingering questions and concerns about allegiance, as it relates to shareholders, insider trading, recent stock purchases to bonuses given to employees while a company attempts to rescue itself via bankruptcy and other issues.

Never before, in my recent memory, has a company's stock fallen so quickly and yet so quietly. I am concerned Mr. Chairman about lost jobs and pensions of thousands of Enron employees. So, this hearing today is both timely and I am sure will provide the Members here with a greater insight into the challenges faced by Enron and our regulatory systems.

This Committee must, as well as other investors, study what happened and learn from it. We have a commitment to the maintenance of our capital markets as well as oversight responsibilities that should never be underestimated.

I hope that today we ask the important and tough questions about financial reporting, information disclosure and transparency, accounting standards, proper and improper management and administration and whether improprieties existed. We owe this to our financial system, the investing public as well as to those employees who no longer are apart of Enron.

In conclusion, I look forward to this hearing. I am sure we have not heard the last of Enron in the days to come. It is my hope, however, that maybe we learn something here, be it a greater need for legislation or greater enforcement, that will work to thwart another Enron-type dilemma.

Lastly, we must examine Enron as many individual and corporate investors have taken a tremendous stock hit. It is our duty to maintain confidence in financial markets for American investors and institutional investors who invest their pensions.

Thank you Mr. Chairman, for calling this important hearing. I yield back.

OPENING STATEMENT OF
RANKING DEMOCRATIC MEMBER PAUL E. KANJORSKI

SUBCOMMITTEE ON CAPITAL MARKETS, INSURANCE,
AND GOVERNMENT SPONSORED ENTERPRISES

HEARING ON THE ENRON COLLAPSE:
IMPACT ON INVESTORS AND FINANCIAL MARKETS

WEDNESDAY, DECEMBER 12, 2001

Mr. Chairman, today's hearing will help us to understand at least some of the factors that contributed to the downfall of Enron Corporation, a once mighty international conglomerate that recently filed the largest corporate bankruptcy in American history. Our hearing will also help us to discern whether Congress needs to take steps to restore the faith and trust of investors in America's dynamic capital markets. Although I have not yet arrived at any conclusions about this disturbing downfall of a corporate icon, I have already identified a number of concerns that I expect we will address during our investigations.

First, I would like to learn more about the serious financial harm done to thousands of Enron's employees and the many others who owned Enron stock. Some press reports suggest that company rules blocked rank-and-file Enron employees from selling Enron stock in their 401(k) retirement plans in the days and weeks following the announcement that Enron had overstated its earnings by $583 million in the past four years. These hard-working Americans had to watch helplessly as their savings shrank without any recourse, while Enron's executives could apparently sell their stock options and avoid the financial pain. That is wrong.

Second, I have concerns about whether the accounting industry experiences any conflicts of interest in serving its customers. In recent years, many have noted that an accounting firm's consulting fees from one company may exceed its auditing receipts from the same company. This practice calls into question whether shareholders can rely on earnings reports and other indicators of a company's health and its future stock price. In order to provide transparency for investors, auditors should actively work to limit potential conflicts.

Third, we will return today to the issue of analyst independence, a topic we have closely studied this year. From our past hearings, we have learned that an analyst working for a firm that handles investment banking for a company the analyst covers could receive a more favorable rating to attract new business. I am therefore interested in learning why of the fifteen analysts covering Enron on the day following the failed merger with Dynegy only one had a sell rating on the company's stock. These ratings misled investors.

Finally, in hindsight, it appears that Enron's board of directors failed to serve Enron's shareholders. Several news stories have detailed how gifts, contributions, and other activities may have compromised some members of Enron's board. I expect that as time goes on, we will learn that Enron is not the only company where these questions arise. Members of a corporate board must retain their independence and hold management accountable.

In closing, Mr. Chairman, I typically prefer private sector regulation to federal regulation. But if the private sector fails in its responsibilities and creates a vacuum, then the federal government has a duty to protect its citizens by addressing the market failure. More Americans than ever have their savings invested in the stock market, and we have an obligation to protect them from the conflicts of interest we are investigating in the Enron collapse.

Congressman Dennis Moore
Statement for Financial Services Hearing
"The Enron Collapse: Impact on Investors and Capital Markets"

I would like to thank Mr. Herdman, Mr. Berardino and Mr. Trumka for appearing before the Committee today. The many issues raised by Enron's collapse will likely take years to examine, and will require the participation of all of the interested parties here today. Today's hearing is a good start, and I appreciate the witnesses who showed up this morning for helping this Committee to examine these complex issues.

While some of the parties associated with Enron's demise may attempt to deflect blame and downplay their roles in the largest corporate bankruptcy in American history, it is apparent that there is plenty of blame to go around. I think it is fair to say that the SEC, the Financial Accounting Standards Board [FASB, pronounced FAS-BE] and Congress all have important roles to play in this matter and share responsibility for preventing a future corporate collapse on the size and scale of Enron's.

The SEC and FASB need to update the rules and generally accepted accounting practices that regulate the accounting industry, and corporate auditing practices in particular. As Mr. Berardino has noted, the Special Purpose Entities [SPEs] and other complex off-balance-sheet financing structures that Enron relied upon, and ultimately led to Enron's demise, operate under outdated rules that allow sponsoring companies to keep the SPEs assets and liabilities off of their annual financial statements. Accounting rules based on a risk/reward concept would provide investors with more information than they currently have access to by keeping more of a company's risky assets and liabilities on corporate balance sheets.

Additionally, Congress will need to examine the '33 and '34 securities laws that were designed to provide investors with adequate information about the companies in which they invest. Our financial reporting system, created nearly seventy years ago, was not designed to deal with "asset light" companies like Enron that traded energy derivatives and relied so heavily upon SPEs and other sophisticated off-balance-sheet structures. Congress will need to revisit our nation's securities laws in the near future, and I look forward to being a part of that process.

In short, the healthy functioning of our capital markets depends upon reliable auditing and accounting information, as well as accurate financial statements. While investors should always scrutinize their investments and make informed decisions on where to invest their money, investors have to be able to trust the financial statements of the companies in which they have decided to place their money.

Additionally, investors need to be able to trust the financial analysts who, more often than not, recommend that investors buy the stocks of companies like Enron. In the case of Enron, according to Forbes Magazine, in October, even as Enron's stock continued to plummet from its 52-week high, most financial analysts that covered Enron recommended that investors buy that company's stock.

I am confident that this Committee, among others, will examine carefully in the months to come the issues that I have touched upon. For the moment, however, there is one additional issue related to Enron's collapse on which I would like to focus, and that is the unfortunate disappearance of most Enron employees' 401(k) pension plans. As everyone is aware, there are now two separate actions underway relating to the way in which Enron prevented its employees from making changes to their pensions, even as Enron's stock, which comprised a significant percentage of employees' 401(k) retirement plans, plummeted.

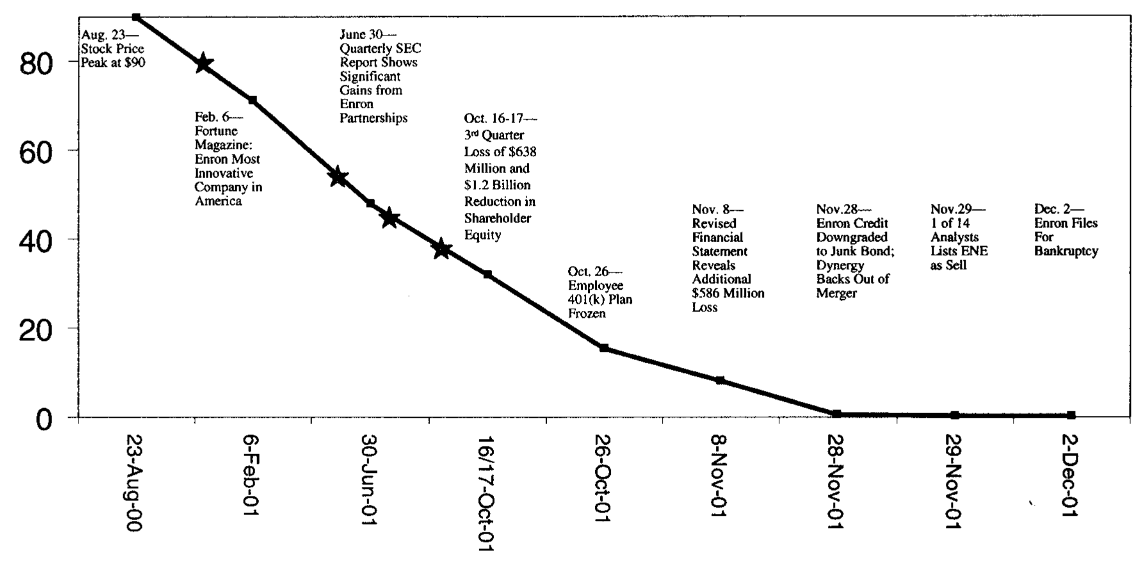
The Department of Labor has launched an investigation into Enron's actions related to the company's 401(k) plan, and a class action suit [*Kemper, et al. V. Enron Corp., et al.*] has been filed on behalf of Enron employees in response to substantial losses in their retirement accounts. Enron matched employee contributions to 401(k) pension accounts solely with Enron stock, and may have encouraged employees to allocate employee 401(k) contributions toward Enron stock. But what I am particularly interested in is the new policy that Enron instituted on October 26, effectively freezing any employee 401(k) transactions. Enron ostensibly instituted the 401(k) freeze due to a change in pension plan administrators.

Unfortunately for Enron's employees, the freeze was in place while Enron's stock plummeted, forcing employees to sit by as the value of their retirement savings collapsed. Further, the pension freeze lasted for three weeks, a much longer period of time than the industry standard for ordinary administrative changes in pension plans. As if that action wasn't harmful enough, the class action lawsuit that has been filed on behalf of Enron employees alleges that the company failed to notify employees in advance of the freeze, so that they had no opportunity to monetize their investments and adjust their 401(k) portfolios ahead of time. While this is now a matter for the courts, Enron's apparent lack of notification to its employees in advance of the 401(k) freeze could be construed as an outrageous, and potentially illegal, attempt by Enron to manipulate the rapidly declining value of its stock by preventing a mass sell-off of the company's stock.

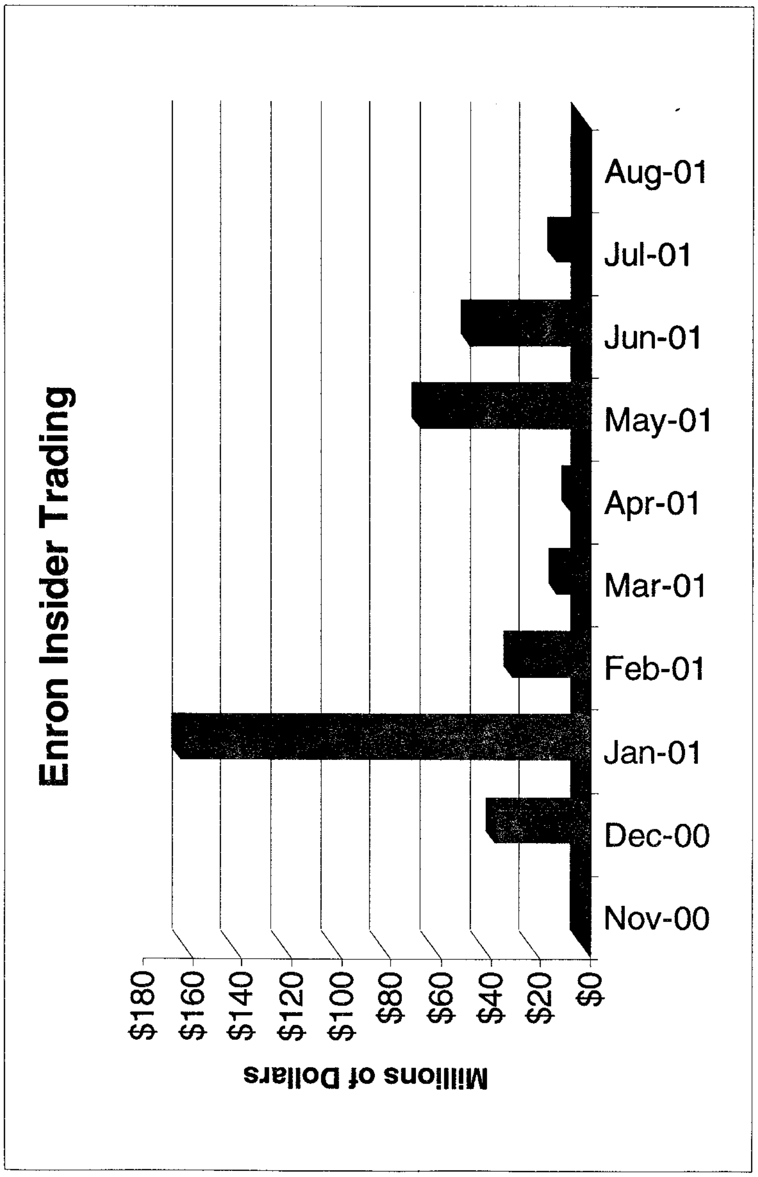
In these difficult economic times, American workers are having a tough time saving their money for retirement, and Congress needs to do whatever it can to encourage long-term savings. In May, the House overwhelmingly passed the Comprehensive Retirement Security and Pension Reform Act, or "Portman-Cardin," which included a modified version of legislation I introduced earlier this year [H.R. 1026, the Increased Individual Retirement Accounts for All Act of 2001] that increased the limit on deductible contributions to IRAs and included a much needed catch-up provision for individuals who are 50 and older. Congress can and should do more, however, to encourage retirement savings for American workers.

Enron's actions and vanishing stock value have highlighted a potentially enormous problem that millions of American workers could face in the next few decades, and it is now the responsibility of the SEC, the accounting industry and Congress to prevent another corporate collapse similar to that of the Enron Corporation.

Enron Stock Value Over Time



★ Indicates Stock Sale by Enron CEO Kenneth Lay
2/1/2001—Proceeds valued at $14, 640,000
5/1/2001—Proceeds valued at $14, 049,280
7/20/2001—Proceeds valued at $1,330,000
8/21/2001—Proceeds valued at $1,051,258
Total Sales Valued at over $100 million



Source: Insider & Form 144 Filings
Totals Reflect Stock Sale Proceeds Only

TESTIMONY OF

ROBERT K. HERDMAN, CHIEF ACCOUNTANT
U.S. SECURITIES AND EXCHANGE COMMISSION

CONCERNING
RECENT EVENTS RELATING TO ENRON CORPORATION

BEFORE THE SUBCOMMITTEE ON CAPITAL MARKETS, INSURANCE AND GOVERNMENT SPONSORED ENTERPRISES AND THE SUBCOMMITTEE ON OVERSIGHT AND INVESTIGATIONS

COMMITTEE ON FINANCIAL SERVICES

U.S. HOUSE OF REPRESENTATIVES

DECEMBER 12, 2001

U. S. Securities and Exchange Commission
450 Fifth Street, N.W.
Washington, D.C. 20549

TESTIMONY OF
ROBERT K. HERDMAN
CHIEF ACCOUNTANT
U.S. SECURITIES AND EXCHANGE COMMISSION
RECENT EVENTS RELATING TO ENRON CORPORATION

Before the Subcommittee on Capital Markets, Insurance and Government Sponsored Enterprises and the Subcommittee on Oversight and Investigation, Committee on Financial Services
U.S. House of Representatives
December 12, 2001

Chairman Baker, Chairwoman Kelly, Ranking Members Kanjorski and Gutierrez, and members of the Subcommittees:

I am pleased to appear before you on behalf of the Securities and Exchange Commission ("SEC" or "Commission") to testify concerning the recent events relating to Enron Corporation ("Enron"). I appreciate the opportunity to discuss the importance of transparent financial reporting to investors and our capital markets and several accounting issues raised by Enron's recent filings with the Commission.

Overview of the Effects of Enron on our System of Capital Markets

The SEC shares the Subcommittees' concern about the recent events surrounding Enron. The bankruptcy filing of a Fortune 10 company gives pause to all of us who care about financial reporting—and, more importantly, about its customers—the investing public. As Enron has disclosed in its public filings with the Commission, the SEC is investigating the Enron matter. Any further information relating to that investigation is nonpublic at this point and, accordingly, my statement will be confined to the public record.[1] The Commission requests that the Subcommittees respect the confidential nature of the Commission's investigation and the Commission's reluctance to address in this public forum specific issues related to Enron's compliance with the federal securities laws.

Enron's announcement of its intention to restate its financial statements comes on the heels of several other widely publicized restatements. We share your concern that such restatements may shake investors' confidence in our system of financial reporting and our capital markets. We also recognize the devastating impact that such events can have on employees whose retirement funds are invested in the company's securities. In the coming weeks and months, we will all learn more about what transpired at Enron, as many of the details are unknown at this time. However, today I will discuss for the Subcommittees what has been announced publicly as well as some of the related disclosure and financial reporting issues.

In some of the staff's discussions with congressional staff, it has been suggested that a chronology of the public events as reflected in Enron's filings with the Commission might be useful to the Subcommittees. An understanding of these public events also may assist in understanding the company's accounting issues. A chronology, therefore, is attached to my testimony as Appendix A.

Transparent Financial Reporting Protects the Financial Markets

A primary goal of the federal securities laws is to promote honest and efficient markets and informed investment decisions through full and fair disclosure. Transparency in financial reporting – that is, the extent to which financial information about a company is visible and understandable to investors and other market participants–

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1 The information contained in this statement concerning the events surrounding the bankruptcy filing of Enron Corporation is based upon publicly available information. The Commission is currently conducting an investigation into a number of aspects of these events and has not made any findings or reached any conclusions related to these events. This statement does not discuss nonpublic matters relating to that investigation or that may become the subject of actions by the Commission or by other authorities.

plays a fundamental role in making our markets the most efficient, liquid, and resilient in the world.

Transparency enables investors, creditors, and the market to evaluate an entity. In addition to helping investors make better decisions, transparency increases confidence in the fairness of the markets. Further, transparency is important to corporate governance because it enables boards of directors to evaluate management's effectiveness, and to take early corrective actions, when necessary, to address deterioration in the financial condition of companies. Therefore, it is critical that all public companies provide an understandable, comprehensive and reliable portrayal of their financial condition and performance. If the information in financial reports is transparent, then investors and other users of the information are not surprised by unknown transactions or events.

Investors and creditors expect clear, reliable, consistent, comparable, and transparent reporting of events as they occur. Accounting standards provide a framework that is intended to present financial information in a way that facilitates informed judgments. For financial statements to provide the information that investors and other decision-makers require, meaningful and consistent accounting standards and comparable practices are necessary. Companies in like circumstances must apply such standards and practices in a like manner if the information is to be comparable.

The SEC Relies on an Independent Private Sector Standards-Setting Process that Is Thorough, Open, and Deliberative

While the Commission has the statutory authority to set accounting principles,[2] for over 60 years it has looked to the private sector for leadership in establishing and improving accounting standards.[3] The quality of our accounting standards can be attributed in large part to the private sector standards-setting process, as overseen by the

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2 See, e.g., section 19(a) of the Securities Act of 1933, 15USC 77s(a), and section 13(b)(1) of the Securities Exchange Act of 1934, 15 USC 78m(b)(1).

3 Accounting Series Release (ASR) No. 4 (April 1938) and ASR No. 150 (December 1972).

SEC. The primary private sector standards-setter is the Financial Accounting Standards Board (the "FASB"), which was established in 1972. An oversight body that represents its core constituency of investors, business people, and accountants appoints the members of the FASB. The FASB's standards are designated as the primary level of generally accepted accounting principles ("GAAP"), which is the framework for accounting. FASB standards set forth recognition, measurement, and disclosure principles to be used in preparing financial statements.

In setting standards, the FASB follows a thorough, open, and deliberative process. For major projects, that process can include: (i) wide distribution of discussion memoranda; (ii) public hearings; (iii) publication of exposure drafts; (iv) solicitation of comment letters; (v) public deliberation on comment letters; and (vi) use of field tests to test standards before their adoption.

The SEC oversees the FASB and its accounting standards-setting process. Specifically, the SEC staff evaluates each project and proposed standard to make sure that the FASB standard-setting process is being administered in an open, fair, and impartial manner, and that each standard adopted is within an acceptable range of alternatives that serve the public interest and protect investors. The SEC staff: (i) monitors the FASB's project developments; (ii) meets with the FASB and its staff on a regular basis to discuss pending FASB projects; (iii) reviews comment letters received by the FASB on its projects; and (iv) after a standard is adopted, continues to consult with the FASB, its staff, and its interpretative body, the Emerging Issues Task Force ("EITF"),[4] on implementation issues.

The Self-Regulatory Processes Administered by the American Institute of Certified Public Accountants ("AICPA")

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4 The EITF is a committee of accounting practitioners that assists the FASB in providing timely guidance on emerging issues and the implementation of existing standards. If the EITF reaches a consensus solution to an emerging or implementation issue, Commission or FASB action may not be considered necessary. The SEC Chief Accountant participates as an observer at EITF meetings.

The SEC staff also monitors the activities of the standard setting functions of the AICPA's Auditing Standards Board ("ASB") and the AICPA's self-regulatory programs, designed to enhance public confidence in the audit process.

Regarding the ASB, the SEC staff attends many of the ASB's public meetings, reviews exposure drafts of proposed auditing standards and selected comment letters responding to those exposure drafts, and periodically meets with representatives of the ASB to discuss current and future projects and other matters of mutual concern. Recently, the ASB was placed under the oversight of the Public Oversight Board ("POB"), which is chaired by former Comptroller General of the United States, Charles A. Bowsher.[5]

The POB was created in 1977 to oversee and report on the self-regulatory programs of the AICPA's SEC Practice Section, which until recently consisted principally of the AICPA's peer review and quality assurance programs. Under the peer review program, accountants from outside the member firm assess the firm's quality control systems over its accounting and auditing practice and test compliance with those systems. Under the quality control inquiry process, a committee of professionals reviews allegations of audit failure contained in litigation filed against a member firm for indications of needed improvements in the firm's quality control systems.

Starting in 2001, the POB's responsibilities have been expanded to include not only oversight of the peer review, quality control inquiry, and auditing standards setting functions, but also to improve the communication and coordination among the various bodies that make up the self-regulatory process and to conduct oversight reviews and other projects that are deemed to be appropriate to protect the public interest.

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5 Other members of the POB include former FASB Chairman, Donald Kirk; the Chairman of the Executive Committee for Lockheed and former Under Secretary of the Army, Norman Augustine; former Counselor to the President and former Secretary of Defense, Melvin Laird; and former SEC Commissioner, Aulana Peters.

An example of the POB's projects that benefit the public interest occurred in 2000 when the POB, at the SEC staff's request, sponsored the Panel on Audit Effectiveness ("Panel"). Although the Panel found that the audit process is fundamentally sound, the Panel's report contained approximately 200 recommendations for the accounting profession, standard setters, audit committees and regulators. The AICPA and others are working to implement those recommendations, including: revising the auditing standards for detecting material misstatements in financial statements that may be due to fraud, enhancing the peer review process, and strengthening the AICPA's disciplinary processes.

In this regard, the AICPA recently amended its self-regulatory processes to require member firms to have specific quality controls related to maintaining their independence from audit clients, to provide for "continuous" peer reviews of the largest accounting firms (which provides for the performance of certain peer review procedures in the two years between the firm's triennial peer reviews), and, in the event of litigation alleging deficiencies in the audit of a public company, in certain situations to terminate, remove from audits of public companies, or subject to additional oversight the individual involved.

As shown by these recent changes, the self-regulatory process can, and does, change over time in response to the needs of investors. In view of the events surrounding Enron, the profession and the Commission are considering what further improvements should be made.

For example, last week the managing partners of the five largest accounting firms issued a joint statement that they intend to work with the SEC and others to evaluate and improve the profession's self-regulatory process, and to enhance disclosures and audit procedures concerning related party transactions, special-purpose entities, and issues related to market risks, including those related to energy contracts.[6] They also indicated

6 See, "Statement From Big Five CEOs," dated December 4, 2001.

their support for the modernization of the financial reporting system, as previously announced by Chairman Pitt.[7] Similarly, AICPA Chairman James Castellano stated that the AICPA is committed to working with the SEC and accounting firms to make needed changes to the self-regulatory process and to provide improved guidance to auditors and to modernize the financial reporting system.[8]

Role of the SEC in Reviewing Filings

As noted above, the Commission is responsible for administering the federal securities laws. These laws are designed to protect investors by requiring full and fair disclosure of all material information about publicly traded securities. Full disclosure ultimately benefits both investors and the capital markets. By enhancing investors' confidence in the completeness and accuracy of information about public companies, these full disclosure requirements encourage investor participation in the capital markets.

The Commission does not have authority to approve or disapprove a security or a transaction on its merits. If a transaction appears to involve a high degree of risk to investors or if a company involved in a transaction is experiencing financial difficulty, we do not, and we cannot, stop the transaction from proceeding on that basis. Rather, the Commission's job is to ensure that the company fully discloses these risks and fully informs investors of its financial condition so that investors can make informed investment decisions. This system is designed to maintain market transparency. It allows market forces rather than regulatory controls to determine what transactions will proceed and at what prices a company's securities will trade. In this way, even small companies and companies with financial difficulties may have access to the public capital markets on an equal footing with larger or more financially secure companies. Full and

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7 See, e.g., Remarks by SEC Chairman Harvey L. Pitt at the Fall Meeting of the ABA's Committee on Federal Regulation of Securities, dated November 16, 2001.

8 "AICPA Statement of James G. Castellano, AICPA Chair, Barry Melancon, AICPA President and CEO," dated December 4, 2001.

fair disclosure allows markets to assign an appropriate value for the securities of all public companies.

Under the securities laws, public companies file registration statements, periodic reports and other disclosure documents with the Commission. The Commission's Division of Corporation Finance ("DCF") has primary responsibility for overseeing disclosures by issuers of securities. The SEC, however, does not have sufficient resources to review all registration statements and other filings that are made with the Commission. Therefore, in 1980, the SEC implemented a "selective review" program by which the DCF reviews some, but not all, of the filings that are made with the Commission.[9] When a filing is made, it is routed to the appropriate industry group within the DCF and it is then "screened" to determine if it will be subjected to a full financial and legal review, a partial review for specific issues only, or no review. In order to preserve the integrity of the selective review process, the Commission does not publicly disclose its screening criteria for filing reviews.

The SEC does not audit public companies. If the DCF has significant concerns or becomes aware of information that suggests that a company may have violated the securities laws, the DCF may refer the matter to the Commission's Division of Enforcement. The SEC has broad authority to investigate possible violations of the securities laws and may bring actions against a company if information in its registration statement or other filings proves to have been materially false or misleading, including actions to stop the sale of securities.

As Chief Accountant, I am the principal advisor to the Commission on accounting and auditing matters arising from the administration of the federal securities laws. My

[9] All registration statements potentially are subject to review by the staff of the DCF. Given the volume of filings each year, we fulfill this obligation by selectively reviewing registration statements and other documents that companies file with the Commission when they engage in public offerings and other transactions in publicly traded securities. We also selectively review periodic reports, such as those on Forms 10-K and Forms 10-Q, which public companies are required to file with the Commission, and current reports on Forms 8-K. These reports are designed to keep investors apprised of the companies' financial condition and results of operations on a periodic basis.

staff also works closely with domestic and international private sector accounting and auditing standards-setting bodies, consults with registrants, auditors, and other Commission staff, such as the staff in the DCF and the Division of Enforcement, regarding the application of accounting standards and financial disclosure requirements, and assists in addressing problems that may warrant enforcement actions.

Having now reviewed the role of the SEC and the FASB in the financial reporting process, I would like to discuss three accounting issues that were raised by Enron in its November 8, 2001 Form 8-K filing: (1) restating previously issued financial statements, (2) accounting for special-purpose entities, and (3) the reduction in Enron's shareholders' equity in connection with the receipt of notes receivables. Finally, as requested by some members of the Subcommittees, I will give a brief overview of a subject that is not mentioned in Enron's filing – mark to market accounting as it applies to nonderivative energy-trading contracts.

Restating Previously Issued Financial Statements

In its November 8, 2001 Form 8-K filing, Enron announced its intention to restate previously issued financial statements dating back to 1997. Various groups have reported increases in the number of companies restating their financial statements over the last several years, with one study citing 233 restatements in 2000.[10] Let me briefly explain the accounting and auditing literature regarding restatements.

Management is responsible for the preparation and presentation of financial statements in conformity with GAAP. If management discovers an error in previously issued financial statements, it should account for the error in accordance with Accounting Principles Board Opinion No. 20 (APB 20), *Accounting Changes*. APB 20 concludes that correction of an error related to a prior period discovered after the issuance of financial statements for that period should be reported as a prior period adjustment.

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10 Two separate studies by Financial Executives International and Arthur Andersen indicate increases in the number of restatements by public companies over the past four years.

Pursuant to Generally Accepted Auditing Standards ("GAAS"), an auditor has responsibilities when an error is discovered regardless of whether the auditor or its client discovers the error. Statement of Auditing Standards No. 1, which is part of GAAS, sets forth the procedures an auditor should follow when, subsequent to the date of the audit report, the auditor becomes aware that facts may have existed at the date of the report that might have affected his or her report. When subsequently discovered information is found both to be reliable and to have existed at the date of the audit report, the auditor should advise the client to make appropriate disclosure of the newly discovered facts and their impact upon the financial statements in cases where the auditor believes: (a) the audit report would have been effected if the information had been known at the date of the report, and (b) there are persons currently relying upon the financial statements who would attach importance to the information.

Our capital markets are much more efficient if, instead of correcting information in restatements, the original financial statements reflect appropriate accounting policies and contain appropriate disclosures the first time. To that end, the staff of the SEC wants to work together with the corporate community, the accounting profession, and private sector standard-setting bodies to advance, not just protect, the interests of investors by helping companies to get financial reporting right the first time.

Accounting for Special-Purpose Entities

Enron's Form 8-K filing discloses that three previously unconsolidated special-purpose entities ("SPEs") should have been included in Enron's consolidated financial statements. An SPE is an entity created by a sponsor to carry out a specified purpose or activity, such as to consummate a specific transaction or series of transactions with a narrowly defined purpose. SPEs are commonly used as financing vehicles in which assets are sold to a trust or similar entity in exchange for cash or other assets funded by debt issued by the trust. In many cases SPEs are used in a structured transaction or series of transactions to achieve off-balance sheet treatment. In addition, use of SPEs can provide a lower cost of financing and can create tax advantages. An SPE, however, is expensive to set up and maintain. Therefore, SPE activities usually occur on a large scale so the impact of the reduced interest rate more than offsets the costs.

To illustrate, here is an example of how an SPE might work. A third party investor unrelated to a transferor may set up an SPE for the benefit of a transferor, which is the company that transfers or contributes the assets to the SPE. The investor will control the activities of the SPE and retain the substantive risks and rewards like common stockholders in a "normal" corporation. The SPE will hold assets and finance them through debt and equity issued to institutional investors or public shareholders. To reduce the interest rate paid on the debt, the SPE will obtain credit enhancements (for example, guarantees or similar derivative arrangements) often from the transferor and or other third parties. This spreading of the risk through the credit enhancements, coupled with the fact that the SPE's securities are usually liquid and easily traded, generally reduces the cost of the borrowing to a level below what it would have been had the transferor directly borrowed money from a bank or the market.

Most SPE transactions are off-balance sheet. This means that financial information about the SPE, including its assets and liabilities, does not appear in the financial statements of the transferor.

The accounting literature regarding SPE consolidation is found in materials issued by the EITF.[11] In order to achieve off-balance sheet treatment of an SPE pursuant to GAAP, two conditions must be met. First, the assets must be sold to the SPE (be legally isolated from the transferor) and, second, an independent third party owner that has made a substantive capital investment (which amounts to at least 3% of the SPE's total capitalization) must both control the SPE and possess the substantive risks and rewards of owning the SPE's assets. If executed properly, the legal isolation and the control by a third party reduce the risk of the creditor, as discussed above. Thus, off-balance sheet

11 See: EITF Issue No. 90-15, *Impact of Nonsubstantive Lessors, Residual Value Guarantees, and Other Provisions in Leasing Transactions*; EITF Issue No. 96-21, *Implementation Issues in Accounting for Leasing Transactions involving Special-Purpose Entities;* and EITF Topic No. D-14, *Transactions involving Special-Purpose Entities.*

treatment of an SPE involves more than just sufficient third-party equity. This equity must be "at risk" from the investor's perspective. If the investor's return is guaranteed or not "at risk," the transferor would be required to consolidate the SPE in its financial statements.

As noted in the Form 8-K filing, Enron has concluded that three previously unconsolidated SPEs did not qualify for nonconsolidation pursuant to GAAP. Thus, Enron plans to restate its financial statements to reflect these entities in the consolidated statements of financial position and results of operations.

The SEC, as noted in its Annual Report to Congress for 2000, has urged the FASB to continue their efforts to provide consolidation guidance concerning SPEs. The FASB has announced its intention to concentrate on developing guidance for dealing with several consolidation issues that would resolve many problems encountered in present practice, including issues related to special-purpose entities. We will continue to urge the FASB to address SPE consolidation issues to increase financial statement transparency.

Reduction in Shareholders' Equity

Part of Enron's announced restatement includes a $1.2 billion reduction in shareholders' equity. Enron created four SPEs in 2000 and, as part of their initial capitalization and a series of ongoing transactions, issued its own common stock in exchange for notes receivable. At the time, Enron increased notes receivable and shareholders' equity to reflect these transactions. However, in announcing its restatement Enron disclosed that it had concluded that pursuant to GAAP[12] these notes receivable should have been presented as a reduction of shareholders' equity. GAAP generally requires that notes receivable arising from transactions involving a company's capital stock be presented as deductions from stockholders' equity and not as assets. Enron has

12 EITF Issue No. 85-1, *Classifying Notes Received for Capital Stock*, and SEC Staff Accounting Bulletin No. 40, Topic 4-E, *Receivables from Sale of Stock*.

indicated that they overstated both total assets and shareholders' equity by $172 million due to a transaction first reported in the financial statements for the quarter ended June 30, 2000, and by an additional $828 million due to a transaction first reported in the quarter ended March 31, 2001. As a result, Enron has announced it intends to restate the financial statements for the second and third quarters in 2000 and its annual financial statements for 2000 for $172 million. The aggregate restatement for the first and second quarters for 2001 will be $1.0 billion

Enron also has disclosed that in the third quarter of 2001, it purchased a limited partnership's equity interest in an SPE, and that transaction resulted in a further reduction of shareholders' equity by $200 million. Enron also disclosed, without further explanation, that the $200 million related to the excess of the fair value of contracts deliverable by Enron over its notes receivable.

Mark-to-Market Accounting

Some members of the Subcommittees have requested that I also discuss mark-to-market accounting issues as applied to energy contracts. It should be noted, however, that Enron has not indicated that it intends to restate its financial statements due to mark-to-market accounting issues.

Entities commonly enter into contracts for the purchase and sale of energy commodities. Historically, most energy contracts were settled by physical delivery. However, in recent years companies have entered into energy contracts, at rapidly increasing rates, to speculate on market movements, to conduct hedging transactions, or otherwise to generate gains from market price differences.

To determine the proper accounting for these contracts pursuant to GAAP, a multi-step process must be undertaken. The first step is to evaluate whether a contract is a derivative[13] in its entirety (as defined by GAAP). If the contract is not a derivative, then the company would determine if the contract is an energy-trading contract. [14]

If the contract is determined to be an energy-trading contract, then GAAP requires that the nonderivative energy-trading contract be marked to market with gains and losses included in earnings and separately disclosed in the financial statements or footnotes thereto. GAAP provides a set of indicators to consider when determining whether an operation's energy contracts are entered into for trading purposes.

Consistent with GAAP for financial instruments such as debt and equity securities and derivatives, GAAP does not specify how to compute fair value for energy trading contracts, other than that it should be done on an individual contract basis. Instead, GAAP provides a general principle, stating that fair value is the amount at which a contract could be bought or sold in a current transaction with willing parties, that is, other than in a forced or liquidation sale.

Pursuant to GAAP, a quoted market price in active markets is considered the best evidence of fair value and shall be used as the basis for the measurement, when available. If a quoted market price is not available, GAAP requires companies to estimate fair value based on the best information available in the circumstances. As quoted market prices may not exist for many energy trading contracts, companies must consider prices for similar energy contracts and the results of valuation techniques to the extent available in the circumstances. When valuation techniques or models are used, the best information for companies to consider includes recent spot prices and forward prices. .An energy price curve is constructed by compiling forward prices of what the energy commodity is expected to be one to five years in the future. Specifically, observable forward prices are

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13 A derivative is an instrument whose value is derived, in part, by reference to a stated index or other means. Derivative instruments are defined in Statement of Financial Accounting Standards No. 133, *Accounting for Derivative Instruments and Hedging Activities.*

14 EITF Issue No. 98-10, *Accounting for Contracts Involved in Energy Trading and Risk Management Activities.* These criteria require an analysis of many factors including capacity, customers, volume, internal controls and the contracts themselves.

generally available up to three years into the future. In addition, broker-dealer prices are often available four to five years into the future. As a result, similar energy contracts with similar durations of five years or less have observable fair values within a narrow range.

However, a wide range of fair value estimates may result as the duration of an energy contract exceeds five years. Forward prices beyond the fifth year must be estimated, so the assumed rate of volatility has an important role in the assignment of fair value. Generally, prices are less volatile in the long run than in the short run. However, the current accounting guidance is not specific as to the application of fair value methods, so the assumed volatility of energy prices may vary, potentially leading to a wider range of assessed fair values.

Enron applies mark-to-market accounting for its energy trading activities. Enron has disclosed that the market prices it used to value its energy trading contracts reflect "its best estimate considering various factors including closing exchange and over-the-counter quotations, time value and volatility factors underlying the commitments."

Enron disclosed that it engages in price risk management activities for both trading and non-trading purposes. Enron's net assets from price risk management activities were approximately $1,088 million and $300 million at December 31, 2000 and 1999, respectively. While Enron discloses that it reports changes in its market values as part of other revenues (total other revenues were $7.2 billion for the year ended December 31, 2000), it is unclear from its public filings what portion of its revenues comes from the changes in values. In its statement of cash flows, however, Enron notes that approximately $763 and $395 million of income was recognized from price risk management activities that did not result in the receipt of cash in 2000 and 1999, respectively.

Improving the Disclosure and Regulatory System

In an "Op Ed Discussion" in the December 11, 2001 issue of The Wall Street Journal, Chairman Pitt has enumerated many initiatives for improving and modernizing the current disclosure and regulatory systems. A copy of the article is attached as Appendix B. Chairman Pitt, with significant input from those inside and outside the Commission, began development of these initiatives prior to the announcements by Enron. These initiatives, not yet adopted by the Commission, include:

- More current disclosure, including "real-time" disclosure of unquestionably material information,
- Disclosure of significant trend data and more "evaluative" data,
- Financial statements that are more clear and informative for investors,
- Disclosure of the accounting principles that are most critical to the company's financial status and that involve complex or subjective decisions by management,
- Private sector standard setting that is more responsive to the current and immediate needs of investors,
- A regulatory environment that continues, as always has been the case, to encourage public companies and the auditors of their financial statements to seek the advice of the SEC staff on new or unusual accounting questions so that they may "get it right the first time" and avoid restatements and the possibility of enforcement proceedings,
- A comprehensive and effective self-regulatory process for the accounting profession, as discussed above, with effective oversight by the Commission and its staff,
- More involvement by audit committees with management and the auditors regarding the selection and application of accounting principles used by the company, and
- Analysts not expressing views or recommendations when they do not have an adequate data foundation or when confused by company presentations.

As noted above, the accounting profession has announced its intention to assist the Commission in these efforts.

Conclusion

While the Commission's work relating to the Enron matter is just beginning, it is clear that with losses this sudden and deep to one of our largest reporting companies, we must look carefully at the adequacy of the current system of financial reporting. You can rest assured that the Commission and its staff are approaching this inquiry with an open mind and a firm intention to find out exactly what occurred and to deter, where possible, similar occurrences in the future. Should we conclude that any legislative solutions seem appropriate or helpful, we will seek the assistance of this Committee and your Subcommittees. We very much appreciate your prompt action and interest in having scheduled this hearing today and inviting us to participate.

Appendix A

Chronology of the Public Events Surrounding Enron

Enron, based in Houston, Texas, describes itself as a provider of products and services related to natural gas, electricity, and communications to wholesale and retail customers.

In 1999, a series of private investment limited partnerships, LJM Cayman, L.P. ("LJM1") and LJM2 Co-Investment, L.P. ("LJM2"), were created with Enron's then Executive Vice President and Chief Financial Officer serving as the managing member of the general partners. The CFO operated these partnerships as the managing member of the general partners while at the same time serving as an Enron senior executive.

In July 2001, the CFO relinquished his operating position in LJM1 and LJM2 and sold his interests to a non-executive officer of an Enron division who had previously reported to the CFO. This individual resigned from Enron immediately before purchasing the CFO's interests in the partnerships.

In August 2001, the President and CEO of Enron resigned citing personal reasons while acknowledging the pressure associated with the decline in the price of Enron's common stock during his six-month tenure as CEO. The current Chairman and former CEO reassumed the CEO title.

On October 16, 2001, Enron announced that it had recorded a $1.01 billion after-tax charge to its third-quarter earnings to recognize asset impairments, restructuring costs, and losses associated with certain investments. Enron subsequently disclosed that $35 million of this charge was related to transactions with LJM2.

In a conference call on October 16, 2001, Enron disclosed that shareholders' equity was reduced in the third quarter by $1.2 billion related to the company's repurchase of its common stock, which previously had been issued as part of a series of transactions involving special-purpose entities associated with LJM2. In subsequent disclosures, Enron has characterized the reduction in shareholders' equity as the correction of accounting errors.

On October 24, 2001, Enron replaced the CFO. He subsequently was terminated.

On November 8, 2001, Enron filed a Form 8-K with the Commission. In the Form 8-K, Enron announced, among other matters, the following:

- Its intention to voluntarily restate its financial statements for the years ended December 31, 1997 through 2000 and the quarters ended March 31 and June 30, 2001 reducing previously reported net income for the last four and one-half years by $569 million, or 16% of reported net income for those four and one-half years. In connection with that announcement, Enron alerted investors not to rely upon the previously issued financial statements for these periods, including the audit reports of Arthur Andersen LLP covering the year-end financial statements for 1997 to 2000.
- Its intention to file a restatement recording: (1) a previously announced $1.2 billion reduction to shareholders' equity reported by Enron; (2) various income statement and balance sheet adjustments as the result of a determination by Enron and its auditors that three unconsolidated entities should have been consolidated in the financial statements pursuant to generally accepted accounting principles ("GAAP"); and (3) prior-year proposed audit adjustments and reclassifications (that were previously not recorded because they were determined to be immaterial in the year originally proposed and therefore never recorded).
- A Special Committee of the Board of Directors had been formed to investigate the matters disclosed in the Form 8-K and the Committee's investigation might result in additional or different information.

The restated financial statements that Enron indicated it would file have not yet been filed with the Commission.

On November 9, 2001, Dynegy Inc. announced its intention to acquire Enron for approximately $9 billion in Dynegy Inc. stock and the assumption of $13 billion in debt.

On November 19, 2001, Enron filed its Form 10-Q for the quarter ended September 30, 2001. The company updated some of the disclosures made in its November 8, 2001 Form 8-K and disclosed that it had initiated an action plan for the restructuring of its business that would negatively impact its fourth quarter earnings. Enron also disclosed that a note payable in the amount of $690 million related to a limited partnership had been accelerated due to a downgrade in Enron's debt rating. In addition, Enron disclosed additional debt amounts that would be accelerated if the company's debt rating fell below investment grade. The filing noted that the auditor of Enron's financial statements was unable to finalize its required review of the quarterly financial statements prior to filing with the Commission due to an ongoing investigation by the Special Committee.

On November 28, 2001, several rating agencies lowered Enron's long-term debt to below investment grade. Shortly after the downgrade, Dynegy terminated the merger agreement, citing breaches of representations, warranties, covenants and agreements in the merger agreement including a material adverse change provision.

On December 2, 2001, Enron filed for Chapter 11 bankruptcy protection and simultaneously sued Dynegy for $10 billion alleging breach of contract in connection with Dynegy's wrongful termination of its proposed merger.

As noted previously, the Commission's investigation into these matters is continuing.

APPENDIX B

How to Prevent Future Enrons
By Harvey L. Pitt

12/11/2001
The Wall Street Journal
Page A18

The Securities and Exchange Commission is investigating **Enron** 's meltdown and its tragic consequences. Until all the facts are known, there is nothing that can or should be said about who may be responsible for this terrible failure. The public can be confident, however, that we will deal with any wrongdoing and wrongdoers swiftly and completely, to ensure full protection of investor interests.

Even before the **Enron** situation, we were working to improve and modernize our disclosure system -- to make disclosures more meaningful, and intelligible, to average investors. Our immediate concern in the wake of this tragedy should be to understand how to prevent more events like this. Of course, those with intent and creativity can override any system of checks or restraints. Believing that we can create a foolproof system is both illusory and dangerous. But investors are entitled to the best regulatory system possible, and we can achieve more than we presently do if we focus attention on finding solutions instead of scapegoats.

Our current reporting and financial disclosure system has needed improvement and modernization for quite some time. Disclosures to investors are now required only quarterly or annually, and even then are issued long after the quarter or year has ended. This creates the potential for a financial "perfect storm." Information investors receive can be stale on arrival and mandated financial statements are often arcane and impenetrable.

To reassure investors and restore their confidence, the public and private sectors must partner to produce a sensible and workable approach that includes, in addition to our existing after-the-fact enforcement actions:

-- A system of "current" disclosure. Investors need current information, not just periodic disclosures, along with clear requirements for public companies to make affirmative disclosures of, and to provide updates to, unquestionably material information in real time.

-- Public company disclosure of significant current "trend" and "evaluative" data. Providing current trend and evaluative data, as well as historical information, would enable investors to assess a company's financial posture as it evolves and changes. It would also preclude "wooden" approaches to disclosure, and encourage evaluative disclosures that begin where line-item and Generally Accepted Accounting Principles disclosures end. This information, upon which corporate executives and bankers already base critical decisions, can be presented without confusing or misleading investors, prejudicing legitimate corporate interests, or exposing companies to unfair assertions of liability.

-- Financial statements that are clear and informative. Investors and employees concerned with preserving and increasing their retirement funds deserve comprehensive financial reports they can easily interpret and understand.

-- Conscientious identification and assessment by public companies and their auditors of critical accounting principles. Public companies and their advisers should identify the three, four or five most critical accounting principles upon which a company's financial status depends, and which involve the most complex, subjective or ambiguous decisions or assessments. Investors should be told, concisely and clearly, how these principles are applied, as well as information about the range of possible effects in differing applications of these principles.

-- Private-sector standard setting that responds expeditiously, concisely and clearly to current and immediate needs. A lengthy agenda that achieves its goals too slowly, or not at all, like good intentions, paves a road to the wrong locale.

-- An environment that encourages public companies and auditors to seek our guidance in advance. The SEC must be, and must appear to be, a constructive resource and hospitable sounding board for difficult and complex accounting issues before mistakes are made. We will always need, and utilize, after-the-fact enforcement, and we can, and will, improve our review of financial reports. But by now it is painfully clear that preventing problems is infinitely superior, and far less damaging, than acting after investor funds, retirement accounts or life savings are dissipated.

-- An effective and transparent system of self-regulation for the accounting profession, subject to our rigorous, but non-duplicative, oversight. As the major accounting firm CEOs and the American Institute of Certified Public Accountants recently proposed, the profession, in concert with us, must provide assurances of comprehensive and effective self-regulation, including monitoring adherence to professional and ethical standards, and meaningfully disciplining firms or individuals falling short of those standards. Such a system has costs, but those who benefit from the system should help absorb them.

-- More meaningful investor protection by audit committees. Audit committees must be proactive, not merely reactive, to ensure the quality and integrity of corporate financial reports. Especially critical is the need to improve interaction between audit committee members and senior management and outside auditors. Audit committees must understand why critical accounting principles were chosen, how they were applied, and have a basis for believing the end result fairly presents their company's actual status.

-- Analyst recommendations predicated on financial data they have deciphered and interpreted. Analysts and their employers should eschew expressing views without an adequate data foundation, or when confused by company presentations.

Our system can be improved and modernized. In a crisis, some seek easy answers to difficult problems by pointing fingers. But true reform requires rigorous analysis, respect for competing views, and compromise and statesmanship by all concerned. We are up to the task, but only if we are able to tap our best minds to produce our most creative solutions, and only if we are able to discuss these issues openly and honestly. We are committed to that end, and we seek participation from everyone with an interest in our capital markets. Together, in partnership, we can make a difference. That is our vision, and our mission.

Mr. Pitt is chairman of the Securities and Exchange Commission.

Remarks of Joseph F. Berardino
Managing Partner – Chief Executive Officer, Andersen

U.S. House of Representatives
Committee on Financial Services
December 12, 2001

Chairman Oxley, Congressman LaFalce, Chairman Baker, Congressman Kanjorski, Chairwoman Kelly, Congressman Gutierrez, Members of the Committee.

I am here today because faith in our firm and in the integrity of the capital market system has been shaken. There is some explaining to do.

What happened at Enron is a tragedy on many levels. We are acutely aware of the impact this has had on investors. We also recognize the pain this business failure has caused for Enron's employees and others.

Many questions about Enron's failure need to be answered, and some involve accounting and auditing matters. I will do my best today to address those.

I ask that you keep in mind that the relevant auditing and accounting issues are extraordinarily complex and part of a much bigger picture. None of us here yet knows all the facts. Today's hearing is an important step in enlightening all of us. I am certain that together we will get to the facts.

If there is one thing you take away from my testimony, I hope it is this: Andersen will not hide from its responsibilities. That's why I'm here today. The public's confidence is of paramount importance. If my firm has made errors in judgment, we will acknowledge them. We will make the changes needed to restore confidence.

Today, I want to address two issues that go to the heart of concerns about our role as Enron's auditor.

First, did we do our job? I want to explain what we knew and when we knew it on several key issues, keeping in mind that our own review – like yours – is still under way.

Second, did we act with integrity? I want to discuss the $52 million in fees we received and respond to concerns that have been raised.

I also want to talk about what I believe are some of the lessons we can already learn from Enron – for our firm, for the accounting profession, and for all participants in the financial reporting system.

Let me start by telling you what we know about three particular accounting and reporting issues:

- the restatements caused by the consolidation of two Special Purpose Entities, known as SPEs, and the recording of previously "passed" adjustments as a required byproduct of the restatement;
- a $1.2 billion reclassification in the presentation of shareholders' equity during 2001 – of which $172 million was misclassified in the audited 2000 financial statement, and;
- the company's disclosures about its off-balance-sheet transactions and related financial activities.

I want to emphasize that my remarks are based on the information that is currently available. We have made our best efforts to be complete and accurate in describing what we know. But our review, like the work of the SEC, this Committee, Enron's board, and others, is not yet complete. It is always possible that new information could be developed that would change current understanding of events or uncover new events.

Consolidation of Special Purpose Entities

Let me begin with the Special Purpose Entities. SPEs are financing vehicles that permit companies, like Enron, to, among other things, access capital or to increase leverage without adding debt to their balance sheet. Wall Street has helped companies raise billions of dollars with these structured financings, which are well known to analysts and sophisticated investors.

Two SPEs were involved in Enron's recent restatement announcement. On one, the smaller of them, we made a professional judgment about the appropriate accounting treatment that turned out to be wrong. On the one with the larger impact, it would appear that our audit team was not provided critical information. We are trying to determine what happened and why.

Let's begin with the larger SPE, an entity called Chewco. What happened with Chewco accounted for about 80 percent of the SPE-related restatement.

In 1993, Enron and the California Pubic Employees Retirement System (Calpers) formed a 50/50 partnership they called Joint Energy Development Investments Limited, or JEDI for short. Among other factors, the fact that Enron did not control more than 50 percent of JEDI meant that

that partnership's financial statements could not be consolidated with Enron's financial statements under the accounting rules. In 1997, Chewco bought out Calpers' interest in JEDI. Enron sponsored Chewco's creation as an SPE and had investments in Chewco.

The rules behind what happened are complex, but can be boiled down to this. The accounting rules dictate, among other things, that unrelated parties must have residual equity equal to at least 3 percent of the fair value of an SPE's assets in order for the SPE to qualify for non-consolidation. However, there is no prohibition against company employees also being involved as investors, provided that various tests were met, including the 3 percent test.

In 1997, we performed audit procedures on the Chewco transaction. The information provided to our auditors showed that approximately $11.4 million in Chewco had come from a large international financial institution unrelated to Enron. That equity met the 3 percent residual equity test. However, we recently learned that Enron had arranged a separate agreement with that institution under which cash collateral was provided for half of the residual equity.

What happened?

Very significantly, at the time of our 1997 procedures, the company did not reveal that it had this agreement with the financial institution. With this separate agreement, the bank had only one-half of the necessary equity at risk. As a result, Chewco's financial statements since 1997 were required to be consolidated with JEDI's which, in a domino effect, then had to be consolidated in Enron's financial statements.

It is not clear why the relevant information was not provided to us. We are still looking into that. On November 2, 2001, we notified Enron's audit committee of possible illegal acts within the company, as required under Section 10A of the Securities and Exchange Act.

Now, about the second SPE structure; specifically, a subsidiary of the entity known as LJM1. This transaction was responsible for about 20 percent -- or $100 million -- of Enron's recent SPE-related restatement.

In retrospect, we believe LJM1's subsidiary should have been consolidated. I am here today to tell you candidly that this was the result of an error in judgment. Essentially, this is what happened:

After our initial review of LJM1 in 1999, Enron decided to create a subsidiary within LJM1, informally referred to as Swap Sub. As a result of this change, the 3 percent test for residual equity had to be met not only by LJM1, but also by LJM1's subsidiary, Swap Sub.

In evaluating the 3 percent residual equity level required to qualify for non-consolidation, there were some complex issues concerning the valuation of various assets and liabilities. When we reviewed this transaction again in October 2001, we determined that our team's initial judgment that the 3 percent test was met was in error. We promptly told Enron to correct it.

We are still looking into the facts. But given what we know now, this appears to have been the result of a reasonable effort, made in good faith.

Adjustments previously not made to Enron's 1997 financial statement

As a result of the restatement for the SPEs, Enron was required to address proposed adjustments to its financial statements that were not made during the periods subject to restatement. Questions have been raised about certain of these "passed adjustments." Let me address that issue next.

As part of the audit process, the auditor proposes adjustments to the company's financial statements based on its interpretation of Generally Accepted Accounting Principles (GAAP). A company's decision to decline to make proposed adjustments does not mean that there has been an intentional effort to misstate. If the auditor believes that the company's actions result in either an intentional error or a material misstatement, it may not sign the audit opinion.

Often, there is a timing issue to consider. These adjustments typically are proposed by the auditor at the conclusion of the audit work – usually one or two months after the close of the year-end. Some companies, like Enron, choose to book those adjustments in the year after the auditor identifies them, when they are immaterial.

Questions have been raised about $51 million in adjustments not made in 1997 when Enron reported net income totaling $105 million. Some have asked how adjustments representing almost half of reported net income could have been deemed to be immaterial.

Auditing standards and SEC guidance say both qualitative and quantitative factors need to be considered in determining whether something is material. The Supreme Court has described this approach as the "total mix" of information that auditors must consider.

In 1997, Enron had taken large nonrecurring charges. When the company decided to pass these proposed adjustments, our audit team had to determine whether the company's decision had a material impact on the financial statements. The question was whether the team should only use reported income of $105 million, or should it also consider adjusted earnings before items that affect comparability – what accountants call "normalized" income?

We looked at "the total mix" and, in our judgment, on a quantitative basis, the passed adjustments were deemed not to be material, amounting to less than 8 percent of normalized earnings. Normalized income was deemed appropriate in light of the fact that the company had reported net income of $584 million one year earlier, in 1996, $520 million in 1995 and $453 million in 1994.

It is also important to remind you that the restatement analysis presented in Enron's recent 8-K filing was not audited. When Enron's audited restatement is issued, the $51 million in adjustments presented in 1997 will be reduced for the effect of adjustments proposed in 1996, which were recorded in 1997.

Reclassification of $1.2 billion of shareholders' equity

Now let me turn to the issue of shareholders' equity. Shareholders' equity was incorrectly presented on Enron's balance sheet last year and in two unaudited quarters this year.

Auditors do not test every transaction and they are not expected to. To do so would be impractical and would be prohibitively expensive. EnronOnline alone handled over 500,000 transactions last year.

Auditing standards require an audit scope sufficient to provide reasonable – not absolute -- assurance that any material errors will be identified. This testing is based on a cost-effective and proven technique known as sampling. If appropriate accounting is found in a properly chosen sample, this generally provides reasonable assurance that the accounting for the whole population of transactions has been done in accordance with GAAP and is free of material misstatement.

Shareholders' equity was initially overstated last year for a transaction with a balance sheet effect of $172 million. This amount was recorded as an asset, but should have been presented as a reduction in shareholders' equity. That amount, $172 million, was less than one third of one percent of Enron's total assets and approximately 1.5 percent of shareholders' equity of $11.5 billion. It was a very small item relative to total assets and equity and had no impact on earnings or cash flow. Accordingly, the transaction fell below the scope of our audit.

In the first quarter of this year, Enron accounted for several more transactions in a similar way, increasing the size of the incorrect presentation of shareholders' equity by about $828 million.

The quarterly financial statements of public companies are not subject to an audit, and we did not conduct an audit of Enron's quarterly reports. Consistent with the applicable standards, our work primarily was a limited review of the company's unaudited financial statements.

In the third quarter, Enron closed out the transactions that included the $172 million and the $828 million equity amounts, and we and Enron reviewed the associated accounting. This review included third-quarter impacts on the profit and loss statement and on the balance sheet. This is when the erroneous presentation of shareholders' equity came into focus.

We had discussed the proper accounting treatment for similar types of transactions with Enron's accounting staff, and therefore, the scope of our work on the year 2000 audit and this year's quarterly reviews did not anticipate this sort of error. When we informed the company of the error, the company made the necessary changes in its financial statements.

Questions about disclosure

Questions have been raised about the sufficiency of Enron's disclosures, especially about unconsolidated entities. I ask you to keep in mind that the company disclosed in its financial statements that it was using a number of unconsolidated structured financing vehicles. Unconsolidated means, by definition, that the assets and liabilities of these entities were not recorded in Enron's financial statements. However, in certain circumstances, footnote disclosures are required.

With that disclaimer, let me offer one man's view of what investors were told. Enron had hundreds of structured finance transactions. Some were simple; others, very complex. The company did not disclose the details of every transaction, which is acceptable under GAAP, but it did disclose those involving related parties and unconsolidated equity affiliates.

- JEDI and other entities are listed in footnote nine of Enron's 2000 annual report.

- LJM1 and LJM2, involving the company's former CFO, both were described in the 1999 and 2000 annual reports and described more fully in its annual proxy statements.

In footnote 11 to the 2000 annual report, Enron also disclosed under the heading "Derivative Instruments" that it had derivative instruments on 12 million shares of its common stock with JEDI and 22.5 million with related parties.

Some people say we should have required the company to make more disclosures about contingencies, such as accelerated debt payments, associated with a possible decline in the value of Enron's stock or changes in the company's credit rating.

I ask you to keep in mind that the company's shares were coming off near record levels when we completed our audit for 2000. No one could have anticipated the sudden, rapid decline we witnessed in this stock and its credit ratings, and accounting rules don't require a company to disclose remote contingencies.

That said, we continue to believe investors would be better served if our accounting rules were changed to reflect the risks and rewards of transactions such as SPEs, not just who controls them. Putting more of the assets and liabilities that are at risk on the balance sheet would do more than additional disclosure ever could. We have advocated changes in these accounting rules since 1982.

I offer an additional observation about Enron's disclosures. Press reports indicate that some who analyzed the company's public disclosures came to the conclusion that perceptions about the company – and thus the market's valuation of Enron – were not supported by what was in the company's public filings.

Fees paid to Andersen

Some are questioning whether the size of our fees, $52 million, and the fact that we were paid $27 million for services other than the Enron audit, may have compromised our independence at Enron. I understand that the size of fees might raise questions, and I think our profession must be sensitive to that perception.

With that in mind, I think it would be helpful for the Committee to have a deeper understanding of the nature of the work we did for Enron, and how the fees for that work were reported.

As a starting point, it is important to recognize that Enron was a big, complex company. Enron had $100 billion in sales last year. It operated 25,000 miles of interstate pipeline and an 18,000-mile global fiber optic network. Enron did business in many countries. Its EnronOnline trading system was the world's largest web-based eCommerce system and handled more than half a million transactions last year – for 1,200 products. Enron was the seventh largest company on the Fortune 500.

This was not a simple company. It was not a simple company to audit. In addition to its operations and trading, Enron, as we know, engaged in sophisticated financial transactions. Not a few, but hundreds. Assets worldwide totaled $65 billion, both before and after Enron adjusted for the restatements

Given this complexity, it should not surprise anyone that the fees paid to our firm for Enron's audit were substantial. The $25 million we were paid for Enron's audit last year is comparable to the amounts that General Electric and Citigroup, two sophisticated financial services providers, paid for their audits. It is slightly more than the audit fees paid by two others -- JPMorgan Chase and Merrill Lynch.

Because of the way the fee categories for new proxy statement disclosures on auditor fees were defined, many services traditionally provided by auditors – and in many cases *only* provided by auditors – now are classified as "Other." Regrettably, without knowledge of the underlying facts, this leads some to believe that such fees are for "consulting" services.

In fact, $2.4 million of the $27 million in "Other" fees reported by Enron last year related to work we did on registration statements and comfort letters. This is work only a company's audit firm can do.

Another $3.5 million was for tax work, which has never even been mentioned as a conflict with audit work. Audit firms almost always do tax work for clients.

Another $3.2 million of the "Other" fees Enron paid us last year related to a review of the controls associated with a new accounting system – a service highly relevant to the auditor's understanding of the company's financial reporting system. Another Big Five firm installed that financial accounting system -- for about $30 million.

Finally, $4 million of the fees listed as having been paid to Andersen were, in fact, paid to Andersen Consulting, now known as Accenture. As most of you know, our firms formally separated last August and had been operating as independent businesses for some time. Nevertheless, the rules said Enron had to report any fees it paid to Andersen Consulting as having been paid to its audit firm.

If you take all these factors into account, the total fees that Arthur Andersen received from Enron last year amounted to $47.5 million. And of this, about $34.2 million, or 72 percent, was audit-related and tax work. Total fees for other services paid to our firm amounted to $13.3 million. This was for several projects, none of which was for systems implementation or for more than $3 million.

Some may still assert that even $13 million of consulting work is too much – that it weakens the backbone of the auditor. There is a fundamental issue here. Whether it's consulting work or audit work, the reality is that auditors are paid by their clients. For our system to work, you and the investing public must have confidence that the fees we are paid, regardless of the nature of our work, will not weaken our willingness to do what is right and in the best interest of the investors as represented by the audit committee and the board.

I do not believe the fees we received compromised our independence. Obviously, some will disagree. And I have to deal with the reality of that perception. I am acutely aware that our firm must restore the public's trust. I do not have all the answers today. But I can assure you that we are carefully assessing this issue and will take the steps necessary to reassure you and the public that our backbone is firm and our judgment is clear.

Lessons for the Future

When a calamity happens, it is absolutely appropriate to ask what everyone involved could have done to prevent it. By asking the other witnesses and me to testify today, the committee is working hard, in good faith, to understand the issues involved and to help prevent a recurrence with another company.

I believe that there is a crisis of confidence in my profession. This is deeply troubling to me, as I believe it is a concern for all of the profession's leaders and, indeed, all of our professionals. Real change will be required to regain the public's trust.

Andersen will have to change, and we are working hard to identify the changes that we should make.

The accounting profession will have to reform itself. Our system of regulation and discipline will have to be improved. I discussed some of the issues that the profession faces in an op-ed in the *Wall Street Journal* last week, which is attached to my testimony.

Other participants in the financial reporting system will have to do things differently as well – companies, boards, audit committees, analysts, investment bankers, credit analysts, and others.

We all must work together to give investors more meaningful, relevant and timely, information.

But our work starts with our firm. We are committed to making the changes needed to restore confidence.

A day does not go by without new information being made available, and I would observe that all of us here today -- and many others who are not here -- have a responsibility to seek out and evaluate the facts and take needed action. My firm, and I personally as its CEO, will continue to do our part. I hope that my participation today has been helpful to your efforts.

Thank you.

ANDERSEN

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The Honorable Richard Baker
House Financial Services Committee
Subcommittee on Capital Markets, Insurance
and Government Sponsored Enterprises
Washington DC 20515

December 13, 2001

Dear Mr. Chairman:

Thank you for giving me the opportunity to testify before the subcommittee yesterday. I would like to request that the official record reflect a clarification of two points in my oral testimony on December 12, 2001.

With regard to fees, please let the record reflect that Andersen received $52 million from Enron last year as the written testimony attests, rather than the $59 million referred to in oral testimony.

With regard to the complexity of Enron, please let the record reflect that the company in engaged in more than 500,000 financial transactions involving EnronOnline alone each year as the written testimony attests, rather than the more than 500 million referred to in the oral testimony.

Sincerely,

Joe Berardino

Joseph Berardino
Managing Partner, Chief Executive Officer
Andersen

CC: The Honorable Michael Oxley
The Honorable John LaFalce
The Honorable Paul Kanjorski
The Honorable Sue Kelly
The Honorable Luis Gutierrez

ANDERSEN

January 21, 2002

The Honorable Michael G. Oxley
Chairman
Committee on Financial Services
United States House of Representatives
2129 Rayburn House Office Building
Washington, DC 20515

Dear Chairman Oxley:

Thank you for your letter dated January 15, 2002. I appreciate the opportunity to clarify and supplement the testimony that I gave on December 12, 2001 at a hearing before the Committee on Financial Services.

We are still learning about what happened at Enron, in light of the complex and challenging issues involved. We do not yet know all the facts, but we are continuing to examine our relationship with, and our work for, Enron.

The hearing in December was an important first step in an open dialogue between Andersen and your Committee. I hope you will review this letter in that spirit of openness and cooperation.

My testimony was intended to communicate the substance of some very complex transactions in a relatively uncomplicated manner. I had hoped to convey at the outset and throughout my testimony the complexity of the auditing and accounting issues at the heart of this matter. What I said was based on my understanding at the time. The essential substance of what I reported to you was correct. However, I have since learned additional details of which I want to be sure your committee is aware.

These details relate to my description of Enron's 1997 transaction with the special purpose entity ("SPE") known as Chewco. While the details of that transaction were known to some members of the team that were investigating the related party issues at Enron, the members of the team helping me draft my testimony were not aware of them. As a result, elements of my written and oral testimony were unintentionally imprecise in some respects.

I want to assure you that the two main points of my original testimony on this issue were, and continue to be, accurate. These are the critical issues of relevance to the major reason that Enron was required to restate its financial statements for the years 1997 through 2000.

- First, we were not provided critical information regarding the nature of the arrangements with the major financial institution that was represented to us as being the source of the independent equity capital at risk in Chewco.

- Second, had we been provided that information in 1997, we would have objected to the accounting treatment used by Enron during the period 1997 through the first two quarters of 2001 for this transaction. Thus, there would not have been any need for the Chewco/JEDI portion of Enron's restatement.

Based on further review, and recognizing that our review of key issues continues, I do want the committee's record to include the following clarification. Based on documents we did not have in 1997 but which were made available to us in early November 2001, the $11.4 million "equity interest" provided by Barclays was, in fact, in the form of yield certificates the bank purchased from two intermediary entities, Big River Funding LLC and Little River Funding LLC. If these facts had been known to us in 1997, a key issue would have been the terms of the certificates. Depending on the terms, Enron could have been required to treat the capital as debt rather than equity, disqualifying the SPE from non-consolidation.

When I appeared before this committee on December 12, 2001, I was not aware of the details of these intermediary relationships. In fact, Little River Funding LLC held interests in Big River Funding LLC. Big River Funding LLC held interests in Chewco. It was my understanding at the time that Barclays' interest was direct. However, these facts were not at the root of our conclusion that Enron's accounting for Chewco was in error.

The reason for our conclusion was that under a separate agreement between JEDI and Chewco dated December 30, 1997 – which was not provided to our team in 1997 when we asked for all Enron and JEDI documents – JEDI agreed to deposit $6 million into a reserve funding account that was established for the benefit of Barclays. In my testimony on December 12, 2001, I stated that this agreement was between Enron and the bank. It appears that the deposit was a condition upon funding of the Barclays certificate. This cash collateral agreement, whether from Enron or JEDI, meant that only about half the required 3% equity was actually at risk. This alone meant Chewco did not qualify as an unconsolidated SPE.

Because the establishment of the reserve funding account was sufficient by itself to cause Enron's accounting for Chewco and JEDI to be incorrect, we did not complete and still have not completed our analysis of the accounting implications of the terms of the intermediary investment vehicles or the yield certificates. We advised Enron of our conclusion immediately and the disclosures made by Enron that it would be restating its financial statements reflect that advice.

As I said at the outset, these are complex issues. I hope that this letter has clarified and expanded your understanding of these events.

Again, Mr. Chairman, I want to express my firm's commitment, as well as my personal commitment, to make every effort to be forthcoming, complete and accurate in helping you in this important work. As I told you in December, what happened at Enron is a tragedy on many levels. Many questions about this company's failure need to be answered. With your help, we will do our best address them.

Sincerely,

Joe Berardino

Joseph F. Berardino

Testimony of
Charles L. Hill
Director of Research
Thomson Financial / First Call
before the joint session of
the House Subcommittee on
Capital Markets, Insurance, and Government Sponsored Enterprises
and
the House Subcommittee on
Oversight and Investigations
12 October 2001

Chairman Oxley, Chairman Baker, Chairwoman Kelly, ranking members Kanjorski and Gutierrez, and members of the Subcommittee:

BROKER ANALYST'S ANALYSIS OF ENRON

Prologue

I welcome the opportunity to again testify in front of the House Financial Services Committee. I believe this committee has been addressing substantive issues that are important not only to the future health of the investment community, but important to the general public's perception of and confidence in the overall capitalist system.

The excesses associated with Enron that led to its bankruptcy are more far reaching than just their impact on Enron.

There is plenty of blame to go around in the mistakes made in the Enron situation. I am here today to focus on the role of the broker analysts in this debacle.

In my previous testimony before this committee, I did not tread lightly on what I thought were some serious problems in analyst behavior that needed to be remedied.

I am here this morning, however, to say that the analysts to some degree were more victims rather than culprits in the Enron situation. Not that they were without blame, particularly in the late stages of the Enron collapse, but they were not the underlying cause of the excessive rise in Enron's stock that later proved to be irrational.

The performance of the analysts should be judged on two fronts. The first is their analysis of Enron's fundamentals, particularly in regard to earnings. The second is their valuation assessment and recommendations of Enron stock.

Analysis of Enron Fundamentals by Broker Analysts

The thing that stands out most visibly about the analyst's analyses of Enron, is that over the three years up to October 2001, their estimates at the beginning of each year for that year had minimal changes. The few changes that did occur were always upward and usually followed the guidance given by the company when they reported quarterly earnings. The narrowness of the spread of estimates among analysts was remarkable, especially for an energy company. The coefficient of variance for Enron estimates was consistently below the average for the S&P500 during the same period.

This pattern is highly suggestive that the analysts were being spoon fed as to what Enron expected earnings to be. The analysts might have been willing to accept company guidance, be it overt or inferred, as long as the company kept meeting expectations each quarter. Since at least the beginning of 1998, Enron has met or exceeded analyst estimates every quarter.

One reason that analysts may have been more willing than normal to accept company guidance for Enron was that it was becoming increasingly difficult to understand how Enron was achieving its revenue growth and profitability. Extensive use of derivatives, particularly when the company is using mark-to-market accounting is extremely difficult in the best of situations. We now know that a big additional reason for the difficulties in analyzing Enron's financials was that there were significant parts of Enron's business that were hidden from the balance sheet.

Often the way out for analysts when faced with difficult to analyze situations like Enron is to drop coverage. Why take the risk when there are plenty of companies that are transparent enough to do meaningful analysis with confidence? The problem with dropping Enron was that it had become the giant in the industry. If you were an analyst covering that industry, you essentially had to cover Enron. That was further reinforced if your firm was one of Enron's investment bankers or investment banker wannabe.

The real problem though was having sufficient information about the off balance sheet items. Whether the accounting for each of these items was within FASB rules or not is not yet clear, although the announced restatement of prior periods earnings is a strong signal that at least not all was kosher. But what is clear is that Enron was not providing what could even be considered minimum transparency in its financials and that the analysts did not have all the tools necessary to make a reasonable analysis.

Valuation of Enron Stock by Broker Analysts

In evaluating analyst performance on recommending Enron stock, one first has to understand how the brokerage community's recommendation really works. As I have testified before to this committee, the investor needs a two level decoder.

The first level of the decoder gets all the brokers on a common recommendation scale. The most common scale is a five tiered one, where the top category is a strong buy, the second is a buy, the third is hold, the fourth is sell, and the fifth is strong sell. Most brokers have a five tier scale, some have a four tier one, and a few have a three tier scale. In addition, many have very different terminology. The term "buy" may be the term used for the top category at some brokers, or for the second best category at many brokers, or, in at least one case, for the middle category. There are more than a dozen different terms used for each of the top three categories, and almost as many for the bottom two.

Unfortunately, getting all the firms on a common scale is not the end of the decoding. Analysts are overly biased on the positive side in their recommendations. The typical distribution is about 33% of all recommendations are in the top or strong buy category, about 33% in the second or buy category, about 33% in the middle or hold category, and only about 1% in the remaining sell and strong sell categories combined.

If the recommendations are put in numeric terms where 1 is a strong buy (or whatever the broker's term is for their top category), 2 is a buy, 3 is a hold, 4 is a sell, and 5 is a strong sell. Using this numerical scale, consensus recommendations can be calculated for each company. Most of the time the average consensus recommendation for either the companies in the S&P500, or for the roughly 5000 companies that analysts cover, is a 2.1. Occasionally, the average may be a 2.0 or a 2.2.

Therefore, the second level of the decoder would move the recommendations into three more meaningful categories. Those in the 1 or strong buy category would really be saying buy, at least in relative terms. Those in the 2 or buy category would really be saying they were neutral on the stock, and those in the 3 or hold, the 4 or sell, and the 5 or strong sell categories all would be saying sell the stock.

For Enron, the consensus recommendation, as shown on the accompanying graph, was about a 1.5 from May 2000 until the end of September 2001. Even if we had our decoder to compensate for analyst optimism, it is clear that the analyst covering Enron were very positive with their recommendations.

But during that same period, the analysts had similar or higher consensus recommendations on competitors like Calpine and Dynegy. While the consensus recommendation for Enron was much better than the average for S&P500 companies, there enthusiasm was not limited to Enron.

In early October 2001, the consensus recommendation spiked up from a 1.5 to a 1.3 as several analysts raised their recommendations ahead of Enron reporting its 3Q01 earnings on 16 October. On the day of the earnings announcement one analyst raised their recommendation, pushing the consensus to a remarkable 1.2. But as the Enron story began to unravel over the next few days, the recommendation downgrades exploded, plus six of the seventeen analysts dropped coverage.

Conclusions

In these kind of situations, it is easy to point a finger at the analysts for mistakes made. In my prior testimony, and in other forums, I have taken the analysts to task for not performing to an acceptable standard in certain situations. While the analysts are certainly not without blame on Enron, they are not the real culprits in this situation.

I am not an expert in doing the actual accounting at a company, or in auditing a company's accounting, but having been an analyst for 22 years, as well as closely observing analyst behavior at First Call for the last ten, I can say without reservation that this was a situation where either the company or its auditors or both were at fault in not providing investors, especially including the analysts, with the tools necessary to understand Enron's business.

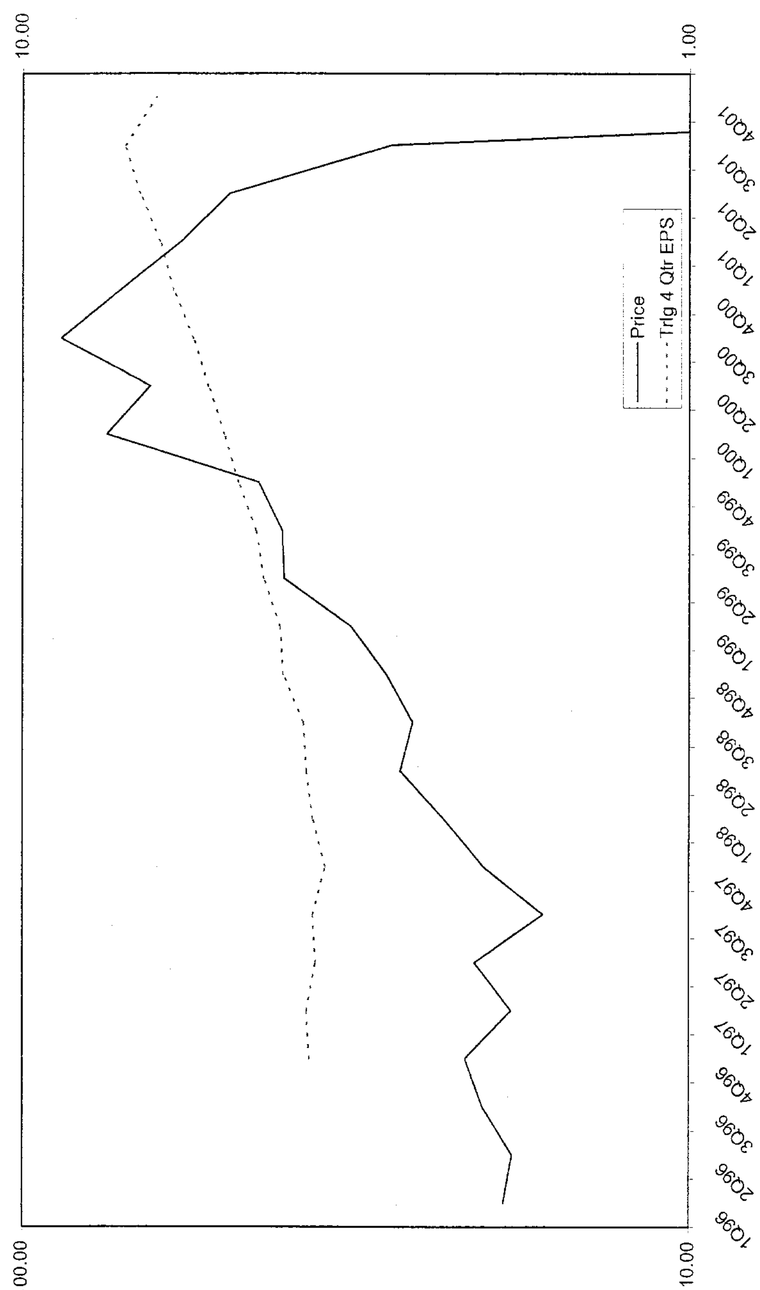
Whether the letter of the accounting rules were met or not, it is patently obvious that the spirit of the rules was violated in that Enron's financial statements did not fairly convey enough information for investors to reasonably analyze the company's operations.

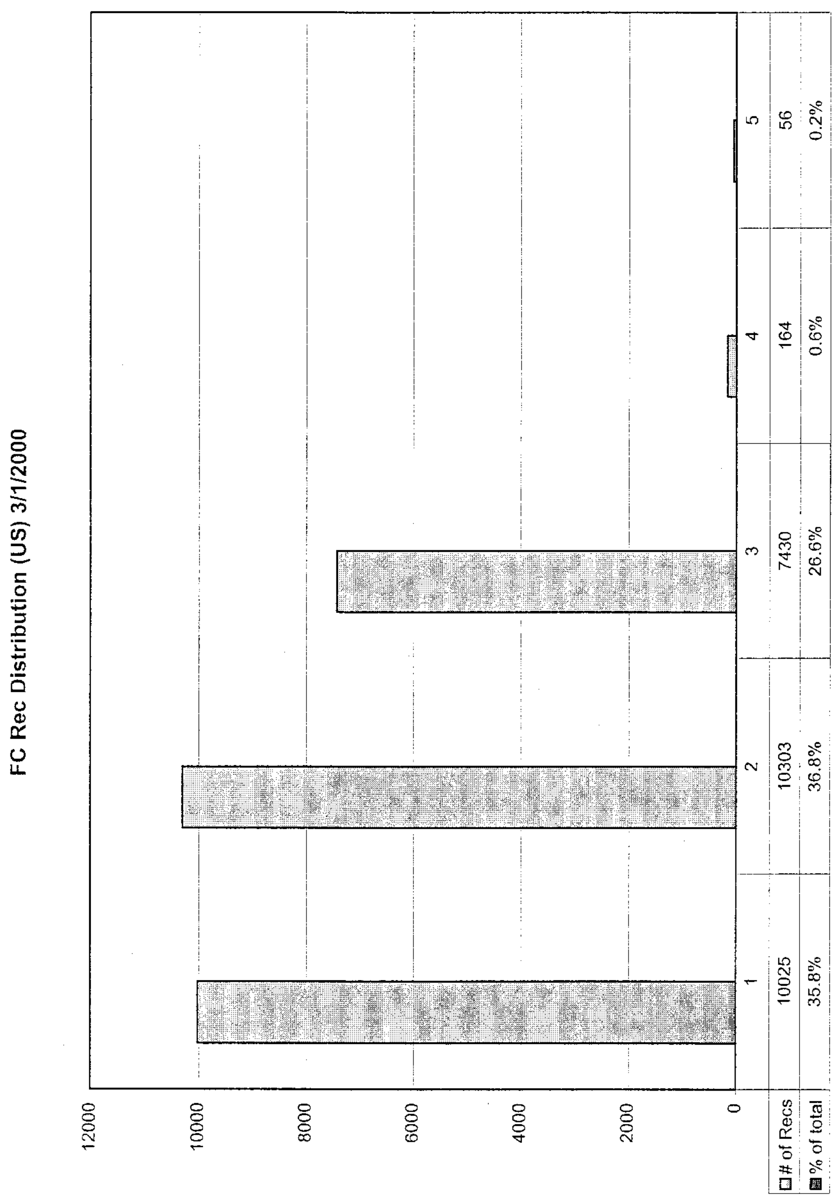
In that climate, it is hard to be too critical of the analysts' optimism. Enron had a long history of showing consistent and substantive earnings growth. If it had been up to me if I was in that situation, I would have dropped coverage long before October 2001. The financial reports and details of operations had become more and more inscrutable well before then. But as I mentioned earlier, most, if not all, analysts did not have that operation. All things considered, they probably did as well as could be expected until October 2001, although in hindsight it is easy to say that they could have at least tempered their bullish recommendations to some degree.

However, once the issues of the off balance sheet items became an unexplained issue on the 16 October 2001 conference call on 3Q01 results, it does seem that the analysts could have moved quicker to either suspend their recommendation or dramatically drop the level of their recommendation. The unexplained $1.2 billion balance sheet writedown was not a caution flag, it was a red flag.

But Enron is not the situation on which to challenge analyst performance. There are far more significant situations were analyst conflicts and performance are at issue. The lessons to be learned here is how to insure that company's and their auditors can be relied on to openly provide the necessary tools for investors to meaningfully analyze the company's business.

Enron - Price and Trailing 4 Qtr earnings

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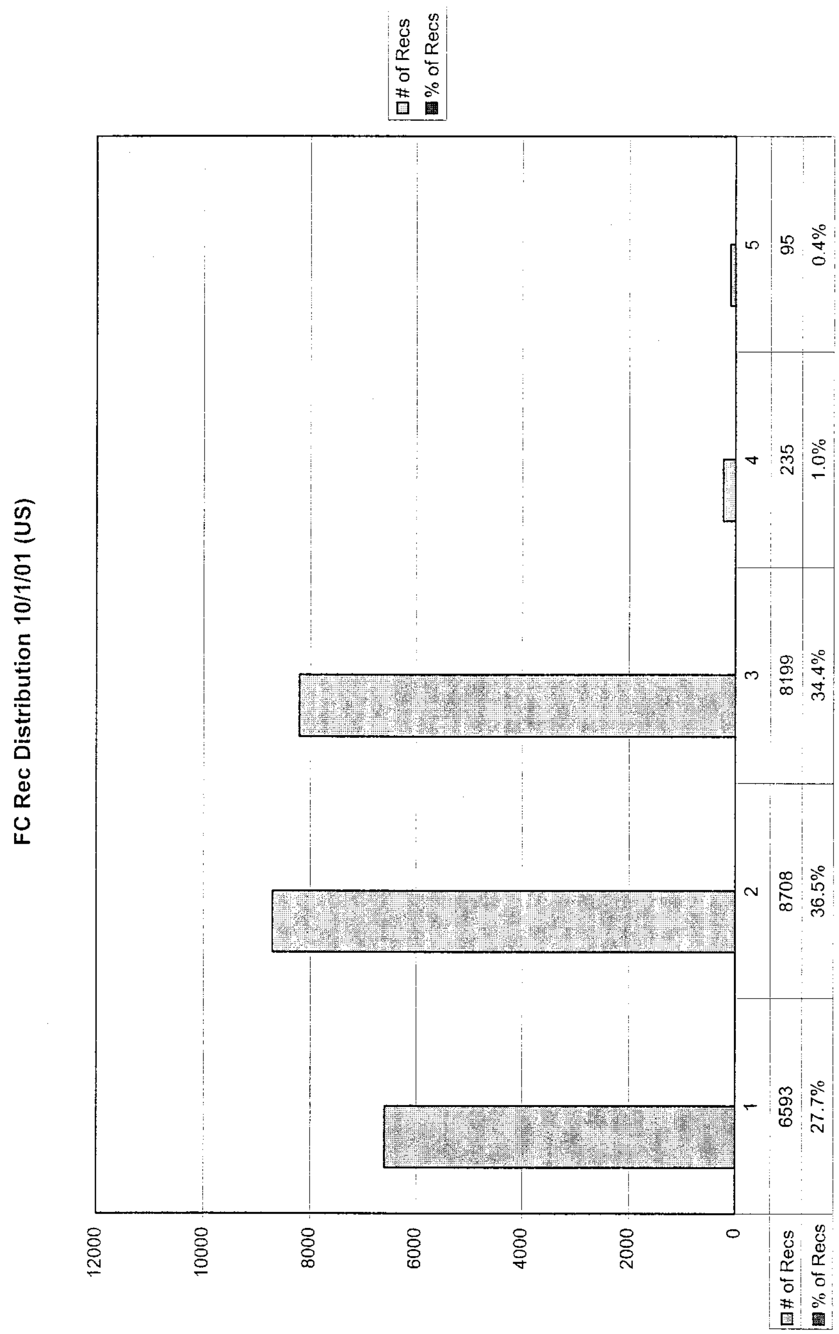
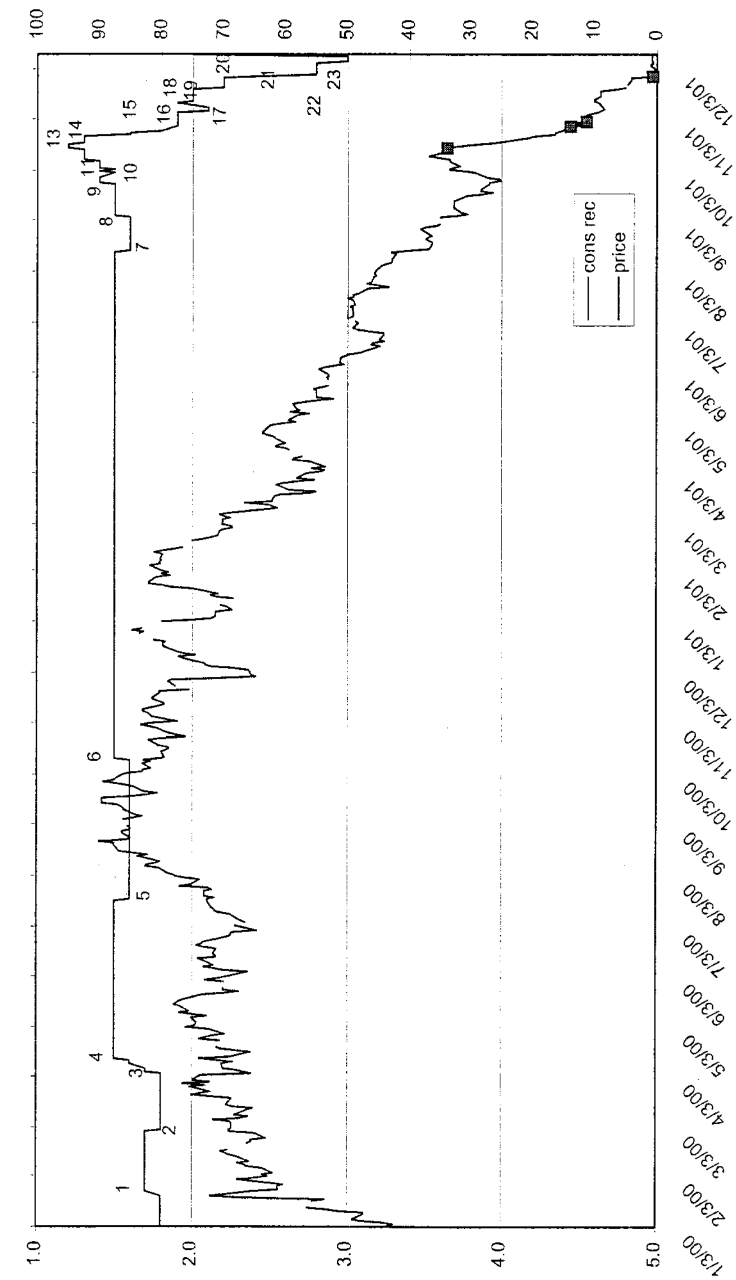
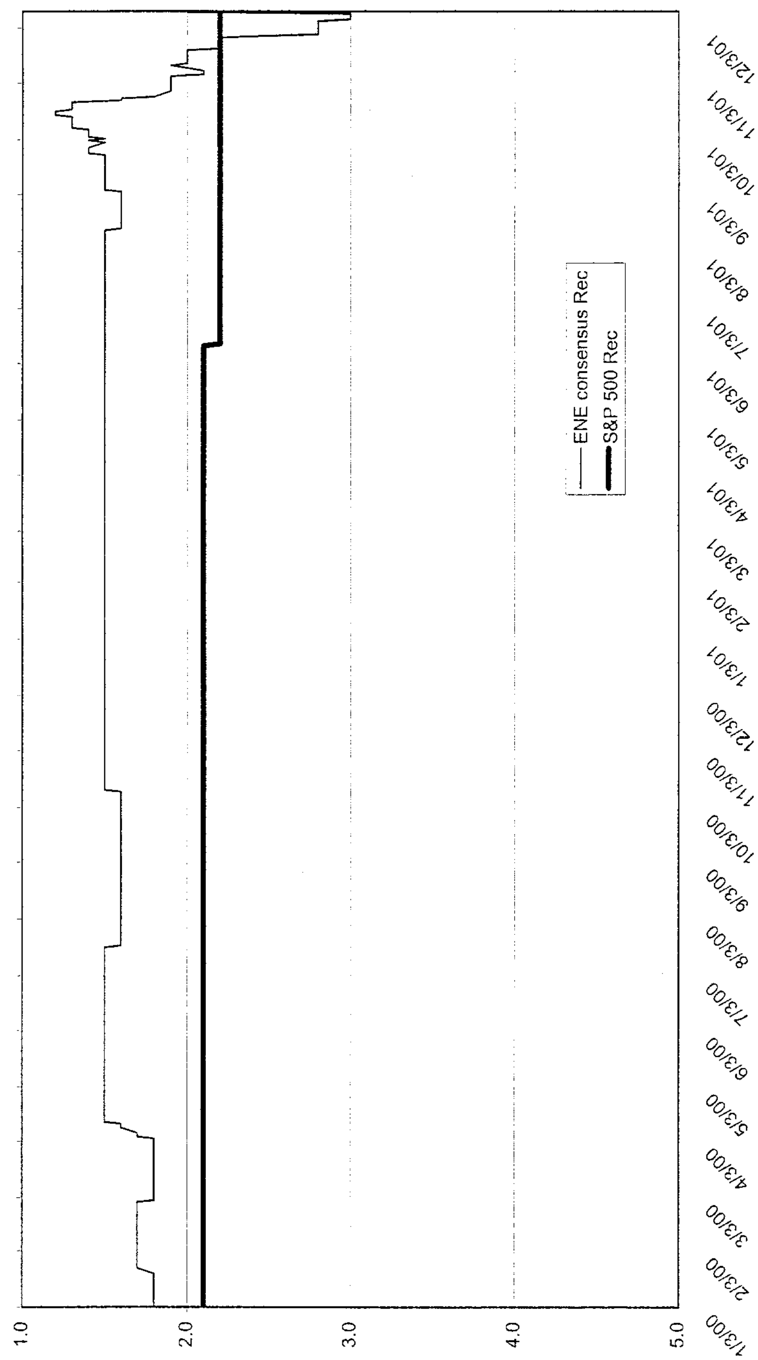
5
# of Recs
10025
10303
7430
164
56
% of total
35.8%
36.8%
26.6%
0.6%
0.2%


FC Rec Distribution 10/1/01 (US)
12000
10000
8000
6000
4000
2000
0
# of Recs
% of Recs
1
2
3
4
5
6593
8708
8199
235
95
27.7%
36.5%
34.4%
1.0%
0.4%

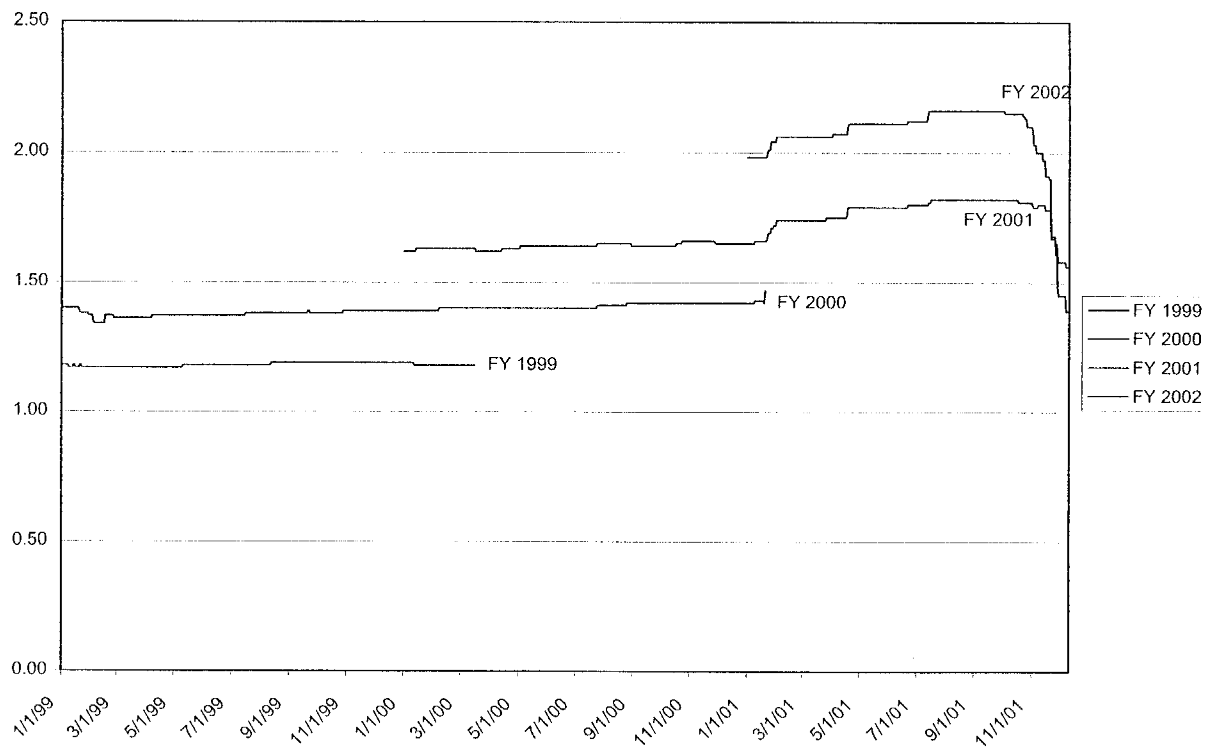
Enron Consensus Recommendation
Strong buy =1, Hold =3, Strong sell =5



Enron Consensus Recommendation versus S&P 500 Recommendation



Enron Earnings Estimate History for FY 1999 - 2002



TESTIMONY OF RICHARD L. TRUMKA

SECRETARY-TREASURER, AFL-CIO

BEFORE THE SUBCOMMITTEES ON CAPITAL MARKETS, INSURANCE, AND GOVERNMENT SPONSORED ENTERPRISES AND THE SUBCOMMITTEE ON OVERSIGHT AND INVESTIGATIONS

DECEMBER 11, 2001

Good morning Chairman Baker. My name is Richard Trumka, and I am the Secretary-Treasurer of the AFL-CIO. On behalf of the AFL-CIO and our unions' 13 million members, I am grateful to the Financial Services Committee for affording us the opportunity to express our views on the implications of the collapse of Enron. In particular I would like at the outset to commend this Committee and Chairman Baker in particular for his leadership in calling this hearing and his foresight in looking at the issue of analyst independence last summer. As I will describe below, that issue is a significant part of what went wrong at Enron.

My purpose in appearing here today is threefold. First I would like to give the committee some sense of the impact the collapse of Enron has had on workers trying to invest for their retirement, and on unions and employers trying to help workers achieve retirement security. Second, I would like to take a moment or two to talk about why Enron collapsed, and the links between Enron's collapse and the issues that were already facing this Congress on the day the Enron disclosures began. Finally, and perhaps most importantly, there is a clear regulatory agenda that the Securities and Exchange Commission and the Department of Labor must take up. Today the AFL-CIO has sent rulemaking petitions to the SEC embodying this agenda of auditor independence and Board integrity. With this Congress' support, the relevant regulatory agencies could take a series of initiatives that would go a long way toward protecting workers' retirement security and the investing public from the conflicts of interest that led to the collapse of Enron.

We are here today because Enron's bankruptcy was of a size and speed not experienced since some of the famous debacles that followed the Great Crash of 1929. And we must begin by recognizing that its collapse has had a real impact not just on big Wall Street firms, but on millions of working people and their pension funds.

This is a catastrophe rich in irony. Enron was a company that talked about a future of transparent markets, but whose CFO openly bragged to the financial press that its own accounting was a black box, saying "We don't want anyone to know what's on those books. We don't want to tell anyone where we're making money."[1] This was a company that complained about the costs of corruption in the global economy, but made campaign contributions an integral part of its business strategy; a company whose own governance was a web of conflicts of interest that completely stymied the protections our legal system provides investors. And finally this was a company whose mantra was deregulation and privatization, but which has ultimately become an advertisement for why workers need both defined benefit pension plans and a Social Security system safe from the conflicts of interest rampant in the capital markets.

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We must, however, begin with those who have been hurt worst and most unconscionably by the conduct of the Board and officers at Enron--the employees of Enron, more that 5,000 of whom have already lost their jobs, and more than 12,000 of whom participated in Enron's 401(k) plan.[2] Enron's contribution to these employees' retirement security was to donate stock to their accounts and to encourage employees to put their own savings into company stock as well. They appear to have done this without even giving their employees a prospectus, as required under current law.[3] The result was that on the eve of the collapse over half of the assets of Enron's 401(k) were invested in the company's stock, and many individual workers had all of their 401(k) assets in company stock.

Then on October 17, 2001, the same day that the Securities and Exchange Commission announced it was investigating Enron, the company chose to implement a plan to switch 401(k) administrators, knowing that their decision would freeze employees' accounts, leaving them unable to get out as the stock price went into freefall.[4] Meanwhile the insiders continued their insider selling, selling that netted a handful of people over $1 billion.[5] The blackout continued for three weeks, two weeks longer than the industry standard for such a change, according to Plan Sponsor magazine.[6] Then at the end of November when the market price of Enron's stock was under $1, Enron placed shares of stock it had purchased earlier this year into the frozen accounts and charged employees' accounts $61 per share. The final insult was that as Enron laid off thousands of employees, management tried to extort waivers of 401-k claims by threatening to withhold portions of worker severance payments.[7] Now Enron employees' only hope of recovering the retirement money they entrusted to their own company lies in the hands of the courts. And frankly, there does not appear to be sufficient assets available to come anywhere near close to the claims against the company.

Ironically, Congress passed the Employee Retirement Income Security Act (ERISA) to prevent situations in which corporate bankruptcies meant workers lost their jobs and their pensions, just like what happened to thousands of workers at Studebaker in the 1960s. Decades later, thousands of Enron employees find themselves in the same position.

I focus particularly on these workers because, unlike most other investors in the company, by and large Enron workers did not have diversified portfolios. The bulk of their retirement savings was in Enron stock. Many of the 1,000 members of the International Brotherhood of Electrical Workers at Enron's subsidiary Portland General Electric have suffered catastrophic losses, members like Roy Rinard, who watched helplessly, his accounts frozen, as his twenty two years of retirement savings dwindled from $472,000 to less than $3,500. Ken Kahloni, a former information and technology manager at Enron, lost $75,000 in his 401(k). He said, "I took a pay cut to work there two years ago, because I wanted to work for the 'best company.'"

But the harm Enron's collapse has caused America's working families by no means stops there. Workers' retirement funds have lost tens of billions of dollars in the collapse of Enron. Earlier this year, Enron was the 7th largest company in America measured by revenue.[8] Enron's equity at its peak was worth about $63 billion, and its bonds another $6 billion more. There was almost twice as much money invested in Enron stock than in General Motors stock.[9] Most pension funds and institutional investors held some Enron stock or bonds. If any person in this room has an S&P 500 index fund in your 401(k) or your mutual fund portfolio, you lost money in Enron-- probably about half a percent of your total assets in that fund. And this is if you invested in index funds-- in a strategy that is designed to cheaply mitigate the risks of investing in any single company.

Let me give you some examples of the monies lost by pension funds. The Amalgamated Bank of New York, a major index fund manager for union and public pension funds, has filed court papers stating index funds it sponsored lost approximately $10 million in Enron equity and debt.[10] The Georgia State Board of Investment has said in court that it has the largest losses. Filings by major commercial money managers with tens of billions of dollars of worker retirement money under management such as Alliance, Janus and Fidelity suggest each has losses in the hundreds of millions of dollars.[11] Most of this money is being invested to fund pension benefits for working families-- for the public employees we are counting on to protect us during this period of national crisis, for the pensions of the iron workers who are as we speak clearing the rubble at Ground Zero, for the firefighters who today, as on September 11, stand ready to give their lives to save ours. Because of the way that our retirement system has become increasingly interwoven with the capital markets, practically every American fortunate enough to be able to save for retirement in any form was hurt by the collapse of Enron.

In part, the moral of this story is that conflicts of interest in the capital markets can do a lot of damage to America's working families. Currently, Congress is considering legislation sponsored by Rep. Boehner that would remove the ban on conflicts of interest in the provision of investment advice to 401(k) participants.[12] Mr.Boehner's bill would leave 401(k) participants prey to the same conflicts that have so distorted the analysis of individual stocks, and as Enron shows, conflicts of interest can truly harm 401(k) participants' retirement savings. Similarly, consider how much worse this situation would be for Enron employees if their Social Security benefits had been invested in Enron, as they would if the privatization advocates had had their way.

Now some may ask, don't people gain and lose money in the markets every day-- isn't the Enron story just a particularly dramatic example of the dynamics of risk and return. Our answer, as stewards of worker capital, is emphatically no-- this is not how the financial markets should work. This is not a story of risk or of ignorance. It is a story of conflicts of interest, of duties breached and duties ignored, of loyalty betrayed. This is a story of vital information whose disclosure might have saved the company being withheld until it was too late. It is a story of people so shameless and greedy that literally as the bankruptcy papers were being drawn up they were still passing what remained of the firm's cash out to themselves--$55 million on the last working day before they filed for Chapter 11.[13]

Now obviously a lot of people have sued in court alleging some of these things. In the end the facts, many of which today are murky, will be sorted out. But even today certain things are clear.

Though Enron began as a utility and pipeline company, and its hard assets remain just that, Enron had become a new kind of financial intermediary. Enron brokered a huge number of contracts allocating price risk and other kinds of risk in an increasingly bewildering array of commodities-- from natural gas and electricity to Internet services to the weather. In that kind of business, a company's most valuable asset is trust-- trust that you are telling all your constituencies the truth, trust that you are a market maker and not merely a gambler. And what seems to have fundamentally happened to Enron is that the company's management abused that trust and ultimately destroyed it. Almost overnight Enron turned from a market colossus with an enterprise value of well over $70 billion to a mere collection of pipes and computer terminals worth considerably less than its debts.

The story of Enron's unraveling begins with self-dealing-- with transferring business out of the company into the hands of related entities that were in large part owned by Enron executives. These transactions were approved by the Board of Directors, the auditors and the lawyers. According to the chairman of the Compensation Committee, Charles Le Maistre, the partnership arrangements served in part to retain executives, saying "We try to make sure that all executives at Enron are sufficiently well-paid to meet what the market would offer."[14] But there was no mention of these transactions anywhere in Enron's extensive disclosure of its already extremely generous executive compensation practices. And the company funds that were put into these partnerships were accounted for as investments, not as payments to executives. These partnerships then went on to lose Enron and its shareholders over $1 billion.[15] The disclosures around these partnerships and the loss that suddenly appeared on Enron's balance sheet in October was the first of a series of increasingly devastating revelations that both recast the company's historic performance and completely destroyed the credibility of Enron's management.

How was this allowed to happen? Let's begin with the first line of defense when management goes bad-- the Board of Directors. At Enron most of the Board was independent of the company according to the SEC's requirements. But look another layer deeper, as we did after the initial revelations, and you find the majority of the supposedly independent directors were dependent on Enron or its executives-- dependent on them for political support, dependent on them for investment opportunities—and were ultimately unsuited to sit on the Audit Committee or the Compensation Committee. Some of these "independent" directors were actually investing in Enron-sponsored limited partnerships. Is it any wonder that when the crisis began and shareholders needed desperately to hear from outside directors, all they got was silence?

Then there were the auditors. Arthur Andersen was the company's long-time auditor. And until its division into a consulting company and an accounting firm, Andersen had been receiving millions of dollars per year in consulting fees.[16] But even on the accounting side, Andersen marketed a variety of consulting services to Enron, including, many believe, advising Enron on the structure of the special purpose vehicles. So you had an audit firm that was dependent on Enron management for higher margin consulting services, purporting to provide independent review on behalf of investors of transactions some of which they themselves, may have designed and charged a fee for.

On the subject of auditors, some have suggested that auditors are not able to detect a carefully hidden fraud, one where the truth is completely hidden by management. And that may very well be true, but that was not what happened at Enron. The financial statements themselves contain the proof that the auditors were aware of each of the transactions that led this company to grief—the self-dealing with the CFO, creating partnerships to trade in the company's own stock, other partnerships whose purpose seemed to be to generate dubious revenues, hide liabilities and otherwise bookable derivatives positions from the investing public.[17] While none of these were disclosed in a way to make them transparent to the investing public or to Enron's employees, there was more than enough information in those statements alone to sound warning bells among the auditors that signed off on them.

Then finally there were the Wall Street analysts. Ultimately investors look to the expert analyst community to interpret the numbers released by the companies they invest in. And here we saw again the spectacle of conflict of interest triumphing over duties to investors. Enron was such a large firm doing so much business in the financial markets that practically every Wall Street firm and post-Glass-Steagall commercial bank had an interest in courting the company. And in the eyes of their analysts, Enron was always a good buy. Of course, if you knew enough to seek out independent analysts, many of whose advice comes with a price tag beyond that of the average 401(k) participant, you would have heard a different story.

As late as October, Salomon Smith Barney, whose parent Citigroup is one of the largest creditors of Enron and a provider of investment banking services, rated Enron a "buy" until October 26, then it went to "neutral" where it remained until the company filed Chapter 11.[18] Lehman Brothers, who stood to earn a large advisory fee if the Dynegy deal closed, rated Enron as a strong buy right through to the end; Lehman Brothers then abruptly dropped coverage of Enron after it filed Chapter 11, stating that the "filing had complicated [the] outlook for [Enron] stock."19 Out of thirteen analysts that covered Enron in October, according to Forbes Magazine, eleven were bullish.20 But among eight independent investment newsletters tracked by Forbes, by August, when Enron CEO Skilling mysteriously resigned, four were already bearish and two more went bearish by October.21

Finally, the last link that failed was the active money managers. And here again investors faced conflicts of interest, including the same conflicts that compromised analysts. But the most glaring apparent conflict is the case of Alliance Capital, a major manager of worker pension fund assets and its link to Enron through Enron board member Frank Savage, a former senior executive and board member of Alliance. In the second quarter of 2001, while Mr. Savage was an executive of Alliance, Alliance Capital increased its Enron holdings by 71 percent to become the largest Enron shareholder, while other large investment managers reduced their stake in the former energy giant during the same time period.[22]

The result was that for years the marketplace set the price of Enron's stock artificially based on fictitious accounting, passed on by a conflicted Board and conflicted auditors, and hyped by conflicted analysts. And both sophisticated institutions and the average investor, following the advice of experts, bought at that price. And at least some of us were buying from insiders, who all this past year were unloading stock at an astounding rate.

Of course I have just described what happened before the attempted Dynegy acquisition. In the weeks that followed the announcement, the same dynamics that appear to have prompted the crisis led to the creation of a new myth-- that the problems at Enron were manageable. Many people had an interest in that myth-- most importantly Enron executives, the investment bankers who stood to reap large fees if the deal went through and the commercial lenders whose ability to avoid an Enron bankruptcy depended on steering the company into the Dynegy safe harbor. No one wanted to disclose what the real state of Enron's finances was, clearly because some very scary things were hidden there. But what this secrecy did was make certain that once the news of the extent of the problems began to leak, no one could stop the collapse.

The AFL-CIO and worker pension funds took several steps during the collapse of Enron to try and reform corporate governance and disclosure, and then as the situation worsened to protect workers' investments in the courts. Initially, the AFL-CIO and the Amalgamated Bank, a large index manager of union pension fund assets, reached out to outside directors. We wrote to Enron's Board asking that a special committee of the Board that had been set up and chaired by Thomas Power, Dean of the University of Texas Law School, broaden its agenda from merely investigating specific past transactions to reforming both the company's executive compensation and its audit policies.[23]

When the Dynegy transaction was announced, we again wrote to the Enron Board, pointing out that the markets continued to be in turmoil due to incomplete disclosure and that investors more than anything needed enhanced disclosure both to stabilize prices and to enable investors to evaluate the Dynegy transaction. We suggested the company immediately recruit people with credibility in the capital markets to its Board. We offered to meet with the Board and discuss possible candidates, but never received a substantive reply. Given what we all know now about the lack of independence of the Board, this is no surprise.[24] Copies of our letters are attached.

As the situation deteriorated the AFL-CIO, together with other large institutions, contemplated a state court action to obtain Enron's books and records to be able to evaluate the Dynegy deal. But before we could begin that process the deal collapsed. In the wake of Enron's bankruptcy, the Amalgamated Bank took the last step remaining open to investors, bringing suit in federal district court in Houston on behalf of Enron's shareholders against both Arthur Andersen and Enron's Board and officers.[25]

The most important lesson to be learned from the collapse of Enron and from our unsuccessful efforts to protect workers' investments is how hard it is to repair the damage done by rampant conflicts of interest aided by regulatory loopholes. We have to get the regulatory system right in the first place. And though the Securities and Exchange Commission has made great efforts in recent years to strengthen investors' regulatory protections, the truth is that too often steps that were necessary have not been taken due to resistance by a variety of entrenched interests. Union pension funds have tried through corporate governance efforts like the building trades funds' support of independent auditors to strengthen these protections firm by firm, but we cannot do it alone.

Therefore, the AFL-CIO is today submitting two rulemaking petitions to the Commission aimed at addressing the structural problems in our securities laws that gave rise to the Enron fiasco, which are attached to our testimony. We ask in these petitions that the Commission act to tighten the definition of who is an independent director, and require the disclosure of the full range of ties that can exist between directors and the corporate officers they oversee. In the accounting area, our proposals address most of the practices I have discussed. Our proposals include a prohibition on accountants reviewing transactions they themselves structured, direct audit committee approval of any auditor consulting arrangement and the audit engagement itself, and a variety of steps designed to ensure that public auditors are always looking at the firms they audit with a reasonably fresh eye. In addition, I would call your attention to testimony the AFL-CIO has previously submitted to this Committee on the subject of analyst independence and the regulatory changes that could improve that situation that contributed so significantly to the debacle at Enron.[26]

While we do not believe legislation is necessary, the fact is that without Congressional support for these kinds of regulatory changes, the interests that profit from the loopholes that brought us Enron will prevail again, as they so often did in the regulatory fights of the 1990's. We hope very much that Chairman Harvey Pitt takes up the agenda embodied in our rulemaking, but frankly we know he cannot do so successfully without the support of this Committee and your counterparts in the Senate.

I urge this Committee and this Congress to support both the Administration's enforcement actions against Enron and its Board and executives, and to urge the SEC and the Department of Labor to step forward and act against the rampant conflicts of interest and the defects in our disclosure system that gave us the Enron debacle. Our funds will fight as hard as we can to get our money back. But the truth is only strong government action can ensure that investors are not victimized again in this way. The AFL-CIO looks forward to working with you in the coming days on these important tasks. Thank you.

1 "Is Enron Overpriced?", by Bethany McLean. *Fortune*, March 5, 2001, Pg. 122.

[2] "Enron: Let Us Count the Culprits." *Business Week*, December 17, 2001, pg. 154

[3] Roy E. Rinard and Steve Lacey, v. Enron Corp. and the Northern Trust Company, Class Action Compliant Filed in the United States District Court Southern District Of Texas.

[4] "Enron Faces Suits by 401 (k) Plan Participants," by Theo Francis and Ellen Schultz. *The Wall Street Journal*, November 23, 2001

[5] Amlagamated Bank et. al. v. Kennath L. Lay et. al. Cass Action Complaint Filed in the United States District Court Southern District Of Texas.

[6] "Recordkeepers: Blackouts can be Shorter," *PlanSponsor.com*, December 10, 2001.

[7] "Enron asks Staff to Drop 401 (K) Suits for Severance," *Wall Street Journal*, Nov 29, 2001, page C13.

[8] "Power Failure: As Enron crashes, angry workers and shareholders ask, Where were the firm's directors? The regulators? The stock analysts?," by Daniel Kadlec. *Time Magazine*,
December 10, 2001, Pg. 68.

[9] As measured by market capitalization on December 29, 2000.

[10] Amlagamated Bank et. al. v. Kennath L. Lay et. al. Cass Action Complaint Filed in the United States District Court Southern District Of Texas.

[11] Alliance, Janus and Fidelity Investments were among Enron's five largest shareholders as of September 1, 2001, as reported in "Enron: Running On Empty As The Collapsed Energy Giant Seems Headed For Liquidation, Many Losers Count Their Losses," by Peter Coy et al. *Business Week*, December 10, 2001, pg. 80.

[12] The Retirement Security Advice Act of 2001 (H.R. 2269).

[13] "Enron Made Payments in Bid To Hold Top Energy Traders", by Richard A. Oppel Jr. *New York Times*, December 10, 2001, pg. C2.

[14] "Enron Jolt: Investments, Assets Generate Big Loss --- Part of Charge Tied To 2 Partnerships Interests Wall Street," by John Emshwiller and Rebecca Smith. *Wall Street Journal*, October 17, 2001, pg. C1.

[15] Enron Corp.'s Form 10-Q for the quarter ending September 30, 2001 filed with the U.S. Securities and Exchange Commission on November 19, 2001.

[16] In 2000 Arthur Andersen received $27 million in other consulting fees and only $25 million in auditing fees. Enron Corp.'s Proxy Statement for 2001 Annual Meeting of Shareholders filed with the U.S. Securities and Exchange Commission on March 27, 2001.

[17] Enron Corp.'s Form 10-K for the year ending December 31, 2000 filed with the U.S. Securities and Exchange Commission on April 2, 2001.

[18] Salomon Smith Barney analyst reports dated July 13, 2001, October 5, 2001 and October 26, 2001.

[19] Lehman Brothers analyst reports dated October 23, October 24, November 12, November 28 and December 7, 2001.

[20] "While Enron Burned, Wall Street Fiddled", by Dan Ackman. Forbes.com, November 29, 2001.

[21] "Enron: An Unreported Triumph For Investment Letters." Forbes.com, December 7, 2001.

[22] AXA Financial, Inc., Form 13-F, September 30, 2001, file with the Securities and Exchange Commission, November 13, 2001.

[23] Letter dated November 2, 2001 to William Powers, Jr., Chairman of Enron Special Committee, and Kenneth Lay, Enron Chairman of the Board and Chief Executive Officer, from Richard L. Trumka, Secretary-Treasurer of the AFL-CIO, and Gabriel P. Caprio, President and CEO of Amalgamated Bank.

[24] Letter dated November 9, 2001 to William Powers, Jr., Chairman of Enron Special Committee, and Kenneth Lay, Enron Chairman of the Board and Chief Executive Officer, from Richard L. Trumka, Secretary-Treasurer of the AFL-CIO, and Gabriel P. Caprio, President and CEO of Amalgamated Bank.

[25] Amlagamated Bank et. al. v. Kennath L. Lay et. al. Cass Action Complaint Filed in the United States District Court Southern District Of Texas.

[26] Testimony of Damon A. Silvers, Associate General Counsel, AFL-CIO, before the House Subcommittee On Capital Markets, Insurance, And Government Sponsored Enterprise on "Analyzing the Analysts—Are Investors Getting Unbiased Research From Wall Street", June 14, 2001.

December 11, 2001

Jonathan G. Katz
Secretary
U.S. Securities and Exchange Commission
450 Fifth Street, N.W.
Washington, DC 20549

Re: Petition for rulemaking

Dear Mr. Katz,

The American Federation of Labor and Congress of Industrial Organizations (the "AFL-CIO") hereby petitions the Securities and Exchange Commission (the "Commission") to undertake a rulemaking proceeding to amend Items 401 and 404 of Regulation S-K to require more proxy statement disclosure regarding conflicts of interest on the part of directors and director nominees. We believe that recent events at Enron Corporation have made plain that the existing disclosures are simply inadequate to ensure that shareholders are informed of all relevant information about director conflicts of interest.

Background

Our system of corporate governance relies heavily on independent directors to act as vigorous monitors of management behavior and to represent shareholder interests. For example, a committee of independent directors is often constituted to evaluate potential transactions or litigation involving a company. Similarly, the tax code requires that incentive compensation in excess of the $1 million cap on deductibility be awarded by a compensation committee composed of independent directors. Many institutional investors, following on that requirement, take compensation committee independence into account when voting on pay packages and deciding whether to withhold votes from director candidates.

One of the most important functions entrusted to independent directors is oversight of the financial reporting process, which is of vital importance both to a company's shareholders and the markets in general. To that end, listing standards of both the New York

Stock Exchange and the Nasdaq market require listed companies of a certain size to maintain audit committees composed of independent directors, and the Commission requires companies to disclose information regarding the mandate, membership and functioning of the audit committee.

Current Disclosure Requirements

The Commission's rules also, in essence, define independence by requiring disclosure in the proxy statement of certain relationships between directors (or director nominees) and the registrant (and in some cases its executive officers) that could compromise the director's objectivity. These requirements focus on employment, family, and business relationships. Currently, the following relationships involving directors and director nominees must be disclosed:[1]

1. Current or past employment by the registrant;

2. Family relationships between the director or nominee and the registrant's executive officers;

3. Transactions with the registrant or any subsidiary in which the amount involved exceeds $60,000 and in which the director or nominee has a direct or indirect material interest;

4. Indebtedness to the registrant or any subsidiary in an amount in excess of $60,000;

5. The ownership of certain equity interests in, or service as an executive officer of, a business or professional entity (a) that is a significant customer of the registrant, (b) that is a significant supplier of the registrant, or (c) to which the registrant is indebted in an amount exceeding a threshold;

6. Status as a member of, or of counsel to, a law firm that the registrant has retained during the last fiscal year or proposes to retain during the current fiscal year, subject to a minimum threshold;

7. Status as a partner or executive officer of an investment banking firm that has performed certain kinds of services for the registrant during the last fiscal year or that the registrant proposes to have perform services during the current fiscal year, subject to a minimum threshold; and

8. Any other relationship similar in scope and nature to the relationships listed above.

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[1] These disclosure requirements are set forth in Items 401 and 404 of Regulation S-K.

Enron Corporation

As you are no doubt aware, Enron Corporation recently filed the largest bankruptcy case in U.S. history, precipitated by a massive crisis of investor and customer confidence. Enron has already announced plans to lay off or put on leave 7,500 workers, and the value o Enron stock held in employees' 401(k) retirement accounts has declined by $1.3 billion sinc the beginning of 2001. The market capitalization of Enron, which was the seventh largest company in the Fortune 500, plunged from over $60 billion at its peak last year to under $1 billion last week. Enron's inclusion in the S&P 500 index until shortly before the bankruptcy filing means that the broader market and the many investors who index their equity holdings are also suffering as a result of Enron's failure.

The AFL-CIO is a federation of trade unions that represent 13 million working men and women who participate in the capital markets as investors through defined benefit and defined contribution plans as well as through mutual funds and individual accounts. Our member unions sponsor benefit plans with over $400 billion in assets, and our members are participants in public employee and collectively bargained single-employer plans with over $5 trillion in assets. Our union-sponsored funds alone are the beneficial owners of approximately 3.1 million shares of Enron stock, through both actively-managed and passiv (or indexed) portfolios.

Enron's meltdown was caused by a number of factors, among them a cavalier attitud toward disclosure, inadequate internal controls and an approach to accounting that at best ca be characterized as careless and at worst constituted a conscious effort to mislead investors and the public about the profitability of Enron's operations. These problems point to an abject failure by Enron's board, especially its finance and audit and compliance committees, in the discharge of its monitoring duties. We believe that the lack of independence on Enron's board and key committees contributed to this failure.

At first glance, Enron's board and key committees appear to be composed primarily of independent directors. According to Enron's 2001 proxy statement, of the 14 directors nominated for reelection at the 2001 annual meeting,[2] eight, or nearly two-thirds, lacked disclosable relationships with Enron. Of members of the audit and compliance committee, which was responsible for reviewing the effectiveness of internal controls and the applicatio of accounting principles, only one, John Wakeham, has disclosable ties to Enron, in the forn of a $72,000 per year consulting arrangement. A majority of members of the finance committee, which oversaw Enron's risk management activities, are similarly independent.

However, further research reveals that several of the eight ostensibly independent directors, including two who serve on the audit and compliance committee and one who serves on the finance committee, actually have relationships with Enron or its senior

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[2] One of those directors, then-CEO Jeffrey Skilling, resigned from both his executive and director positions ir August 2001.

executives that could interfere with those directors' ability to be objective and to challenge company decisions and policies.[3]

- Audit committee member John Mendelsohn is the president of the University of Texas M.D. Anderson Cancer Center. The Cancer Center has received contributions from Enron, and Enron chairman and CEO Kenneth Lay was part of what the Houston Chronicle characterized as a "coalition" to lobby the Texas legislature for $20 million worth of infrastructure improvements to support the development of the Southeast Texas BioTechnology Park, which will be built on University of Texas land and house the Cancer Center's Life Sciences Center. Compensation committee chairman Charles LeMaistre is the Cancer Center's president emeritus and serves on its Board of Visitors.

- According to Enron's 2001 proxy statement, directors Norman Blake and John Duncan own common units of EOTT Energy Partners, L.P. ("EOTT"), a limited partnership whose general partner is a wholly-owned subsidiary of Enron. Enron thus exercises significant control over EOTT, which could affect the economic return available to Messrs. Blake and Duncan. Mr. Blake serves on Enron's financ committee; Mr. Duncan is a member of the audit and compliance committee.

- Wendy Gramm, a member of the audit and compliance committee, is director of the Mercatus Center at George Mason University. According to a December 10, 2001 article in Time magazine, Enron contributed $50,000 to the Mercatus Center.

Uncovering the relationships described above was neither easy nor inexpensive. An investor thus cannot evaluate the independence of the board and key committees at all or even a substantial number of the companies in its portfolio without expending significant funds. Because of the economics involved in undertaking such research, even proxy voting and research services such as the Investor Responsibility Research Center—which exploit economies of scale in assembling corporate governance data—rely solely on the disclosures set forth in the proxy statement when evaluating boards and key committees. Accordingly, we believe that additional proxy statement disclosure regarding relationships between directors and director nominees, on the one hand, and registrants and their senior executives, on the other, is vital in enabling investors to select investments wisely, monitor companies ir which they have invested and cast informed votes in director elections.

Specifically, we urge the Commission to amend the rules to require disclosure of:

1. Relationships between the registrant or any executive officer of the registrant and any not-for-profit organization on whose board a director[4] or immediate family member[5] serves or of which a director or immediate family member serves as an officer or in a similai

[3] We raised these concerns in a letter to Enron's special committee, which is attached to this petition.

[4] For the sake of simplicity and readability, "director" also refers to director nominees.

[5] "Immediate family member" should be defined to include a person's spouse, parents, children, siblings, in-laws and first cousins.

capacity. Disclosable relationships should be defined to include contributions to the organization in excess of $10,000 made by the registrant or any executive officer in the last five years and any other activity undertaken by the registrant or any executive officer that provides a material benefit to the organization. "Material benefit" should be defined to include lobbying efforts such as those engaged in by Mr. Lay on behalf of the M.D. Anderson Cancer Center as well as fundraising activities undertaken by the registrant or any executive officer on the organization's behalf.

2. Relationships in which the registrant or any executive officer exercises significant control over an entity in which a director or immediate family member owns an equity interest or to which a director or immediate family member has extended credit. Significant control should be defined with reference to the contractual and governance arrangements between the registrant or executive officer, as the case may be, and the entity. For example, in most cases, a general partner exercises significant control over a partnership, while a limited partner may exercise significant control depending on the terms of the partnership agreement.

It may be necessary to provide that the existence of significant control may depend, in part, on the overall ownership structure of the entity and not just the stake held by the registrant or executive officer. For example, the owner of less than a majority of a corporation's stock may nonetheless exercise significant control if the other stockholders are numerous and fragmented.

3. Joint ownership by a registrant or executive officer and a director or immediate family member of any real or personal property.

4. The provision of any professional services, including legal, financial advisory or medical services, by a director or immediate family member to any executive officer of the registrant in the last five years.

We understand that in 1998 the Council of Institutional Investors ("CII") filed a petition for rulemaking relating to disclosure of director conflicts of interest and that the Commission has not responded to that request. Although CII's proposed language is more general, we believe that our request covers many if not all of the conflicts that were of concern to CII.

We urge the Commission to take up these important issues immediately. Investor confidence in the United States capital markets depends in large measure on their transparency. Full disclosure of director conflicts of interest will improve transparency and enable investors to assess more accurately the quality of companies' governance structures.

If you have any questions regarding this petition, please do not hesitate to contact Damon Silvers on 202-637-3953. We look forward to discussing this with you further.

Very truly yours,

Richard Trumka
Secretary-Treasurer

December 11, 2001

Jonathan G. Katz
Secretary
U.S. Securities and Exchange Commission
450 Fifth Street, N.W.
Washington, DC 20549

Re: Petition for rulemaking

Dear Mr. Katz,

The American Federation of Labor and Congress of Industrial Organizations (the "AFL-CIO") hereby petitions the Securities and Exchange Commission (the "Commission") to undertake a rulemaking proceeding to amend the rules governing auditor independence to revise the definition of an independent auditor and limit the services accounting firms may provide to their audit clients. We also ask the Commission to require additional proxy statement disclosure regarding the role of the audit committee in approving both audit engagements and non-audit consulting agreements with the audit firm. As shown by the scandal currently unfolding at Enron Corporation, investor confidence in the U.S. capital markets requires that auditors be, and be perceived as, truly independent from their clients.

The AFL-CIO is a federation of trade unions that represent 13 million working men and women who participate in the capital markets as investors through defined benefit and defined contribution plans as well as through mutual funds and individual accounts. Our member unions sponsor benefit plans with over $400 billion in assets, and our members are participants in public employee and collectively bargained single-employer plans with over $5 trillion in assets. Our union-sponsored funds alone are the beneficial owners of approximately 3.1 million shares of Enron stock, through both actively-managed and passive (or indexed) portfolios.

Background

Independent auditors occupy a central position in promoting confidence in the integrity of the financial reporting system and U.S. capital markets. Because the Commission requires that financial information filed with it be certified or audited by independent auditors, auditors are, as the Commission recently stated, the "gatekeepers" to the public securities markets.[1] Auditors work not only for their clients, but also for the investing public.

The role of the independent auditor is once again in the spotlight, as it was following relevations of accounting fraud at Sunbeam, Cendant and Waste Management. Now, the stunningly rapid failure of Enron Corporation, where there is evidence that Enron's auditor, Arthur Andersen, knew about and identified accounting errors but did not insist on their timely correction, focuses attention on the factors that might lead a company's auditor to sign off on misleading financial statements. Foremost among these is a dependence on a company and its management that can serve to undermine an auditor's objectivity.

Independence can be compromised in various ways. The provision of certain kinds of non-audit consulting services to audit clients may create economic incentives that can lead a firm to devalue the audit services and focus on retaining the client, even at the cost of making inappropriate audit judgments. In 2000, Arthur Andersen received more non-audit fees than audit fees from Enron. A "mutuality of interest" not conducive to independence may develop from the provision of certain kinds of non-audit services or from the employment by an audit client of former employees of the auditor. Certain services result in the auditor acting as management or an employee of the client. Finally, auditors may not be able to audit objectively work performed by the audit firm itself under a consulting agreement.

Over the past several decades, the proportion of audit firms revenues derived from non-audit services, such as internal audit, information technology, financial advisory and appraisal and valuation services, has grown steadily. At the five largest public accounting firms, revenues derived from non-audit services grew from 13% of total revenues in 1981 to half of total revenues in 2000.[2]

The 2000 Commission Rulemaking

Citing these threats to independence and their potential effect on capital formation, as well as the increased pressure on companies to make or surpass analyst earnings estimates, the Commission undertook last year to revise its rules governing auditor independence. With respect to the provision of non-audit services to audit clients,

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[1] Revision of the Commission's Auditor Independence Requirements, Exchange Act Release No. 43602 (Nov. 21, 2000) (adopting release).

[2] Revision of the Commission's Auditor Independence Requirements, Exchange Act Release No. 42994 (June 30, 2000) (proposing release).

the Commission solicited comment on three alternative approaches: banning the provision of such services altogether, imposing limits on the provision of those non-audit services deemed most likely to impair independence, and requiring only additional disclosure.[3]

Although a number of commenters and those testifying at the Commission's public hearings favored a ban on non-audit services, there was also significant opposition, mainly from the accounting profession, to any substantive reform. As a result, the final regulations reflected a compromise in which auditors could provide those non-audit services that posed a danger to independence, but only under certain circumstances. (The proposed limitation on providing expert testimony were dropped in its entirety.) A compromise was also reached regarding the additional disclosure required of registrants regarding the non-audit services provided by their auditors and the involvement of their audit committees with respect to auditor independence issues.

In light of subsequent developments, however, we ask the Commission to revisit some of the issues raised in the 2000 rulemaking, and to consider some new reforms, in order to strengthen its auditor independence safeguards. As discussed more fully below, both substantive reform and additional disclosure are necessary to preserve confidence in our capital markets.

The Rules on the Provision of Non-Audit Services Should be Strengthened

We believe that the Commission's final rules give too much flexibility to audit firms to provide non-audit services that could compromise the firms' objectivity and create economic incentives that may undermine the effectiveness of audits. A December 5, 2001 Washington Post article highlighted the pressures on individual auditors to "cross-sell" non-audit services to audit clients, recounting a case in which a Coopers & Lybrand accountant's performance review varied according to the amount of such services he was able to sell. That case involved Phar-Mor, which later filed for bankruptcy protection following revelations of accounting fraud; a jury found that Coopers, Phar-Mor's auditor, had committed fraud.

We believe that in some cases the sheer amount of the consulting services may create perverse incentives. During testimony in connection with the 2000 rulemaking, much was heard about the "loss leader" phenomenon, in which firms submitted artificially low bids, not consistent with providing high quality audit services, as a way to establish a relationship with a client and sell audit services. The audit then makes up an even smaller proportion of the total revenue stream from the client. And here, the danger not only lies in the auditor's impaired judgment. Anecdotal evidence suggests that executives of some companies encourage audit firms to undertake non-audit consulting as a way of obtaining leverage for the company over the audit process.

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[3] See id.

Certain non-audit services pose a more significant threat to an auditor's independence than others. The Commission recognized this in the 2000 rulemaking, when it prohibited firms from providing certain services, like bookeeping services. However, the Commission determined that audit firms could continue to sell information technology and internal audit consulting services to audit clients, as long as certain requirements, designed to lodge ultimate responsibility for the systems with the client, are satisfied. We believe this was a mistake.

The provision of information technology and internal audit services raise several serious problems. First, in cases where an information technology project is unsuccessful, a company may not be permitted to capitalize the costs of the project on the balance sheet (thereby creating an asset), but rather is required to expense them, thus reducing income. An accounting firm that botched the consulting job will be less likely, we think, to be assertive with management about the need to expense the item.

Similarly, if the auditor discovers, during the course of an audit, a theretofore undiscovered problem with software or an internal audit system the auditor designed and installed, the auditor is in the uncomfortable position of having to inform the client about the audit firm's own error. Finally, in a real sense the audit firm is auditing it own work because assessing the reliability of the numbers generated by an information technology or internal audit system is a part of the audit function.

We believe that the conditions imposed on audit firms in connection with information technology and internal audit consulting services are easily manipulated and do not mitigate the danger that the auditor and client will come to view the auditor as an extension of management and that the auditor will experience difficulty in vigorously auditing its own work.

Attention should be focused on another kind of consulting service, one that was not raised in the 2000 rulemaking but that has been brought to the fore by the Enron debacle. Enron's restatement of several years' worth of financial statements stemmed in part from the acknowledgment by Enron that the financial results of off-balance-sheet special purpose entities ("SPEs") set up by Enron—and in some cases managed by Enron officers—should have been consolidated with Enron's own results. In one case, Enron conceded that consolidation was necessary because the SPE had been inadequately capitalized when it was established.

Enron paid Arthur Anderson $27 million in 2000 for non-audit consulting services, including fees for "business process and risk management consulting." We are concerned that this category may include consulting regarding the transactions pursuant to which one or more of the erroneously non-consolidated SPEs were established. Such an arrangement would, we think, create an unacceptable conflict of interest, requiring Arthur Andersen's audit personnel to question the judgment of its consultants on a matter which could—and eventually did—have a major impact on Enron's financial results. We urge the Commission to consider amending Rule 2-01 of Regulation S-X to provide that an independent auditor may not design and/or structure a transaction the audit firm must pass on in connection with the audit.

Auditors Should be Rotated

Currently, audit firms must rotate the audit engagement partner every seven years, in order to remove the risk of over-familiarity with the client. However, the engagement partner may remain in a relationship management position with respect to the client, which mitigates the effect of partner rotation.

We believe a more sensible approach is to require mandatory rotation of audit firms every seven years. Such rotation would provide a number of important benefits. First, a new audit firm would bring to bear a skepticism and fresh perspective that a long-term auditor may lack. Second, auditors tend to rely excessively on prior years' working papers, including prior tests of the client's internal control structure, particularly if fees are a concern.[4] Relatedly, longtime auditors may come to believe they understand the totality of the client's issues, and may look for those issues in the next audit rather than staying open to other possibilities. Finally, an auditor may place less emphasis on retaining a client relationship even at the cost of a compromised audit if it knows the engagement will end after several years.

In our opinion, the benefits to shareholders, lenders and the investing public from requiring rotation of auditors outweighs the additional cost that may be entailed in connection with a new auditor becoming familiar with the client. We urge the Commission to consider revising Rule 2-01 of Regulation S-X to provide for mandatory auditor rotation.

Additional Disclosure Should be Required

We also think that additional disclosure regarding the involvement of the audit committee in entering into the audit engagement and pre-approving non-audit consulting arrangements would enhance the effectiveness of audit committees and provide valuable information to investors. The Commission originally proposed in 2000 to require disclosure of whether the audit committee, before any disclosed non-audit service was rendered, approved and considered the effect on independence of such service. Only the latter disclosure was included in the final rule.

Requiring disclosure about the audit committee's role with respect to both the audit engagement and non-audit consulting contracts would advance important goals. Disclosing whether the audit committee, rather than the registrant, entered into the audit engagement would give investors information about whom the auditor views as its audit

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[4] See Richard G. Brody & Stephen A. Moscove, "Mandatory Audit Rotation," The National Publc Accountant 32 (May 1998).

client. Commentators have noted that an auditor that views a registrant's management as its client is less likely to challenge that management in the context of an audit.

Similarly, investors would be better informed about the extent of the audit committee's involvement if the Commission required disclosure regarding audit committee pre-approval of consulting arrangements. The Panel on Audit Effectiveness organized by the Public Oversight Board, which was convened on the request of the Commission and issued its report last year, recommended that audit committees pre-approve non-audit services that exceed a threshold arrived at by the committee. Disclosure will assist investors in determining whether a registrant has implemented that recommendation.[5]

We urge the Commission to consider taking the steps proposed herein as soon as practicable. It is vital, we think, in light of recent events, to assure the investing public of the integrity and reliability of the audited financial statements of U.S. public companies. We believe that the reforms we propose to the auditor independence and audit committee disclosure rules can be an important step in that direction.

If you have any questions regarding this petition, please do not hesitate to contact Damon Silvers at 202-637-3953. We look forward to discussing this with you further.

Very truly yours,

Richard Trumka
Secretary-Treasurer

[5] The Panel on Audit Effectiveness Report and Recommendations, sec. 5.30 (Aug. 31, 2000).

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