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AN OVERVIEW OF THE ENRON COLLAPSE

HEARING

BEFORE THE

COMMITTEE ON COMMERCE, SCIENCE, AND TRANSPORTATION UNITED STATES SENATE

ONE HUNDRED SEVENTH CONGRESS

FIRST SESSION

DECEMBER 18, 2001

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SENATE COMMITTEE ON COMMERCE, SCIENCE, AND TRANSPORTATION

ONE HUNDRED SEVENTH CONGRESS

FIRST SESSION

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AN OVERVIEW OF THE ENRON COLLAPSE

TUESDAY, DECEMBER 18, 2001

U.S. SENATE,
COMMITTEE ON COMMERCE, SCIENCE, AND TRANSPORTATION,
Washington, DC.

The Committee met, pursuant to notice, at 9:30 a.m. in room SR-253, Russell Senate Office Building, Hon. Byron L. Dorgan, presiding.

OPENING STATEMENT OF HON. BYRON L. DORGAN, U.S. SENATOR FROM NORTH DAKOTA

Senator DORGAN. This hearing will come to order. This is a hearing of the full Commerce Committee. I am the Chairman of the Subcommittee on Consumer Affairs, Foreign Commerce and Tourism. Senator Hollings has asked that I chair the hearing today. We will be joined by other colleagues on the Committee shortly, but we do want to begin on time. The subject of the hearing is the meltdown and bankruptcy of the Enron Corporation over the past four months. This raises many serious and troubling issues, and we want to, in this hearing, explore some of these issues.

This will be the first of several hearings on this matter. Mr. Ken Lay, the Chief Executive Officer of Enron, did not accept our invitation to testify at this hearing. However, we have been informed this morning that Mr. Lay has committed to appear before our Committee and present testimony at a second hearing which will be held on February 4.

We also intend to request at that hearing the attendance of Mr. Skilling and Mr. Fastow, former top executives at Enron, and others, who can help explain what happened. I spent many hours in recent days reading and learning about the events that preceded the collapse of one of the world's largest corporations.

Frankly, the more I have learned, the more troubled I have become. This is not your average business failure. This is a tragedy for many, including workers and investors who, it appears to me, have been cheated out of billions of dollars. This is about an energy company that morphed itself into a trading company involved in hedge funds and derivatives. It took on substantial risks, created off-the-books partnerships, and in effect cooked the books under the nose of their accountants and investors.

At a time when the executives, board members, and other insiders were selling nearly \$1 billion in stock in recent years and were profiting handsomely, employees and investors were set up to take the financial beating. Was this just bad luck, incompetence, or greed? Were there some criminal or illegal actions, as have been

suggested by the accounting firm that reviewed Enron's books? Where was the board of directors when this was happening? How much did they profit from it? Were they brain dead, or just kept in the dark? What about the accounting firm? Were they duped? Incompetent? How on earth can there be adjustments of billions of dollars? Is it not a conflict of interest for the accounting firm to depend on the company they are auditing for tens of millions of dollars in consulting contracts? Where were the Federal agencies? Did they bear some responsibility, those in Congress who derailed efforts at Federal regulations for this type of trading activity? Did the stock analysts who kept recommending a strong buy know what they were doing? Was there a conflict of interest there?

This is a company that operated between the cracks of Federal regulations. It created secret, off-the-books partnerships with names like Jedi, Chewco, LJM and others, and allowed a top executive to take ownership in these partnerships, which seems to me to be a clear conflict of interest. Who in the company approved these transactions? Who are the investors, besides Enron, in these partnerships? How much were their investments, and what was their return?

These are some but not all of the questions the American people deserve to have answered, and we intend to search for those answers.

If this were just another business failure, there would be no need for congressional hearings, but it is anything but just another failure. More than \$60 billion in value has been lost in just months. Some at the top of the pyramid got rich, many at the bottom lost everything. It appears to me to be a combination of incompetence, greed, speculation with investors' money, and, perhaps, some criminal behavior. Investigations will sort out all of that, but the tens of thousands of employees and investors in the end will have lost billions of dollars.

It is my hope these hearings and other investigations will help us determine whether laws need to be changed. If they do, we should change them. They will help us determine whether laws have been broken. If they have, those who did so will be held accountable.

I would like to read a quote from Business Week's editorial page, which I think goes a long way in summarizing why this hearing is so important, and why the work of this Committee is necessary. The editorial goes, and I quote, "Enron Corp.'s bankruptcy is a disaster of epic proportions by any measure—the height from which it fell, the speed with which has unraveled, and the pain it has inflicted on investors, employees, and creditors. Virtually all checks and balances designed to prevent this kind of financial meltdown failed. Unless remedied, this could undermine public trust, the capital markets, and the nation's entire equity culture." That is from Business Week, and I certainly agree with those sentiments, and that describes the importance of this hearing. It sums up why we are here today, and I look forward to hearing from many of our witnesses, many of whom traveled some long distance to be here.

Let me call on the Chairman of the full Committee, Senator Hollings.

The CHAIRMAN. I yield.

Senator DORGAN. Let me call on the Ranking Member, Senator McCain.

**STATEMENT OF HON JOHN McCAIN,
U.S. SENATOR FROM ARIZONA**

Senator McCAIN. I thank the Chairman for convening today's hearing to provide us with an overview of the Enron collapse. I hope that the witnesses can provide a better understanding of the facts leading up to the company's bankruptcy and allow us to understand whether U.S. investors and employees may face similar situations with other companies.

The losses experienced by Enron's shareholders, particularly those who lost a substantial portion of their life savings so close to retirement, is a tragic example of losses that appear to be due not to poor investment decisions but to misplaced reliance on those entrusted to protect the integrity of their investment, the company's executives and independent auditors. The purpose of this hearing is to examine how such a situation can happen and what, if anything, the federal government can and should do to prevent future instances from occurring. Whether the law has been violated is not for us to decide. Rather, the issue for Congress is whether existing controls, if adhered to, are sufficient to protect shareholders.

Thank you, Mr. Chairman. I look forward to today's hearing.

Senator DORGAN. Senator McCain, thank you. The Chairman of the full Committee, Senator Hollings.

**STATEMENT OF HON. ERNEST F. HOLLINGS,
U.S. SENATOR FROM SOUTH CAROLINA**

The CHAIRMAN. Well, Mr. Chairman, thank you very, very much for chairing this hearing for our full Committee.

I have been engaged full-time in trying to make certain that they did not give away the broadband spectrum. We have got a Chairman of the Federal Communications Commission that is determined to divest ownership in spectrum, and they have got a \$5 billion kitty for the K Street crowd to make sure it happens by December 31, so that has kept me very, very busy.

Otherwise, they have got the full court press over there on the outside with Tauzin-Dingell to make sure they extend monopolies rather than engage in competition. That has kept me busy, along, of course, with the conference committees that are going on right now between the defense appropriations and the labor, health and human resources appropriations and then, of course, Mr. Chairman, this Committee has jurisdiction over terrorism insurance. We got together a bipartisan bill after hearings with the Secretary of the Treasury and would've otherwise reported it out. It is on the calendar, and then the political maneuvering started.

I was called one morning by the Secretary of Treasury, and he and I talked informally. We agreed that we could get at least, without all of these differences, a 1-year terrorism insurance bill, so everyone would have security here in the renewal of policies at the first of the year. Our staff started working early the next morning, but the Republican conference came in to the working session and pulled all the Members out, and we have not heard from them since.

Trying to get your job done around here is next to impossible in these closing days, and by your holding this hearing it is quite an eye-opener to this particular Senator. I noticed that Money magazine reported that Lay made \$66 million in selling shares, while Jeff Skilling garnered another \$60 million, and 16 board members had made \$164 million in selling their shares by June. Money magazine quotes, "While insider sales do not automatically spell trouble for a company . . . the selling of Enron was prolific. And the fact that the selling persisted even as the stock fell throughout 2001 was a 'screaming red flag,' . . . If Skilling and Lay believed the stock was undervalued—as they repeatedly told investors—then why were they cashing in?"

And then I never had heard, until Enron, of a special purpose entity (SPE). In fact, I am determined to put in a bill to eliminate that thing. I do not know what it is. Its best description by the SEC in the hearing before the House, and I quote, "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."

Well, Enron's board of directors have been accused of allowing the board members and officers of the company to run these SPE's. Arthur Andersen has been accused of engaging in a conflict of interest when it served both as a consultant and an accountant. That thing ought to be stopped. Arthur Andersen claims they were paid \$25 million for its accounting services and \$27 million for its consulting services. If that is not a conflict on its face, I do not know what is.

Between October 1998 and November 2001, Arthur Andersen received over \$100 million in accounting and consulting fees, including \$52 million in 2000 alone, and then you have got Salomon Smith Barney. They rated Enron a buy until October 26, when it went to neutral, where it remained until, of course, they filed for Chapter 11.

So you can go on and on. There is no doubt about the shenanigans that have been going on. I hesitated when you mentioned the need for us to hold this hearing in light of the jurisdictional concerns regarding this subject. Frankly, by asserting the jurisdiction over insurance in this Committee, and with the Banking Committee taking over with a reinsurance loan guarantee bill, that is a sweetheart deal for the insurance companies, I wanted to make sure that our inquiry was not interpreted as a response to the Banking Committee encroaching on Commerce Committee's jurisdiction. The Consumer Subcommittee that you head has a responsibility to investigate this matter, and we rightfully are in our rights here in holding this hearing, but the truth of the matter is that all of these financial deals and these SPEs, are Banking issues that are within the Banking Committee's purview. We must work together, and support the Banking Committee's efforts to craft possible solutions to the problems at hand. Brooksley Born suggested

tighter regulation of the securities, but not only was Enron successful in blocking this action in the Congress, but it was able to get Congress to pass legislation exempting energy derivatives that are traded without rigid regulations. So we might get the members of the Commission up here and hear what has been going on here. This is a cancer.

When you see in Business Week in August of 2000, last year, the company was worth \$90 billion and today it is worth \$1 billion, that thing has got to stop, and we are all guilty in letting it happen.

I thank you.

Senator DORGAN. Senator Hollings, thank you very much.

Senator Wyden.

**STATEMENT OF HON. RON WYDEN,
U.S. SENATOR FROM OREGON**

Senator WYDEN. Thank you, Mr. Chairman, and let me thank you for holding this hearing. You have a long record of advocating for the consumer and workers and investors, and I just appreciate the chance to work with you and especially appreciate you including the Oregon witnesses we will hear from today.

Because of what happened at Enron, Mr. Chairman, there are Oregon families going to grief counseling rather than holiday parties this year. These are Oregonians who lost retirement security because its Enron stock plunged like the Titanic. In effect, the senior executives on the deck locked the workers in the boiler room, preventing them from selling off 401(k) shares while they dumped their own.

What is especially unsettling to me is, there is a law on the books right now that was designed to prevent the sort of carnage that took place at Enron. I wrote this law. It is called the Financial Fraud Detection and Disclosure Act, and it stipulates that there would be significantly stiffer requirements on accountants to search for fraud at publicly held companies like Enron and disclose it when they find it.

I am going to withhold my judgment on this case until the Securities and Exchange Commission and criminal investigators have completed their inquiry, but given what is already on the record it sure does not look like much was done to detect and disclose the very conduct that the Financial Fraud, Detection, and Disclosure Act was designed to root out. This law was written after more than 30 hearings into the accounting profession, hearings chaired by John Dingell, and I intend to see to it that this law is complied with.

For example, the Financial Fraud, Detection, and Disclosure Act requires that every single audit include procedures designed to detect illegal acts, and that they specifically identify related party transactions that are essential to the integrity of the financial statements. Here, there were clearly related party transactions that had financial hide-and-seek written all over them, and yet the auditors failed to have procedures in place to identify them.

When Enron's chief financial officer set out a special purpose entity funded primarily with Enron's stock bought at a discount while continuing to serve as an officer of Enron, that should have set off

the warning lights required by the Financial Fraud, Detection, and Disclosure statute. Certified financial statements are not supposed to be a game of financial hide-and-seek, and our review should pay particular attention to how it was that Enron transactions big enough to bring down this financial house of cards were not big enough to clearly and visibly be reported by the auditors.

Mr. Chairman, I thank you, and again I appreciate all of your leadership.

Senator DORGAN. Senator Wyden, thank you. Senator Burns.

**STATEMENT OF HON. CONRAD BURNS,
U.S. SENATOR FROM MONTANA**

Senator BURNS. Mr. Chairman, I am looking forward to listening to the witnesses. Thank you.

Senator DORGAN. Senator Burns, thank you very much.

I would like to ask the first panel to come forward. I will call your name as you come to the table. Ms. Janice Farmer, Ms. Mary Bain Pearson, Mr. Charles Prestwood, Mr. Robert Vigil, and Mr. Donald Eri, if you would come forward and take seats at the table we would appreciate that.

The Committee thanks you for being here today. We know many of you have traveled many miles, and we will benefit from your testimony. We will ask Ms. Janice Farmer to go first. Ms. Farmer, you are, I understand, accompanied by your daughter. Is that correct?

Ms. FARMER. Yes, that is correct.

Senator DORGAN. Ms. Farmer, why don't you proceed, and we will include the entire statement you have produced for the record. You may summarize. Thank you very much.

STATEMENT OF JANICE FARMER, ENRON (RETIRED)

Ms. FARMER. Dear Members of the Commerce Committee, thank you for inviting me to speak today. Although in some ways it is an exciting experience for an average American to be appearing before the Senate, I wish the circumstances were such that I was not here. My name is Janice Farmer, and I am from Orlando, Florida. I spent 16 years in the natural gas industry, starting with Florida Gas Transmission Company, which later became a part of Enron. I worked in the Right of Way Department and also at the training center, where people were trained to handle natural gas safely.

One year ago, I retired from Enron Corporation with nearly \$700,000 in Enron stock. This was my life savings, my nest egg. I am a single woman, and I am proud that I was able to amass this amount in the Enron 401(k) plan. I did without many things that I would like to have spent money on in order to participate in this plan. I thought that I had prudently planned for my financial future and that of my children and of my grandchildren.

I was proud to invest in Enron stock. The company encouraged me and others to do so, saying that employee ownership would help prevent any possible hostile corporate takeovers. We were a loyal and hardworking group of employees. We lived, ate, slept, and breathed Enron, because we were owners of the company. I trusted the management of Enron with my life savings.

Senators I will not mince words here. They betrayed that trust. My life savings are gone. I am now left, a year away from Social

Security, with a \$63 a month pension check from another company. On top of all of this is the lockdown. By October 22, 2001, I was upset and dismayed over the news of Enron's financial status. When I saw the stock drop, I called to sell and was told that I was locked out, so I had to stand by and watch my savings disappear. In the end, I received a check for \$4,000. That is all that was left.

I leave it to you and the courts, I guess, to decide if locking me and other employees out was a breach of trust by those running the plan. I know that many other employees share my financial pain, and the sense of betrayal.

Senators I am not a lawyer, but I understand there is a law called ERISA, and that this law imposes some fiduciary obligations on those in charge. I cannot help but feel that I and thousands of employees like me have been lied to and we have been cheated. Instead of being rewarded for my hard work and loyalty, I am left with a lawsuit against my employer and those responsible. It may be too late for you to help me, but it is not too late for you to take some action to help make certain that this does not ever happen to anyone else again.

Thank you very much.

[The prepared statement of Ms. Farmer follows:]

PREPARED STATEMENT OF JANICE FARMER, ENRON (RETIRED)

Dear Members of the Commerce Committee,

Thank you for inviting me to speak today. Although in some ways it is an exciting experience for an average American to be appearing before the Senate, I wish the circumstances were such that I was not here.

My name is Janice Farmer. I am from Orlando, Florida. I spent sixteen years in the natural gas industry starting with Florida Gas Transmission, which later became a part of Enron. I worked in the Right of Way Department and also at the training center, where people were trained to handle natural gas safely.

One year ago, I retired from the Enron Corporation with nearly \$700,000 in Enron stock. This was my life savings, my nest egg. I am a single woman and am proud that I was able to amass this amount into the Enron 401(k) plan. I did without many things I would have liked to have spent money on, in order to put money in that plan. I thought that I had prudently planned for my financial future and that of my children and grandchildren.

I was proud to invest in Enron stock. The company encouraged me and others to do so, saying that employee ownership would help prevent any possible hostile corporate takeovers.

We were a loyal and hard-working group of employees. We lived, ate, slept and breathed Enron because we were owners of the company.

I trusted the management of Enron with my life savings. Senators, I won't mince words here. They betrayed that trust. My life savings is gone. I am left now a year away from Social Security and am living off a \$63.00/month pension check from another company.

On top of all this is the lockdown. By October 22, 2001, I was upset and dismayed over the news of Enron's financial status. When I saw the stock drop, I called to sell and was told I was locked out. So I had to stand by and watch my savings disappear. In the end, I received a check for \$4,000. That's all that was left. I leave it to you and the courts, I guess, to decide if locking me and other employees out, was a breach of trust by those running the plan.

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Instead of being rewarded for my hard work and loyalty, I am left with a lawsuit against my employer and those responsible. It may be too late for you to help me, but it is not too late for you to take some action to make certain that this does not happen again.

Thank you very much.

**STATEMENT OF HON. BILL NELSON,
U.S. SENATOR FROM FLORIDA**

Senator NELSON. Mr. Chairman, I just want to point out that the lady is from my home town area of Central Florida, and there is a great deal of concern among the retirees that live in Florida that are suffering as has been stated here. I will get into some specifics later on, but I just want to thank Ms. Farmer for being here.

Ms. FARMER. Thank you. It is an honor to be here.

Senator DORGAN. Senator Nelson, thank you. Ms. Farmer, thank you for your testimony.

Next, we will hear from Ms. Mary Bain Pearson. Ms. Pearson.

STATEMENT OF MARY BAIN PEARSON, ENRON SHAREHOLDER

Ms. PEARSON. My name is Mary Bain Pearson. I am a 70-year-old Latin teacher and tutor. I am a widow of G. P. Pearson, who was a Representative in the Texas Legislature from Grimes County, Texas.

I have always tried to handle my business in a logical manner, like you conjugate a verb or decline a noun. I am also a child of the Depression, when my father was working in a bank and the bank failed during the Depression, and he never got over that, and for the next 50 years he used to always warn me to save something for an emergency or an illness, and not to put all my eggs in one basket, and be careful with my money. I used to laugh at him and kid him, but you know what, he was right.

After a while, I decided I would invest in Enron stock. Now, I do not want you to think I am too naive. I did a lot of work investigating it, and learned about its history. Finally, I bought 100 shares so I could go to the board meeting, and I did go to some board meetings and met some of the members of the board, who I held in the highest esteem.

We had Charles Lemaistre, who I still hold in the highest esteem, who is a very wonderful man, and Mrs. Phil Gramm was there that day, and I thought she was smart, because she already had a job in the economy up here in Washington, and I thought she was smart. There were other people on the board in Houston that I knew, and I always held them in high esteem, and so I thought, well, this must be a good company to invest in, so I bought some more stock.

Many times I would pick up the newspaper and see Ken Lay's name in it. He was very generous. He was always at charity parties and giving millions of dollars to this and hundreds of thousands of dollars to that, and it was a wonderful thing, and it made the company look very, very good.

I am just a pebble in the stream, a little bitty shareholder. I did not lose billions. I did not even lose a million, but what I did lose seems like a billion to me. In fact, what really hurts is, I bought my granddaughter some Enron stock, and she is 10 years old, so I feel real bad about that.

I was going to use my Enron stock as my long-term health care. I had taken my father's advice and put that aside in case of an

emergency if I got sick. I had nursed my husband for 7 years with cancer, day and night, and been happy to do it, but after he passed away I did not want that to fall on my children's shoulders, so I put this stock aside so that I could call on it and use it in case I had a long-term disease.

Well, I do not know what I am going to do now. I am going to have to go home and reevaluate my life and see what I can do. I am not a big stockholder, just a little person, but when they asked me how I felt about Enron I said, well, at first I was in a state of shock for a while. I could not believe that it happened so quickly. I asked my accountant if I should not sell the stock and he said no, hold onto it. I can hardly wait till April 15 when I go to see him.

[Laughter.]

Ms. PEARSON. And then after that wore out, a veil of disappointment fell over me. I was disappointed in the people that I put my trust in years ago. 1986 is when I bought my first stock. And then after a little time passed on, bitterness came into being, and bitterness will eat you alive if you let it, but sometimes at night I do feel real bitter over what I have lost, because it was a big part of my future, and I do not know how I am going to handle the future now. All I can do is hope and pray I do not get sick.

So thank you for letting me pour my heart out to you.

[The prepared statement of Ms. Pearson follows:]

PREPARED STATEMENT OF MARY BAIN PEARSON, ENRON SHAREHOLDER

My name is Mary Bain Pearson. I am 70-years of age. I am the widow of G.P. Pearson, formerly a state representative from Grimes County, Texas. After my husband passed away, I tried to follow the teachings of my husband and my father by setting aside money for the eventual downturn in the economy which always seems to occur. I am a child of the depression and my father had told me after having worked in a bank that failed, that I should set aside my money in safe investments for my retirement and for needed medical expenses.

After attending a board meeting, I was impressed with what the leaders of the company had to say and decided to buy more stock for my granddaughter. I have been adding to my stock over the years and have not sold because my accountant also believed Enron was a good company and that I shouldn't sell. I believed what the people at the company said, not only in their public statement, but in the annual reports and believed in the people who were on the board of directors such as Dr. Charles LeMaitre, former Chancellor of the University of Texas and Wendy Gramm, wife of U.S. Senator Phil Gramm. I knew some other members of the board who resided in Houston and believed them when they represented that they were running the company in the best interest of the shareholders.

Many times when I picked up the newspaper Ken Lay was either giving money to charities or helping raise money for some worthy purpose. I believed he was a good man and kept my money with his company because I thought he and the people he had placed in positions of trust in the company were honest.

I am just a pebble in the stream, just a little bitty stockholder, but both my granddaughter and I have lost money we had set aside for our future and do not know how we will replace those losses. I specifically set aside my stock for my long-term health care needs because I took care of my ailing husband for seven years before he passed away. I was happy to take care of him, but I do not want my grown children to have the responsibility to take care of me if something should happen to me health wise.

Thank you for taking the time to listen to me and to consider my plight which is not nearly so bad as many of the people who worked for Enron for many years and had their life savings disappear.

Senator DORGAN. Ms. Pearson, thank you very much for being here.

Next, we will hear from Mr. Prestwood.

STATEMENT OF CHARLES PRESTWOOD, ENRON (RETIRED)

Mr. PRESTWOOD. Thank you, Mr. Chairman, and all the Committee members and other Senators that are here. My name is Charles Prestwood, and I have come from Conroe, Texas, which is about roughly 50 miles north of Houston, I am 63 years old, and I have been with Enron ever since the beginning. I have been with the Houston Natural Gas System before that. Internorth and Houston Natural Gas, they merged, and that is where Enron was formed, and I have been there the whole way, all the way from the beginning to the end.

Senator MCCAIN. How many years is that, Mr. Prestwood?

Mr. PRESTWOOD. 33½ years that I was in the gas business, in Enron most of that time, and I am a very broke person. I lost everything I had.

I was what I call very loyal. The word loyalty to a company, you know, is something that we helped build. We worked real hard on building the corporation of Enron to be the number 1 gas supplier, or the number 1 energy supplier for which we achieved that goal, and we were very happy to achieve that goal, and then just to see it evaporate right in front of our eyes, and I had all my savings, everything in Enron stock. I lost \$1.3 million, and I hope and pray that it can be recovered, or I hope and pray that—my solemn prayer is that no other company will ever go through what we did, because Enron was a good corporation.

We made lots of money. We were trained to believe that we were number 1 no matter what we did, and we achieved every goal we set out to achieve, and everything was just so lovey-dovey, you know what I mean, with our financial standing and stuff. In other words, I reached the age of retirement at 62. I retired October 1 in the year 2000, and I had everything kind of financially under control. In other words, I could take my retirement. I could take my social security and bridge it with a little out of my savings account and live a fairly decent and happy life, you know, but all those plans have changed now. In other words, it was from rags to riches and back to rags, and that is a simple way of explaining it.

In other words—and the way that the company prospered, the bookkeeping and the accountants, and the way they did things was way over our heads. We did not know anything about that, us retirees in 99 percent of the Enron employees they did not know anything was wrong with our company. They had no idea. I had no idea that our company was in trouble, that our company was on the verge of collapse, but you know, it does not take long.

And then we get back to the lockdown. The strategy that was used there, they called it a coincidence, you know. Coincidences happen, you know, and everybody understands that, but when we were locked down we could not get to our stock. We could not get to our broker to move our stock out because it was in the process of being transferred to another company. All we could do was just sit there and watch it melt down.

I still have all my stock, but the most important thing about that stock is the ink on it. That is about what it is worth, and it is very touching to be in a predicament like this, because a lot of people

have asked me, Charlie, why in the world didn't you get out beforehand?

I go back to that one simple word of loyalty. Loyalty to a corporation, loyalty to something that I helped build, that I strived and worked a lifetime to build, and that is the reason I did not, and the revenues are simply stunning, of our company. In other words, how a company—well, let me just read a little quotation here.

It says, that is how Chief Executive Officer Jeff Skilling described Enron's strong financial operating performance in 2000. Every major business pipelines, wholesale services, retail, and broadband turned in strong performances in the year that were reflected in record volumes, contract value, and profitability. In other words, we reached \$101 billion in the year 2000. That was our sales, and right now, in other words, that was the business that we had done across the Nation and across the world, all of the foreign works we have got overseas and stuff.

We had a great year in the year 2000, and now we are down to the year of 2001, when our stock started just falling. We thought it was just the economy. You know, the economy is bad, and so everybody's stock is going down. It did, but then when the balance sheet started coming out we still—we thought we had the best.

In other words, if there is a good accountant, we will hire him. That was our goal, our motto. We were supposed to have the best, and not get things messed up like they did, and back on January 26 is another illustration of why the employees and the retirees did not sell their stock. It was—I pulled a copy of it off of the computer that the estimated value of the Enron stock at the close of the year of 2001 would be between \$122 and \$126, with an average of \$124 to \$125, and at the end of 2002 the value of the Enron stock would be \$145 on the average.

Well, you know, common sense will tell you you do not get rid of stock like that. You hang onto it, and try to achieve those goals, and another just common sense way I see it, they said, well, you could have rolled out of that and rolled it into something else, but who wants to get off a winning horse?

So where does that leave me? I can tell you without pulling punches something stinks here, and it really does. There are people at Enron who made millions selling Enron stock, encouraging the retirees and encouraging the Enron employees to just hang on to it, it is going to get better. It will get up there and our stock will split again, for which I have been very fortunate. I have been very fortunate, but the fact is that I have seen two or three stock splits, 2 for 1. The stock would come up and split, and it would come back up, and that is where I gained mine.

But in other words, I lost it a whole lot quicker than I made it, and I and my coworkers, and I am speaking for the Enron employees that are still working for Enron. I am speaking for the employees that got discharged here a few days back, and all the retirees that are not here. I am honored to be here and get to say a few words on our behalf that you all will know the actual truth of what actually is happening to us in this good old U.S.A., and I hope and pray that there is something that can be done about it, and I hope and pray that there are some laws that can be set up to where every corporation in the United States will be on the same page on

keeping books, that there will not be any of this thing happening again.

So I thank all of you for listening, and that is my story.
[The prepared statement of Mr. Prestwood follows:]

PREPARED STATEMENT OF CHARLES PRESTWOOD, ENRON (RETIRED)

Thank you, Mr. Chairman, for the opportunity to appear before you today.

My name is Charles Prestwood. I am from Conroe, Texas and I am 63 years old. I built my retirement fund over the course of a long career in the natural gas industry, most of which I spent in the field with Houston Natural Gas working on pipelines. In the 1990s, when Enron acquired HNG, all my retirement investments were automatically converted to Enron stock.

Enron stock was aggressively promoted by executives within the company. I continued to receive part of my compensation from Enron in company stock and stock options. Enron promoted employee stock ownership verbally and through internal publications. Here is a quote from an internal publication sent to all employees in early 2001:

Simply stunning. That's how Chief Executive Officer Jeff Skilling describes Enron's strong financial and operating performance in 2000. Every major business—pipelines, wholesale services, retail and broadband—turned in strong performances for the year that were reflected in record volumes, contract value and profitability. Revenues increased two-and-a-half times, reaching \$101 billion. For the first time, Enron's pre-tax net income exceeded \$1 billion, a 32 percent increase over last year, and shareholders received an 89 percent gain on the stock price. Other significant highlights included:

- Fourth quarter revenues of \$40.75 billion, exceeding 1999's entire reported revenues of \$40 billion;
- 25 percent increase in earnings per diluted share to \$1.47;
- 59 percent increase in marketed energy volumes to 52 trillion British thermal unit equivalents per day; and
- Nearly doubling of new retail energy contracts to \$16.1 billion.

Enron Business met with Jeff to discuss last year's results and his outlook for 2001.

EB: Enron had a great 2000. How did we do it?

Jeff: Every one of our businesses performed beyond our expectations.

We believed in the story in this publication and it is typical of the type of promotion by Enron executives. I recall when the company did particularly well, these types of internal publications would be circulated. I also recall attending a breakfast with Mr. Lay where he told us not to sell our Enron stock.

As a result of this type of promotion, I and many others continued to invest in Enron up until the bitter end. To me, this is the American way, loyalty to your employer.

I retired from Enron Corp. in October 2000 feeling that after a lifetime of hard work, my retirement account with Enron provided financial stability. I could no longer keep pace with the physically demanding work required in plant operations. I expected that Enron stock would support me. I worked hard to make it so. I had \$1.3 million in savings, all in Enron stock.

Let me mention the lockdown. The lockdown started, to the best of my knowledge on October 17, 2001. At this point, Enron had just announced the bad news that shocked us all. Much to our chagrin, we were locked out of our accounts. So folks who bought Enron on the street could trade, but we could not.

So where does that leave me? I can tell you, without pulling punches, something stinks here. There are people at Enron who made millions selling Enron stock, while we, the rank and file, got burned. It's that simple. I am left with a tiny fraction of my \$1.3 million, or about \$8,000. It's too late in my life to start over to build up my funds.

I don't know the law, but I know what is right and what is wrong. There is something terribly wrong here. I thought someone was supposed to be looking out for our interests. I thought that people had to treat us honestly and deal fairly with us. In my neck of the woods, what happened is not right.

I am only one of thousands who have been wiped out. I hope you can do something about it for me and the many like me.

I and my co-workers are proud of the industry we helped build, including the work we did for Enron and its predecessors. For most ordinary workers, Enron's failure taints lifetimes of dedicated work as well as striking a devastating blow to our futures.

Thank you all for listening to me today.

Senator DORGAN. Mr. Prestwood, thank you very much.

Next, we will hear from Mr. Vigil. Mr. Vigil, will you proceed?

**STATEMENT OF ROBERT VIGIL, ELECTRICAL MACHINIST
WORKING FOREMAN, PORTLAND GENERAL ELECTRIC
PELTON/ROUND BUTTE HYDROELECTRIC PROJECT**

Mr. VIGIL. Good morning. Thank you for allowing me to be here. My name is Bob Vigil. I am an Electrical Machinist working for Portland General Electric (PGE). I work at PGE's Portland Hydroelectric Plant in Central Oregon. I am 47 years old and have been employed by PGE for 23 years.

I come to you representing hundreds of hardworking PGE employees who have been financially devastated by Enron's recent stock price collapse and bankruptcy. I am one of 911 current PGE employees representing the Local 125 International Brotherhood of Electrical Workers. In addition to the members of our bargaining unit there are 1,870 other employees at PGE.

Since 1981, all of PGE's employees have participated in a 401(k) plan which we expected to provide us with a comfortable retirement. For every \$1 that we individually contribute to the plan, up to 6 percent of our income, the company has committed to contribute an equal amount in stock.

Enron purchased PGE in 1997, at which time all of PGE's stock we had in our accounts automatically converted to Enron stock. At first, this looked like good news for the employees. Enron was riding high, and as we saw the company officers and supervisors investing in company stock we felt assured that our own investments were sold.

As you probably are aware, by August 2001 stock had shot up to an all-time high of \$90.56. At that time, my 1,800 shares were worth \$163,000. Little did those of us working hard every day to help make the company successful know what was going on at the top of Enron. We trusted management's glowing reports of strong financial growth and opportunity with Enron. Then in October 2001, Enron's house of mirrors came crashing down in the largest bankruptcy in history.

There are a few things you need to understand about our 401(k) plan to understand the impact of Enron's collapse. First, we are free to make various kinds of investments with our own contributions, but the plan prohibits any employee under age 50 from trading the company's contributions. In other words, the company puts in its own stock, and until we reach age 50 they hold that stock.

Second, until very recently, even after age 50 we could only trade 25 percent of the company's contributions per year.

Third, I said before that the company is committed to contributing stock equal in value to our cash contributions. The company's practice, however, has been to purchase blocks of stock at the beginning of the year which it then uses to match our contributions over the course of the year. In making those contributions, Enron

uses the cost of the stock when it purchased it, not the value when it makes the contributions. In good years, this certainly has been advantageous, but over the course of the last year our employer has been contributing stock worth a fraction of the contribution it is supposed to be matching.

Finally, as all of you well know, we were all barred from trading our stock during a critical period this last fall. It seems strange to me that as soon as the really bad news came out on Enron we found ourselves unable to move out of the stock. Enron suddenly changed account managers, and our investment accounts were locked down. I have seen that Enron says we were only locked out of our accounts for 10 trading days, from October 29 through November 12, but as early as September 26 my coworkers were finding that they could get access to their accounts but they could not conduct any transactions.

As the truth about Enron started to come to light and the officers at the top cashed out, we, the employees, had no choice but to ride the stock into the ground. We were all somewhat hopeful that the proposed Dynegy buy-out of Enron would at least give us relief from the \$5 per share range, but when Dynegy pulled out on November 28, 2001, Enron's stock dropped below the \$1 per share range, where it currently stays.

Every PGE employee tells a tale about his or her losses. All of them are tragic, and most of them are life-changing. All of us regarded the 401(k) plan as a way of investing our hard-earned wages for future security, and we assumed that in matching our contributions our employer was giving us something of value. It all now appears to have been a cruel illusion. As a result, retirees are finding their nest eggs gone. Older employees are facing having to work much longer than they had intended, and younger workers are being forced to revise their financial and career plans.

To give you an idea of the magnitude of the overall losses, a number of my coworkers at PGE have agreed to allow me to give their names, ages, years of service with PGE and losses in Enron stock. Keep in mind that the losses I am about to list represent only the lost stock value since we were locked out of our accounts in mid-September:

- Tim Ramsey, age 55, 33 years with PGE, \$995,000 loss;
- Roy Rinard, age 53, 22 years with PGE, \$472,000 loss;
- Al Kaseweter, age 43, 21 years with PGE, \$318,000 loss;
- Joe and Diane Rinard, age 47, 12 years with PGE,
\$300,000-plus loss;
- Dave Covington, age 32, 22 years with PGE, \$300,000 loss;
- Tom Klein, age 55, 30 years with PGE, \$188,000 loss;
- Mike Schlenker, age 41, 10 years with PGE, \$177,000 loss;
- Patti Klein, age 47, 24 years with PGE, \$132,000 loss.

Just eight employees who have together invested 188 years with PGE have together lost \$2,882,000. You can imagine how this catastrophe has affected us. Now multiply that feeling across thousands of our homes.

Rest assured that our experience represents just the tip of the iceberg of the heartache and family devastation caused by Enron's collapse. It is estimated that Enron's collapse resulted in employee

pension plan losses of up to \$1 billion. If my eight coworkers alone lost \$2.8 million that estimate is probably low.

I came from across the country today to urge you to fully investigate the circumstances surrounding Enron's collapse. We are not looking for a handout. We are looking for solid, truthful answers as to what happened here so that we may possibly recoup some of this money, maintain our dignity, and prevent further theft occurring to others who worked their entire lives only to become victims of robbery.

In addition, the working people in this country need your assurances that neither the future solvency of their social security benefits nor any greater share of their pension benefits will depend on the goodwill of corporate traders.

Thank you sincerely.

[The prepared statement of Mr. Vigil follows:]

PREPARED STATEMENT OF ROBERT VIGIL, ELECTRICAL MACHINIST WORKING FOREMAN, PORTLAND GENERAL ELECTRIC PELTON/ROUND BUTTE HYDROELECTRIC PROJECT

Good morning. My name is Robert Vigil. I am an Electrical Machinist Working Foreman for Portland General Electric ("PGE"). I work at PGE's Pelton/Round Butte Hydroelectric Project, in Central Oregon. I am 47 years old, and I have been employed by PGE for 23 years.

I come to you today representing hundreds of hard-working PGE employees who have been financially devastated by Enron's recent stock price collapse and bankruptcy. I am one of 911 current PGE employees represented by Local 125, International Brotherhood of Electrical Workers. In addition to the members of our bargaining unit, there are some 1870 other employees at PGE. Since 1981, all of PGE's employees have participated in a \$401(k) plan, which we expected to provide us with a comfortable retirement. For every dollar that we individually contribute to the plan, up to 6% of our income, the company is committed to contributing an equal value in its stock.

Enron purchased PGE in 1997, at which time all of the PGE stock we had in our accounts automatically converted to Enron stock. At first, this looked like good news for the employees. Enron was riding high, and as we saw the company officers and supervisors investing in company stock, we felt assured that our own investments were solid. As you are probably aware, by August 2000, Enron's stock had shot up to an all-time high of \$90.56. At that time, my 1800 shares were worth \$163,000.

Little did those of us working hard every day to help make the company successful know what was going on at the top of Enron. We trusted management's glowing reports of strong financial growth and opportunity with Enron. Then, in October 2001, Enron's house of mirrors came crashing down in the largest bankruptcy in history.

There are a few things you need to understand about our \$401(k) plan to understand the impact of Enron's collapse. First, we are free to make various kinds of investments with our own contributions, but the plan prohibits any employee under age 50 from trading the company's contributions. In other words, the company puts in its own stock, and until we reach age 50, we hold that stock. Second, until very recently, even after age 50, we could only trade 25% of the company's contributions per year. Third, I said before that the company is committed to contributing stock equal in value to our cash contributions. The company's practice, however, has been to purchase blocks of stock at the beginning of the year, which it then uses to match our contributions over the course of the year. In making those contributions, Enron uses the cost of the stock when it purchased it, not the value when it makes the contributions. In good years, this certainly has been advantageous. But over the course of the last year, our employer has been contributing stock worth a fraction of the contribution it is supposed to be matching.

Finally, as you all well know, we were all barred from trading our stock during a critical period this last fall. It seems strange to me that as soon as the really bad news came out on Enron, we found ourselves unable to move out of the stock. Enron suddenly changed account managers, and our investment accounts were "locked down." I have seen that Enron says we were only locked out of our accounts for ten trading days—from October 29 through November 12. But as early as September

26, my coworkers were finding that they could get access to their accounts, but they could not conduct any transactions. As the truth about Enron started to come to light—and as the officers at the top cashed out—we, the employees, had no choice but to ride the stock into the ground.

We were all somewhat hopeful that the proposed Dynegy buyout of Enron would at least give us relief in the \$5-per-share range. But when Dynegy pulled out of the deal on November 28, 2001, Enron's stock dropped below the \$1-per-share range, where it currently stays.

Every PGE employee has a story to tell about his or her losses. All of them are tragic, and most of them are life changing. All of us regarded the §401(k) plan as a way of investing our hard-earned wages for future security. And we assumed that, in matching our contributions, our employer was giving us something of value. It all now appears to have been a cruel illusion. As a result, retirees are finding their nest eggs gone; older employees are facing having to work much longer than they had intended; and younger workers are being forced to revise their financial and career plans.

To give you an idea of the magnitude of the overall losses, a number of my coworkers at PGE have agreed to allow me to give you their names, ages, years of service with PGE, and losses in Enron stock. Keep in mind that the losses I am about to list represent only the lost stock value since we were locked out of our accounts in mid-September:

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Just these eight employees—who have together invested 188 years with PGE—have together lost \$2,882,000.

You can imagine how this catastrophe has affected us. Now multiply that feeling across thousands of other homes. Rest assured that our experience represents just a tip of the iceberg of the heartache and families' devastation caused by Enron's collapse. It is estimated that Enron's collapse resulted in employee pension plan losses of up to \$1 billion. If my eight co-workers alone lost nearly \$2.8 million, that estimate is probably very low.

I come from across the country today to urge you to fully investigate the circumstances surrounding Enron's collapse. We are not looking for a handout. We are looking for solid, truthful answers as to what happened here so that we may possibly recoup some of this money, maintain our dignity and prevent further theft from occurring to others who work their entire lives only to become victims of robbery. In addition, the working people in this country need your assurances that neither the future solvency of their Social Security benefits nor any greater share of their pension benefits will depend on the good will of corporate traders.

Thank you sincerely.

Senator DORGAN. Mr. Vigil, thank you very much.

Finally, we will hear from Mr. Eri. Mr. Eri, you may proceed.

**STATEMENT OF DONALD ERI, SPECIAL TESTER (RETIRED),
PORTLAND GENERAL ELECTRIC**

Mr. ERI. Good morning. My name is Don Eri. I am 57 years old. I retired from Portland General Electric (PGE) in April of 2001, after 33 years of company service. I joined the company in December 1967, and worked my way up the ranks, retiring as a Senior Tester. I come to you today representing the thousands of PGE retirees who have been financially devastated by Enron's recent stock price collapse and bankruptcy.

Enron purchased PGE in 1997. Because of the sale, the PGE stock that my coworkers and I had in our 401(k) accounts automatically converted to Enron stock, and from that time to the present PGE met its obligation to match employee contributions to

the 401(k) plan by giving us Enron stock. For a time, that looked real good. As you probably are aware, by August of 2000, Enron stock had shot up to an all-time high of \$90.56 a share. Before I retired in April of 2001, I sold all but 600 of my Enron shares. I expected the remaining stock to provide me with some growth in my retirement and give me a cushion to provide for the basics in my later life, such as the rapid rise in medical cost.

How wrong I was. It turns out the people at the top of the company seriously misrepresented the financial picture of the company's future to those of us who worked to keep the lights on for over 700,000 customers. We took pride in what we did. We worked in all kinds of adverse weather conditions for days at a time without rest to make sure that our Oregonians had light and heat when they needed it. Since I had the sheer luck of getting out of Enron before it collapsed completely, my exposure was, as I mentioned, only 600 shares, but Enron's smoke and mirrors still cost me over \$40,000. Next to the stories you have heard from my coworkers, who have lost hundreds of thousands of dollars, \$40,000 may not sound like much to you, but to me it is a significant amount of money that I had counted on to help support me through my retirement. Moreover, if I had not retired and cashed out in late April I probably could not afford to retire now, since far more of my pension would have disappeared.

The money I lost represents past earnings that I invested on my own, as well as contributions toward my pension that the employer was committed to provide for me. Now it is gone. With Enron in bankruptcy, it will be something short of a miracle if I ever get any of it back. PGE retirees who had Enron stock are hurting. They do not know what the future holds. For some of them a substantial portion of their retirement portfolio has simply disappeared.

What they want from our country's leaders are some straight answers about what happened at Enron. Then they can make their own decisions whether there are any realistic means for trying to recover their hard-earned money. We are not looking for handouts. We just want to be heard, and help this Committee and others to determine the truth so we can get on with our lives.

Thank you.

[The prepared statement of Mr. Eri follows:]

PREPARED STATEMENT OF DONALD ERI, SPECIAL TESTER (RETIRED),
PORTLAND GENERAL ELECTRIC

Good morning. My name is Donald Eri. I am 57 years old. I retired from Portland General Electric—PGE—in April 2001, after 33 years with the company. I joined the company in November 1968 and worked my way up the ranks, retiring as a Special Tester.

I come to you today representing the thousands of PGE retirees who have been financially devastated by Enron's recent stock price collapse and bankruptcy. Enron purchased PGE in 1997. As an immediate result of that sale, the PGE stock that my co-workers and I had in our 401(k) accounts automatically converted to Enron stock, and from that time to the present, PGE met its obligation to match employee contributions to the 401(k) plan by giving us Enron stock.

For a time, this looked like a good deal. As you are probably aware, by August 2000, Enron's stock had shot up to an all-time high of \$90.56 a share. When I retired in April of 2001, I sold all but 500 of my Enron shares. I expected the remaining stock to provide me with some growth in my retirement and give me a cushion to provide for basics in my later life, such as the rapidly-rising medical costs most people can no longer afford to insure against.

How wrong I was.

It turns out that Enron was really a sham. Here it was, the 10th-largest company (in revenue) in the United States, a leader in the move toward a deregulated energy market. Its top executive, Ken Lay, was a personal friend of President George Bush and Vice President Dick Cheney. Its directors were prominent people, with valuable political and industrial ties. They were all making huge amounts of money, apparently off of a highly successful company. We saw our supervisors buying up the stock, and encouraged by the smell of success, we used our own money in our 401(k) plan to do likewise.

Despite our employer's enthusiasm for deregulation, those of us who have worked in the electric utility industry over the years have always had serious misgivings about whether a deregulated industry would be able to provide the kind of reliable service that the nation expects and that we have taken pride in providing. But we had no idea how unregulated the industry actually is—and that our employer's financial dealings would completely escape any meaningful regulatory scrutiny.

It turns out that the people at the top of the company seriously misrepresented the financial picture and the company's future to those of us who worked to keep the lights on for over 700,000 customers. We took pride in what we did. We worked in all kinds of adverse weather conditions for days at a time without rest to make sure that Oregonians had light and heat when they needed it. And this is how we get paid back.

And they lied to you, and to legislators and regulators around the country, painting a picture of an industry that could flourish without government intervention.

Since I had the sheer luck to get out of Enron before it collapsed completely, my exposure was, as I mentioned, only 500 shares. But Enron's smoke and mirrors still cost me over \$40,000. Next to the stories you have heard of my co-workers who have lost hundreds of thousands of dollars, \$40,000 may not sound like much to you. But to me, it's a significant amount of the money that I had counted on to help support me through my retirement. Moreover, if I had not retired and cashed out last April, I probably could not afford to retire now, since far more of my pension would have disappeared.

The money I lost represents past earnings that I invested on my own, as well as contributions toward my pension that my employer was committed to provide for me. Now it's gone and, with Enron in bankruptcy, it will be something short of a miracle if I ever get any of it back.

PGE retirees who had Enron stock are hurting. They don't know what the future holds now that, for some of them, a substantial portion of their retirement portfolio has simply disappeared. What they want from our country's leaders are some straight answers about what happened at Enron. Then they can make their own decisions whether there are any realistic means for trying to recover their hard-earned money.

What Enron's current employees want is the same as what employees throughout this country want—some assurances that the pensions they are promised, and in which they are investing today, will have some real value when the time comes for them to retire.

We are not looking for a handout. We just want to be heard and to help this Committee and others determine the truth so that we can get on with our lives and—for some of us—retain our dignity.

Thank you.

Senator DORGAN. Thank you very much. Let me thank all five of you. It is not easy to come to Washington and appear at a Senate hearing. You represent, the five of you represent thousands and thousands and thousands of employees and investors across this country who could be here telling similar stories, and you tell your stories on their behalf, and we appreciate your willingness to do that.

Let me just ask one question, then I will call on my colleagues. I will show a chart a bit later on that shows the substantial amount of stock that was sold by the officers of the company, directors of the company, and other insiders, a very substantial amount of stock over a period of years, especially in recent years, totaling nearly \$1 billion.

Were any of you aware that there was very vigorous activity among top officers of the company to sell stock at the time they were suggesting to you you ought to buy stock? Was anyone on the panel aware of the amount of selling that was going on by those who were running the company, the board of directors, officers, and others?

Mr. VIGIL. We were aware that there was some activity going on. As far as those individuals that are 50 years and less of age, it did not make any difference. We could not do anything, so we did watch, and we did see the executives dumping a lot of stock, but we were bound by the plan. We could not do anything.

Senator DORGAN. Let me just ask one additional point on that matter. I believe it was Ms. Farmer who talked about the question of being locked out. Someone said—Mr. Vigil, you said that the company is responding by saying that lock-out, with respect to the change in plan, administrators really effectively only caused about a 10-day problem, and you are saying that employees did not have that experience at all. That lockout was more prohibitive than that and much more costly than that. Can anyone respond to that? The company is saying there was just this narrow and short period, because of the change in plan administrators, during which the employees were not able to sell their stock.

Mr. PRESTWOOD. Well, Mr. Chairman, I would like to respond on that, because down in the Houston Chronicle we got a statement last weekend where management was trying to confuse some dates or something, but I know exactly the date that I got my letter. The letter was written on October 8. The letter was mailed on October 10, and from Conroe to Houston it normally takes about 2 to 3 days for me to get my mail, and then I would have then until October 19, from October 19 through November 19 it was locked down, so that is the dates that I have.

Senator DORGAN. So your notification was 30 days during which you were locked out of transactions?

Mr. PRESTWOOD. Yes, it was.

Senator DORGAN. Senator McCain.

Senator MCCAIN. Mr. Prestwood, how much money did you lose?

Mr. PRESTWOOD. Sir, I lost \$1,310,000. That—sometimes people might think that is not very much money, but to me it was my life savings.

Senator MCCAIN. It depends on what committee you serve.

[Laughter.]

Senator MCCAIN. Mr. Prestwood, at any time, did you hear of Enron executives selling off blocks of stock.

Mr. PRESTWOOD. Yes, sir. Yes, sir. I saw it on the computer, but they hold us normally a month behind times on the channel. In other words, the page that I was pulling mine off of, I never thought anything about it, because I had great trust in our executives. In other words, I did not think anything about it. If I had, that should have been the first red flag that went up right there to me, but apparently it never dawned on me that it was bail-out time, because who would think there is anything wrong with Enron Corporation, the largest energy company in the world.

Senator MCCAIN. Ms. Pearson, you are familiar with Texas politics?

Ms. PEARSON. Just a little bit, by marriage.

Senator MCCAIN. Do you think that the Texas regulators should have had something to do with this, or do you think it is a federal responsibility?

Ms. PEARSON. Since so many shareholders are from all over the country, I would think it would be Federal.

Senator MCCAIN. Did you have any idea that Enron was in any kind of difficulty?

Ms. PEARSON. Why, no, of course not. The prediction was, like he said, \$100 now and \$125 in the next 6 months, so you do not think about selling the stock that has that bright outlook. No, I had no idea. I am on the perimeter. I am not a member of their employees. I am a stockholder, not an employee.

Senator MCCAIN. But, as you said, you got to know some of the board members.

Ms. PEARSON. I did know some of them, yes, I did, but I certainly thought if they were in there it was a good company, and they were smart enough to run it well, but I was wrong.

Senator MCCAIN. Mr. Vigil, do you think that the stockholders should be reimbursed?

Mr. VIGIL. I believe the employees that counted on the Enron executives to maintain and protect something that we considered a part of our wage package, there should be some way to recoup some of that, yes. I do not know how the entirety of all the stockholders can ever be repaid, but I think for the employees there should be something done, and I think legislation should be enacted to help that.

Senator MCCAIN. I thank you.

Yes, Ms. Farmer.

Ms. FARMER. May I respond to the first question that was asked? As far as the lockdown goes, I did not get the notification from Enron that they were changing administrators and that there would be a lockdown, and so I was totally unaware of that. When I called the new administrator I was transferred to their phone number in order to sell my stock on October 22. That is when I found out that there was a lockout of the employee's stock plan, savings plan, and when I pled with the person I was speaking to, the main response that I got was, yes, the timing is very unfortunate, and that was basically the main response, and I cannot even begin to describe to you how devastating that was to find out on that telephone call that I could not do anything with my stock.

Enron had made all employees responsible for their own retirement in mid-1990. They no longer wanted to be responsible for paying a monthly pension check after their employees retired. Therefore, when they made us responsible for our own retirement, at the most crucial time they denied access to our own money, and that is so wrong.

Senator MCCAIN. Mr. Prestwood, let me get this straight. You worked for 33½ years?

Mr. PRESTWOOD. Yes, sir.

Senator MCCAIN. And in those 33½ years you accumulated stock worth \$1.3 million?

Mr. PRESTWOOD. Yes, sir.

Senator MCCAIN. And how much do you have left now?

Mr. PRESTWOOD. Well, for whatever it is per share. I started out, I had about 16,500 shares. I have not figured it up. Whatever the market closed yesterday. It would be roughly \$20,000 or less, zero you might say.

Senator MCCAIN. I Thank you. Thank you, Mr. Chairman.

Senator DORGAN. Senator McCain, thank you.

I would like to just show a chart that describes part of what you were asking about, if I might.

This chart, if I could just hold it up, shows—and this is from November of last year to November of this year. This bar shows insider and restricted shareholder transactions, and it is very interesting that based on your testimony, management was counseling you all that the future was going to be quite wonderful and you need to hold onto your Enron stock, but at the same time, it is interesting that those who really knew from the inside moved their stock right at the top of the price range. It looks like there was an interesting paradox here about what they were doing with what they knew and what they were telling you.

This somehow cannot be an accident, that the officers and directors found the exact top of the price range to sell stock, while at the same time as you say in your testimony Mr. Prestwood, that assurances to employees are describing a simply stunning future and financial performance and that you ought to hang onto the Enron stock. I think it relates to the questions you asked, Senator McCain, and I think that is a fascinating chart.

Senator Hollings.

The CHAIRMAN. Thank you, Mr. Chairman, and I certainly thank this panel, because it has been the most important appearance we have had before this Committee this year. I say that not just casually.

Mr. Prestwood, you have really emphasized the need for Federal Government oversight. I have to listen to this nonsense of deregulation as proposed by people like Enron's leadership team who ran the company into the ground. You have got a whole coterie of people that comes up here to the Congress wanting to get rid of the Federal Government, as if the Government is the enemy. They claim the Government is not the solution, the Government is the problem. They succeeded in deregulating the oversight of energy derivatives, and we can all see where that has led.

You get the best of the best, Arthur Andersen, Salomon Brothers and all of these highly credentialed financial entities working with special purpose entities that you and I do not know anything about, but we put all of those things in the law because some people in government are persuaded to deregulate and remove protections that are there for a reason. They are there to protect loyal employees like you all. I have been here for 50 years, since the late forties, working on economically and industrially developing my little State, and I know all about the balanced budget, transportation and the market and tax system and everything else of that kind, but the one thing that businesses come to South Carolina for is that loyalty that you mentioned, loyalty to the employer.

We have a BMW plant in South Carolina with about 4,000 employees. They come from within 50 miles, a majority of them, of that particular plant. They produce a quality car better than what

they produce in Munich, Germany, where they have been making cars for years on end, but that employee loyalty, that is the thing. We need Government up here to protect the loyalty of you folks, because you all cannot tell what is going on. You all are working hard, a day's work for a day's dollar, as we say, and Enron's losses just emphasize that some businesses use all these little gimmicks and you have just got to watch how these things put everyday folks in peril. They say deregulate, deregulate, deregulate, and here we are, the finest working group in the world gone in a year's time from \$90 billion to \$1 billion and everybody is broke.

So your testimony here has been the best. We do not need any more hearings, but we are going to have some more hearings. We are going to find out from Lay and Skilling and all these other fellows exactly what went on, and follow it right down to affix individual responsibility as best we can, but overall, you have emphasized our particular need, which I have to constantly emphasize at every one of these endeavors up here, the necessity for regulation.

There is no question that we have the Federal Communications Commission to regulate, not to give away, or the Federal Trade Commission to protect consumers, or the Securities and Exchange Commission to protect the employees and these 401(k) plans and everything else of that kind, and I hope they will transmit your particular testimony time and again on C-SPAN so the public will understand the necessity of all these regulations.

They say get rid of the Government. They say the Government is not the solution, that the Government is the problem. Well, we have found what happens when Government does not deal with a problem, because we are not following through with regulations on the books. Thank you very much.

Senator DORGAN. Senator Hollings, thank you very much.

Senator Wyden.

Senator WYDEN. Thank you, Mr. Chairman. First, I so appreciate your coming. There is additional evidence that the lockdown period where you all could not sell your shares and your 401(k)s worked exactly how you all described it, and Mr. Chairman, I will just ask unanimous consent to put into the record an article from the newspaper, the Oregonian, that indicates that the plan was frozen, as the workers suggested, from October 17 until November 14, and that the stock price dropped almost \$24 per share during that period.

Senator DORGAN. Without objection.

[The information referred to follows:]

ENRON'S RISE AND FALL JULY 1985:
HOUSTON NATURAL GAS MERGES WITH INTERNORTH

The Oregonian, November 29, 2001

(Copyright 2001)

July 1985: Houston Natural Gas merges with InterNorth, a natural gas company based in Omaha, Neb., to form Enron, a natural gas pipeline company.

1989: Enron begins trading natural gas commodities, later becoming North America's largest natural gas merchant.

June 1994: Enron North America begins to trade electricity. Enron goes on to become the largest U.S. electricity marketer.

July 1996: Enron announces a deal to buy Portland General Electric for \$3.23 billion in stock and assumed debt.

March 1998: FirstPoint Communications, a division of Portland General Electric, becomes Enron Communications.

April 1999: Enron agrees to pay \$100 million over 30 years to name new Houston ballpark.

November 1999: Enron launches EnronOnline, the first global commodity trading site.

January 2000: Enron Communications becomes Enron Broadband Services, a bandwidth-trading subsidiary.

December 2000: Enron announces that President and Chief Operating Officer Jeffrey Skilling will take over as chief executive in February. Kenneth Lay will remain as chairman. Shares hit 52-week high of \$84.87 on Dec. 28.

July 13: Enron announces it will close its 100-employee Enron Broadband office in Portland, then plans subsidiary's shutdown by Oct. 1.

August: Skilling resigns; Lay becomes CEO again.

Oct. 16: Enron reports a \$638 million third-quarter loss and discloses a \$1.2 billion decline in shareholder equity, partly related to partnerships run by Chief Financial Officer Andrew Fastow, who is later ousted.

Oct. 17: Enron's 401(k) plan is frozen so that the company can change plan administrators. Employees can't sell their holdings, including Enron stock.

Oct. 22: Enron acknowledges Securities and Exchange Commission inquiry into a possible conflict of interest related to Enron's partnership dealings.

Nov. 6: Enron's stock price drops below \$10 a share after reports that the company was seeking additional financing.

Nov. 8: Enron files documents revising financial statements for past five years to account for \$586 million in losses.

Nov. 9: Dynegy announces an agreement to buy its much larger rival Enron for more than \$8 billion in stock.

Nov. 14: Enron announces it is trying to raise an additional \$500 million to \$1 billion. Enron 401(k) also reopens to transactions; Enron stock is \$23.86 a share lower than on Oct. 17.

Nov. 21: Enron reaches critical agreement to extend \$690 million debt payment.

Nov. 28: Dynegy drops deal. Enron shares end at 61 cents.

Senator WYDEN. You all have made the point. The fact of the matter is that Enron was just sinking like the TITANIC, and you have got the top officers up on the deck selling shares and all of you are locked in the boiler room not able to get rid of the stock. I really appreciate Mr. Vigil making the point as well about the company barring the employees from selling in a number of instances where they could have provided for their future.

A question I wanted to ask all of you is that with respect to 401(k)s, it is sort of Investing 101 that you diversify, that you have a variety of stocks in your portfolio. In fact, there are fiduciary standards that you have a diversified portfolio. Did Enron ever, at any point, take the workers aside and say, you know, you have really got to look at your 401(k) in terms of putting your eggs in a lot of different places, rather than just all going through Enron.

Mr. Vigil, I see you nodding your head.

Mr. VIGIL. To the best of my knowledge, nobody from Enron ever suggested that we diversify. In terms of the Enron stock, that was being awarded to us on the matching contribution.

There is one little comment I would like to make here. Those of us who were participating in the 401(k), we were putting as much

as 10 to 15 percent of our own money into that 401(k), and it was diversified in another separate portfolio, or various portfolios, but what has been lost in this whole discussion is that those portfolios lost money also, because the people in Vanguard, Windsor II, and other places, they were also buying Enron stock, and so there is more to the losses here than just the 401(k) plan in terms of the company contributions.

Senator WYDEN. Ms. Farmer, did you ever get the word that you ought to have a diversified portfolio?

Ms. FARMER. No, sir, never.

Senator WYDEN. Well, we are going to look into that some more, because as I say there is supposed to be a spread in terms of investments in a 401(k), and that is just Investing 101. There are fiduciary standards with respect to these plans, and I have real questions about whether they were complied with.

A question for the PGE folks, and as you all know, this is a bittersweet holiday for a lot of Oregonians. When PGE was taken over by Enron your stock was automatically converted to Enron stock, but obviously this is going to be a very different company. Certainly Enron is much more aggressive, experimenting with all of these financial derivatives. You do not just have a basic utility stock any longer. Were all of you at PGE given any warning or notification that when that change was made it would change the nature of your 401(k) holdings, and in particular that they would become more risky?

Mr. ERI. Not to my knowledge. The first that I realized that my 401(k) needed to be adjusted was when I got ready to retire in April, prior to April, when I went out and summoned some financial advisors to look at my portfolio, and at that time that is when they told me that I had way too much Enron stock in my portfolio, and I needed to have that diversified more than what it was.

Senator WYDEN. One last question for you, Mr. Vigil. Did the company provide any justification for forcing employees to hold onto company-contributed Enron stock until age 50?

Mr. VIGIL. None. Nobody under age 50 understood why we could not roll that stock over. There was no justification ever given.

Senator WYDEN. Well, I want you to know I am also going to look into whether this is another example of the double standard at Enron, because its senior management did not have that rule applied to it and the workers did. That would be more evidence that there was one set of rules for folks like yourselves, who did a lot of the heavy lifting, and another set of rules for folks at the top. I appreciate your coming before the Committee today.

I have real questions about whether the laws on the books like the one I wrote on financial fraud are being complied with, so we are going to stay at this, and stay at it until we get to the bottom of it.

Thank you, Mr. Chairman.

Senator DORGAN. Senator Wyden, thank you.

Senator Burns.

Senator BURNS. I have no questions for this panel. I think what we have to do now is to find out the roots of the problem, and it sounds like to me, with the work that Senator Wyden has done, and a lot of other work that has been done, but it is hard to legis-

late or pass laws that deal with conscience, and responsibility. Just like, Mr. Prestwood, your loyalty to the company should have been matched by the loyalty of the management of the employees, and that is a hard thing to legislate, as you well know, but it points out, I think, we have to find out what went wrong and when it went wrong, to prevent it from here on.

The recovery, of course, may be a more difficult thing, and we are certainly aware of your circumstances, and so I think what we have to do in the Senate is to find out what happened, and when did they know it, and if their loyalty to the employees was matched by the loyalty of the employees to the company. That is what we have to find out.

So I am looking forward to the next panel, and to those people who were a little bit closer to the fire, so to speak, and find out what really happened, because it is a devastating thing, and I thank the Chairman.

Senator DORGAN. Senator Burns, thank you.
Senator Fitzgerald.

**STATEMENT OF HON. PETER G. FITZGERALD,
U.S. SENATOR FROM ILLINOIS**

Senator FITZGERALD. Thank you, Mr. Chairman, and I appreciate your convening this hearing. I think it is a very important hearing. I have a question for all of you, both as employees who held shares in Enron, and also Ms. Pearson, as an outside shareholder.

To what extent were you relying on what financial analysts were saying about Enron stock? I ask you that because my understanding is that in the case of Enron, in September of this year, when things were going south, you had 17 analysts covering Enron, and of them, 16 had a "buy" or "strong buy" rating on the stock, one had a "hold", and none had a "sell" or a "strong sell."

In April 1999 the head of the Securities and Exchange Commission, Arthur Levitt, gave a speech that cited a study that found sell recommendations account for just 1.4 percent of all analyst recommendations, compared to 68 percent of all recommendations being buys, and I have to tell the panelist from The Motley Fool who is up next that I am borrowing this from some of his testimony, reading ahead, but I think it is very good testimony.

Clearly, you have analysts out there hyping stocks. The analysts work for some investment bank that meanwhile is providing investment banking services to the corporation—in this case, Enron. Does that, or did this play a role in your decisions to hold the stock until you could not sell it and it was locked down?

Ms. FARMER. Absolutely.

Senator FITZGERALD. Were you all following those "buy" recommendations and so forth?

Ms. FARMER. Yes.

Senator FITZGERALD. Did any of you think that you needed to take those "buy" recommendations with a grain of salt, or did you think of those recommendations as objective, nonbiased opinions?

Ms. FARMER. Objective, nonbiased opinions, and I relied upon them as a guidance.

Senator FITZGERALD. Does anybody say they did not rely on them?

[No response.]

Senator FITZGERALD. Well, it seems to me those analysts' recommendations are an issue that we want to get into.

Ms. PEARSON. If you cannot rely on them, who can you rely on? They are supposed to be smarter than we are.

Senator FITZGERALD. That is a good point. They are supposed to know more than all the rest of us on this, and they were all recommending "buy" or "strong buy", only one "hold", even after Jeff Skilling, the Enron CEO, suddenly resigned and the company stock had already lost 60 percent of its value from the high of the year, and we, of course, saw the same thing with the Internet stocks in some cases, too.

Well, thank you all very much. I appreciate your being here, and let us hope that out of your misfortune, we can create better controls and better laws to protect others from having to experience the same financial fate. I know that is not much of a consolation here, but that may be the most we can do, and so we thank you for your contribution.

Ms. PEARSON. Can I say one thing? As a sort of a funny side point, one of the directors under question was building a new house on a very valuable piece of property in a very valuable part of Houston, and he built it about halfway, and I am talking about a \$4 million house, and it has stopped work. There is no more being done on that house, and that gives me great satisfaction.

[Laughter.]

Senator BURNS. What about the carpenters that were working on that house?

Ms. PEARSON. I just hope they did not own any Enron stock.

[Laughter.]

Senator DORGAN. Ms. Pearson, one has to take satisfaction where one finds it. We appreciate your answer.

Senator NELSON.

Senator NELSON. Thank you, Mr. Chairman. All of you have been absolutely riveting in your testimony. Ms. Farmer, it hurts when it comes close to home; that you would lose nearly all of your nest egg of over \$700,000 in your 401(k). Unfortunately, we have got a lot of folks like you in our State that are retirees that were relying on the same thing. I am curious, tell us a little bit more about when you got wind that the management had changed, and then you called the pension plan because you had received no written communication.

Ms. FARMER. They had made a statement there that they were going to, I believe on October 16 that they were going to have to restate their earnings for the last several years, and at that time the stock had dropped to a point to where I no longer felt like I could maintain, and I was going to sell and keep what I had, even though I had already lost about 50 percent of my retirement fund, and that is when I called. On October 22 was the first point in time I could get through, and that is when I learned that there was a lockdown.

Senator NELSON. Did they say how long the lockdown had been in place?

Ms. FARMER. They said it had started on October 17 and would go through November 20, and if I may, at this point I would like

to mention that on November 20, with the Thanksgiving holidays, the phones at the Plan Administrator were very busy, because I am sure there were a lot of other people trying to get through. I could not sell my stock until Monday, November 26, and therefore lost even more money, because the stock had dropped even lower.

Senator NELSON. When you had called on October 22, it looks like the stock was somewhere about the mid-twenties, and it was precipitously dropping every day.

Ms. FARMER. Yes, sir.

Senator NELSON. You said that they told you October 17 that the lockdown occurred, and Mr. Prestwood had testified that he knew that the letter was written October 8 but not mailed until October 10, and therefore if you figure 3 or 4 days for mail to be delivered, that is bumping right up against October 17, the very day that you said that they said the lockdown is in effect. That does not give a participant in a 401(k) retirement plan much time.

Ms. FARMER. Personally, in my opinion, I do not think that is coincidence.

Senator NELSON. That is interesting. Well, we are going to investigate that.

Ms. FARMER. Thank you very much.

Senator NELSON. What did any of the managers tell you concerning the reason for not allowing you to sell? In other words, the reasons for the lockdown? What did they say to you?

Ms. FARMER. I did not hear from the managers. As I said, I did not get the notification that there was going to be a lockdown, but when I spoke to the new administrators of the 401 savings plan they were told that it was strictly for a change in plan administrators, that it was going to take approximately 30 days in order to complete that change, and that I would have to wait till the end of that period before I could transfer or sell any of my stock.

Senator NELSON. Did you have any knowledge as to who had made that decision there was going to be a 30-day lockdown?

Ms. FARMER. No, sir.

Senator NELSON. Were there any kind of internal company newsletters to retirees like yourself that would give any indication as to the financial condition of the company and of the retirement savings plan?

Ms. FARMER. No, sir.

Senator NELSON. Well, Mr. Chairman, it is just very clear we have got a lot to investigate here. Mrs. Farmer started with the Florida Gas Corporation. It is headquartered in my old congressional district of Winterpark, Florida when I went to Congress in 1978. It was a good company. It had a gas pipeline that came all the way from Texas right down the spine of Florida to supply all the natural gas, and she started to work for that—what year did you start?

Ms. FARMER. In 1981. I began with Florida Gas Transmission Company.

Senator NELSON. Was Mr. Lay at Florida Gas when you started?

Ms. FARMER. I do not believe he was. I believe Mr. Lay came with Florida Gas in the mid-eighties, maybe 1983, some thing of that nature, and then beginning in 1985 was when several pipeline companies merged throughout the United States and Enron was

formed, and the home office was moved for Florida Gas Transmission from the Winterpark, Florida location to Houston.

Senator NELSON. Well, in my opinion, each one of these participants at our witness table today is very heroic. Here is a lady from my home area, she worked hard, she played by the rules, she saved, she believed in the company, and now she has lost everything for her retirement years. I am looking forward to finding out what this investigation is going to reveal, Mr. Chairman.

Thank you.

Senator DORGAN. Senator Nelson, thank you.

Senator Boxer.

**STATEMENT OF HON. BARBARA BOXER
U.S. SENATOR FROM CALIFORNIA**

Senator BOXER. Thank you very much, Mr. Chairman. I want to thank you and Senator McCain for having this hearing. I think it is important that we listen and we learn, and we come out with a plan that is well-thought-out. Let me say this is an incredible panel. I would like to take Ms. Pearson home with me.

Ms. PEARSON. That could be arranged.

[Laughter.]

Ms. PEARSON. Do you have any Enron stock?

Senator BOXER. That is another story for another day. We will talk, but here is the point. These people have been deeply, deeply, deeply hurt, their dreams shattered, and they are here helping us, and I want to thank you so much.

In my former life, way back many years ago, I was a stockbroker, and I saw many smiles and many tears and went through a lot of ups and downs. The stock market in those days was a little easier. There were only 12 million shares traded per day back then, and I never saw anything like this. I never saw anything with the depth of this.

Unfortunately, in my State, we had a couple of things that were really the precursor to this. I want to see if my colleagues remember the Color Tile failure where a company went broke—some of you are nodding in the audience—and they forced their employees to buy the company through their 401(k) plan, so when the company went broke they had nothing. They had real estate in the company which was gone, so they had nothing.

And then we had Carter Hawley Hale, which was a giant retailer that had emporium stores. The same thing happened. No one could believe this happened, the same thing, so as Senator Wyden alluded, my other colleagues and I who worked in this area, wrote a law that I think could come into play here, and I want to tell you about it and tell you what I have done.

Sad to say, and I apologize, it was watered down. I could not fight. I mean, I had to fight so hard to get what little I got, but the law that passed in 1997 says that an employer—and I want you to follow this—cannot force an employee to buy company stock with the employee's contribution. Now, I know you were not forced. They did not force you that I know, because I have checked it. You did it of your own free will. However, I believe that when the plan was locked down, in essence you were forced to keep that company stock. Is there anyone on the panel that would disagree with that?

In other words, you wanted out, some of you called, so my view is that they violated that law.

Now what is the punishment for that in the law? The punishment for that is that the tax advantages that Enron got could well be taken away from them in retrospect, putting the IRS at the front of the line to collect some of this money and hopefully, if we work together, maybe we can direct some of that money back to the employees.

Now, we are looking at how much that would be, but I want to tell you something. As I checked into this, when an employer makes a contribution in stock to a plan they get a 100-percent tax deduction, based on the value of the stock at the time, so they took big, big write-offs, and they said that they were a good actor, they were in good faith. Well, they were in good faith until the lockdown, so we have written to the IRS, and I am hoping to get some of my colleagues to work with me to see if there is some hook here where we can get the employees more to the front of the line to get some of this back.

Whether we have a shot, I am not sure. I feel that it is true what Senator Burns said, you cannot legislate a conscience or good character, or fairness in people. I mean, let us take a look at this insider stuff. Kenneth Lay, Enron's Chairman, sold 1.8 million shares for \$101 million. All this happened in a period of a couple of years. Jeffrey Skilling—this is all public information—former chief executive, sold 1 million shares for \$66 million, so when you asked, Mr. Prestwood, \$1 million, I think \$1 million is a lot of money, but it pales compared to these people. \$268 million for Lou Pai, and this goes on, and you probably know these names. I do not. I am not familiar with them.

Here is the thing. I think we need to do more. First, we have to make sure that laws such as Senator Wyden's law and my law and other pension laws are definitely followed here, and if not, we have to come down hard and see what we can do to recover some of these loss streams.

But Senator Corzine and I are introducing legislation which I am very excited about, and in my remaining time I will tell you the principles. It would limit to 20 percent the investment an employee can have in an individual account, or individual retirement plan. I mean, it is all the eggs in one basket. We always know it is not right, but when we are sort of tempted into it, and I think this would be a good thing.

Second, and this speaks to something that Mr. Vigil pointed out, it would limit to only 90 days the time an employer could force an employee to hold a matching employer stock contribution. In other words, why should you have to wait till you are 50? You are a grown person. If this is the way they are helping you, and they are making stock contributions, that is great, but why should you have to sit tight when the market starts to change?

Third, we would change the tax deduction to 50 percent if they made the contribution in stock. If they made the contribution in cash, they could get 100 percent. Those are the main points I want to make, and they are as a result of what you have been telling us about your experience.

So Mr. Chairman, again my deepest thanks for your leadership, and I thank the panel.

Senator DORGAN. Senator Boxer, thanks very much. This panel has been extraordinary. As all of us know, public companies' financial statements are supposed to be transparent and public. We now know that in the case of Enron's secret off-the-books partnerships they were neither transparent nor public. As a result of that, as I indicated in my opening statement, it appears to me that we have what some in my home town they would say, "cooked books" here, and those that cooked the books made off with a fair amount of money. I wanted to, in respect to Senator Boxer's comments, display a chart that shows the sale of stock by some of the key people at Enron from 1998 to the present. I have, I think, 25 pages of this information.

But one individual, Kenneth Lay, sold \$101 million; Mr. Rice, \$72 million; Mr. Skilling, \$66 million; Mr. Horton, \$45 million; and Mr. Fastow, \$30 million. I might just again show this chart, because I think it is important. This shows the value of the stock, and the green line is when the insiders were selling the stock, and so those folks that I just described making money off the sale of stock actually managed to find the top stock price for the largest block of sales.

They knew something, but they were telling the employees: hang onto your stock, this company is going to get bigger and better and stronger, and tomorrow is going to be better for you. At the same time, they were selling their own stock. I think that raises all of the questions that have been described by my colleagues.

Senator BOXER. Would you yield for just a very quick point? This is so discouraging and depressing, and what adds to it is, you had these big companies which have been mentioned before, and the auditors. It is one thing for a stock analyst to be fed a bunch of baloney. We have seen that happen. It is another thing for people who are paid to tell the truth and to be honest, these big accounting firms that we rely on, that in my day the first thing you look at when you make a recommendation for a stock, what do these people say, they are the honest ones, but their eyes were glazed over from these big contracts they were getting from Enron. It is a whole other area.

Senator DORGAN. Senator Boxer, we will have the auditors next.

Mr. Prestwood from Texas, you are familiar with Bob Wills and his Texas Playboys and their rather famous refrain, "Little bee sucks the blossom, but the big bee gets the honey. Little guy picks the cotton, but the big guy gets the money." We understand those things happen in life all too often, but there is much more at work with respect to this, so we intend to pursue this as long as it takes to get to the bottom of it.

Again, thank you for spending the time to be with us.

Ms. Farmer, one final comment?

Ms. FARMER. Yes, I would like to have one final comment, please. I was fortunate enough to have my daughter accompany me here to Washington, D.C. to appear before this Committee. My family, my son Jeffrey Farmer, he serves with the U.S. Marine Corps, and he sends his thanks to you also for any help that you can give us in this concern, and we do appreciate and I am honored to have

had the opportunity to appear here, and I thank you from the bottom of my heart.

Senator DORGAN. Well, Ms. Farmer, you thank your son for his service to our nation in this important time, and thanks to all of you for being at the table today. You are welcome to stay for the rest of the hearing.

We would now like to call the next panel, and I indicated that Mr. Kenneth Lay was invited. He will not appear today, but his representatives told me this morning that Mr. Lay will be available for a second hearing scheduled for February 4. We will also ask Mr. Skilling and Mr. Fastow to be present, along with others.

The global head of auditing for Arthur Andersen, Mr. C. E. Andrews is with us, and I am going to ask, because of the time problem, Mr. Scott Cleland, Chief Executive Officer, Precursor Group,[®] to join the second panel.

Following the second panel, we will have three individuals on the third panel testify as well, but if we could ask Mr. Andrews to please come forward, and Mr. Scott Cleland, if you are here, would you please come forward and take a seat at the table. My understanding is Mr. Cleland has a travel issue, and so we want to move him up to the second panel.

Mr. Andrews, thank you very much for joining us today. You have heard a generous amount of discussion today about a range of questions that are asked about auditors, analysts' records, secret partnerships, et cetera. We appreciate the fact that your company went to a hearing in the U.S. House upon request and have now appeared at a hearing in the U.S. Senate.

I understand that, given what has happened, it is not pleasant to respond to these requests, but this Committee very much appreciates your company's willingness to come when asked and provide testimony. Why don't you proceed. Your entire statement will be made a part of the permanent record, and you may summarize.

**STATEMENT OF C. E. ANDREWS, GLOBAL HEAD OF AUDITING
AND BUSINESS ADVISORY, ANDERSEN**

Mr. ANDREWS. Chairman Dorgan, Chairman Hollings, Senator Fitzgerald, Senator McCain, and members of the Committee, good morning. Thank you for inviting me to appear before you. I am the Managing Partner of Anderson's global audit practice. I am here because faith in our firm and in 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 that this business failure has caused for employees and others, as you have heard very poignantly this morning.

Many questions need to be answered. Some involve accounting and auditing. I will do my best to address these. I ask you keep in mind the auditing and accounting issues are very complex and 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 take away from my testimony, I hope it is this. The public's confidence is of paramount importance. Andersen will not shrink from its responsibilities. If our firm has made errors in

judgment, we will acknowledge them. We will take the actions 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 Committee in its inquiry I have provided detailed answers to these questions in my written statement, but let me touch on some 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 SPE's. 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 that important information was not revealed to our team. We and the board's special committee are looking into why.

As required by section 10A we have notified the audit committee of possible illegal acts within the company. We have not concluded that any illegal acts occurred. On the smaller of the SPE's, which were responsible for 20 percent of the SPE restatement, we now believe, based upon a second look, that our team made an error in judgment, an honest error, but an error nonetheless, but I do believe that we did a professional job overall and that this error did not cause Enron's collapse.

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

Finally, let me spend a minute on fees. We were paid \$52 million by Enron last year, including \$25 million for our audit. There is the 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 can only be done by auditors. \$13.3 million was for consulting work done by Arthur Andersen.

Some may 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 is 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 that 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 we 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 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.

Andersen will have to change to restore the public's confidence, and we are working hard to identify the changes we need to make. The accounting profession will also have to reform itself. Our sys-

tem of regulation and discipline will have to improve, and others will have to do things differently as well, companies, boards, audit committees, analysts, investment bankers, credit analysts and others.

I believe we can work together to give investors more meaningful, relevant, and timely information. Our firm will do its part. Thank you.

[The prepared statement of Mr. Andrews follows:]

PREPARED STATEMENT OF C. E. ANDREWS, GLOBAL HEAD OF AUDITING AND
BUSINESS ADVISORY, ANDERSEN

Chairman Dorgan, Senator Fitzgerald, Chairman Hollings, Senator McCain, Members of the Committee.

I am the managing partner for Andersen's global audit practice. 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: The public's confidence is of paramount importance. Andersen will not shrink from its responsibilities. If our firm has made errors in judgment, we will acknowledge them. We will take the actions needed to restore confidence.

Today, I would like 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 would like to cover 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. My firm has publicly discussed many of these already.

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 Public 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. We identified the impact of this separate agreement on Enron's financial statements in the course of examining a number of documents provided to us by Enron management and the Board's special committee in November 2001. Kenneth Lay and Richard Causey have told us that they were not aware of this separate agreement until its discovery in November 2001 and we do not know of any contrary facts.

It is not clear why the relevant information was not provided to us in 1997. We and the Board's special committee are still looking into that.

We have notified Enron's audit committee of possible illegal acts within the company, as required under Section 10A of the Securities and Exchange Act. Because the special committee is investigating all of these matters, Section 10A does not require us to take any additional action until the special committee finishes its work and the Board acts upon any recommendations. We have not concluded that any illegal acts occurred.

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. I do believe that we did a professional job overall and that this error did not cause Enron's collapse.

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. We recognize that this is a large number in absolute terms, but our work as auditors requires us to put such numbers into their proper context. 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. (The remaining \$200 million of this adjustment in equity was the result of transactions that occurred during the third quarter of 2001.)

We had discussed the proper accounting treatment for other transactions affecting equity 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.
- Enron's unaudited quarterly financial statements also disclosed transactions with LJM1 and LJM2.

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. The Company did disclose this possible risk in its Management's Discussion and Analysis, or MD&A, section of its annual report.

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. 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, 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, 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—hundreds of them. 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 fee 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.

Additional questions have recently arisen about whether Andersen served as Enron's internal auditor.

Enron has engaged Andersen to issue two separate reports: (1) a report on Enron's financial statements, and (2) a report on management's assertions about the reliability of Enron's system of internal control. Andersen is Enron's external auditor in preparing both types of reports. This second report is not required by federal law but has long been recognized—by the GAO, among others—as a best practice for large, complex companies like Enron. The standards for issuing such reports on internal controls, which are a type of attest work, are covered in the auditing literature. The fees associated with our report on Enron's system of internal control were part of our engagement as Enron's external auditor. These fees were properly reported as “audit” fees in Enron's proxy statement since Andersen performed the work as part of a single integrated audit.

From 1994–1998, Enron outsourced parts of its internal audit function to Andersen. That arrangement ended in 1998. Enron then began to add to its existing internal audit function under the umbrella of Enron Assurance Services (EAS). Enron's Risk Assessment and Control group also performs internal audit-type work.

From time to time after 1998, we were asked by Enron to perform certain consulting projects related to prospective changes to the control system. The fees for these projects in 2000 were disclosed as “non-audit” fees in Enron's proxy statement.

It is important to understand that internal auditing is not the same as book-keeping. Internal auditors do not prepare a company's financial statements; those statements are prepared by the company—at Enron, by the accounting and financial reporting function led by the company's Chief Accounting Officer. An internal auditor does some of the same activities that an external auditor does, such as testing the company's system of internal control to assess whether it provides “reasonable assurance” that the company is accurately recording transactions on its books. Internal auditors can also perform additional functions such as operational auditing and reviews of prospective changes to the control system.

Next, I would like to address questions about our fees for non-audit services. 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. That is incorrect.

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 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 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. The scope and amount of this work, which is a type of work sometimes performed by a company's internal auditors, complied with the AICPA professional standards and the SEC rules governing internal audit outsourcing which take effect next August.

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 our firm 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. Our CEO discussed some of the issues that the profession faces in an op-ed in the *Wall Street Journal*, 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 will continue to do our part. I hope that my participation today has been helpful to your efforts.

Thank you.

Attachment

ENRON: A WAKE-UP CALL

By Joe Berardino

The Wall Street Journal, December 4, 2001

(Copyright 2001, Dow Jones & Company, Inc.)

A year ago, Enron was one of the world's most admired companies, with a market capitalization of \$80 billion. Today, it's in bankruptcy.

Sophisticated institutions were the primary buyers of Enron stock. But the collapse of Enron is not simply a financial story of interest to major institutions and the news media. Behind every mutual or pension fund are retirees living on nest eggs, parents putting kids through college, and others depending on our capital markets and the system of checks and balances that makes them work.

My firm is Enron's auditor. We take seriously our responsibilities as participants in this capital-markets system; in particular, our role as auditors of year-end financial statements presented by management. We invest hundreds of millions of dollars each year to improve our audit capabilities, train our people and enhance quality.

When a client fails, we study what happened, from top to bottom, to learn important lessons and do better. We are doing that with Enron. We are cooperating fully with investigations into Enron. If we have made mistakes, we will acknowledge them. If we need to make changes, we will. We are very clear about our responsibilities. What we do is important. So is getting it right.

Enron has admitted that it made some bad investments, was over-leveraged, and authorized dealings that undermined the confidence of investors, credit-rating agen-

cies, and trading counter-parties. Enron's trading business and its revenue streams collapsed, leading to bankruptcy.

If lessons are to be learned from Enron, a range of broader issues need to be addressed. Among them:

—Rethinking some of our accounting standards. Like the tax code, our accounting rules and literature have grown in volume and complexity as we have attempted to turn an art into a science. In the process, we have fostered a technical, legalistic mindset that is sometimes more concerned with the form rather than the substance of what is reported.

Enron provides a good example of how such orthodoxy can make it harder for investors to appreciate what's going on in a business. Like many companies today, Enron used sophisticated financing vehicles known as Special Purpose Entities (SPEs) and other off-balance-sheet structures. Such vehicles permit companies, like Enron, to increase leverage without having to report debt on their balance sheet. Wall Street has helped companies raise billions with these structured financings, which are well known to analysts and investors.

As the rules stand today, sponsoring companies can keep the assets and liabilities of SPEs off their consolidated financial statements, even though they retain a majority of the related risks and rewards. Basing the accounting rules on a risk/reward concept would give investors more information about the consolidated entity's financial position by having more of the assets and liabilities that are at risk on the balance sheet; certainly more information than disclosure alone could ever provide. The profession has been debating how to account for SPEs for many years. It's time to rethink the rules.

—Modernizing our broken financial-reporting model. Enron's collapse, like the dot-com meltdown, is a reminder that our financial-reporting model—with its emphasis on historical information and a single earnings-per-share number—is out of date and unresponsive to today's new business models, complex financial structures, and associated business risks.

Enron disclosed reams of information, including an eight-page Management's Discussion & Analysis and 16 pages of footnotes in its 2000 annual report. Some analysts studied these, sold short and made profits. But other sophisticated analysts and fund managers have said that, although they were confused, they bought and lost money.

We need to fix this problem. We can't long maintain trust in our capital markets with a financial-reporting system that delivers volumes of complex information about what happened in the past, but leaves some investors with limited understanding of what's happening at the present and what is likely to occur in the future.

The current financial-reporting system was created in the 1930s for the industrial age. That was a time when assets were tangible and investors were sophisticated and few. There were no derivatives. No structured off-balance-sheet financings. No instant stock quotes or mutual funds. No First Call estimates. And no Lou Dobbs or CNBC.

We need to move quickly but carefully to a more dynamic and richer reporting model. Disclosures need to be continuous, not periodic, to reflect today's 24/7 capital markets. We need to provide several streams of relevant information. We need to expand the number of key performance indicators, beyond earnings per share, to present the information investors really need to understand a company's business model and its business risks, financial structure and operating performance.

—Reforming our patchwork regulatory environment. An alphabet soup of institutions—from the AICPA (American Institute of Certified Public Accountants) to the SEC and the ASB (Auditing Standards Board), EITF (Emerging Issues Task Force) and FASB (Financial Accounting Standards Board) to the POB (Public Oversight Board)—all have important roles in our profession's regulatory framework. They are all made up of smart, diligent, well-intentioned people. But the system is not keeping up with the issues raised by today's complex financial issues. Standard-setting is too slow. Responsibility for administering discipline is too diffuse and punishment is not sufficiently certain to promote confidence in the profession.

All of us must focus on ways to improve the system. Agencies need more resources and experts. Processes need to be redesigned. The accounting profession needs to acknowledge concerns about our system of discipline and peer review, and address them. Some criticisms are off the mark, but some are well deserved. For our part, we intend to work constructively with the SEC, Congress, the accounting profession and others to make the changes needed to put these concerns to rest.

—Improving accountability across our capital system. Unfortunately, we have witnessed much of this before. Two years ago, scores of New Economy companies soared to irrational values then collapsed in dust as investors came to question their business models and prospects. The dot-com bubble cost investors trillions. It's time to get serious about the lessons it taught us.

In particular, we need to consider the responsibilities and accountability of all players in the system as we review what happened at Enron and the broader issues it raises. Millions of individuals now depend in large measure on the integrity and stability of our capital markets for personal wealth and security.

Of course, investors look to management, directors and accountants. But they also count on investment bankers to structure financial deals in the best interest of the company and its shareholders. They trust analysts who recommend stocks and fund managers who buy on their behalf to do their homework—and walk away from companies they don't understand. They count on bankers and credit agencies to dig deep. For our system to work in today's complex economy, these checks and balances must function properly.

Enron reminds us that the system can and must be improved. We are prepared to do our part.

Mr. Berardino is managing partner and CEO of Andersen.

Senator DORGAN. Mr. Andrews, thank you very much.

Mr. Cleland, you represent—you are the Chief Executive Officer of The Precursor Group.[®] We appreciate your willingness to participate today. Why don't you proceed.

**STATEMENT OF SCOTT CLELAND, CHIEF EXECUTIVE OFFICER,
THE PRECURSOR GROUP[®]**

Mr. CLELAND. Thank you for the honor to testify and allowing me to go early. I am Scott Cleland, founder and CEO of the Precursor Group[®]. We are an independent broker-dealer. We provide investment research to institutional investors. We do no investment banking, no proprietary trading. We do not manage money, and none of our analysts are allowed to own individual stocks.

Before entering the investment business, I worked for the U.S. Government and gained experience in improving internal controls at the U.S. Treasury Department and the U.S. Office of Management and Budget.

My message to you is very simple today. There are more Enrons out there ready to blow up and devastate more investors, but you will know now about it because the system of internal controls, the early warning systems, are so rampantly affected by conflicts of interest, and it does not need to be that way. Government and industry, if they would just officially discourage the conflicts of interest, I think a lot of the problem could be addressed.

If the system worked as designed, essentially we would not have had the first panel. We would have had a couple of years ago a stock that was battered, but we would not have had a devastating meltdown with a frighteningly swift collapse. That was because this thing had been going on for 3 or 4 years and none of the watch-dogs spotted it.

The stakes are really high here. As baby boomers are nearing retirement age, the Nation is increasingly depending upon 401(k)'s and other types of market instruments to supplement social security, so now more than ever we need to restore the integrity of the markets.

The problem is obvious. Just like an ounce of prevention is worth a pound of cure, unsanitary conditions breed disease. Conflicts of interest now plague the system. Government and industry have not

been vigilant enough to keep the system clean, because almost all of the watch-dogs supposedly watching the system are not paid by investors, they are paid by somebody else.

But what is this plague of conflicts of interest? Let me briefly run through eight that are glaring. Companies routinely now pay consulting fees to audit companies that are supposed to keep the company honest. In Government, that would be a violation of public trust.

2. Auditors are increasingly doing the company's inside audit work and also doing their independent outside work. That is like grading your own papers or hearing your own appeal.

3. Through the investment banking back-door, company interests effectively pay for most of the research that is produced in the United States. The problem is, the average American does not get the joke that most all of the research they are reading is paid for by investment banking, by the companies.

4. It is common for analysts to have a financial stake in the companies they are covering. That is just like essentially allowing athletes to bet on the outcome of the game that they are playing in.

5. Most payments for investment research is routinely commingled in the process with more profitable investment banking and proprietary trading. The problem with this is that it effectively means most research analysts work for the companies and do not work for investors.

6. Credit agencies may have conflicts of interest.

7. Analysts seeking investment banking tend to be more tolerant of pro forma accounting, and the conflict there is essentially the system is allowing companies to make up their own accounting to describe their own financial performance that no one then can compare objectively with other companies.

8. Surprise, surprise, companies routinely beat the expectations of a consensus of research analysts that are seeking their investment banking business.

Common sense suggests that conflicts of interest breed trouble. I believe the focus of congressional and regulatory oversight should be on how to improve the current system, how to prevent future Enrons from happening, so I have five simple common-sense recommendations.

1. Officially discourage conflicts of interest. Make it U.S. policy to discourage financial conflicts of interest, and definitely do not economically reward conflicts of interest in the law or in regulation.

2. I think it is pretty simple. Prohibit auditors from consulting for companies they audit, and from reviewing their own work, doing the independent review of their own internal review.

3. You really need to strengthen the objectivity of the overall investment research system. Discourage the bundling of banking, trading, and research, because the commingled nature of commissions when there is not a transparent and official separate accounting for each type of business, essentially what it means is that the more profitable parts of banking and trading are rewarded, and it discourages research objectivity.

One idea you have heard many times is the trading they suggest, we need to get best execution for investors, best execution of trad-

ing. I suggest there should be some evidence or some emphasis getting best research execution for investors.

My last recommendation is there needs to be increased awareness among the press and among the Government to stock manipulation. Two instances. When the press headlines or gives prominence in a story to pro forma accounting financial results, the press is lending credibility to a serious conflict of interest, because they are allowing public companies to make up their own accounting so that they cannot be compared or judged relative to other people.

The second thing is, the press lends credibility to another conflict of interest by being allowed to be spun, and playing along with the companies in the street in their quarterly expectations game that inflates stock prices.

So I thank you very much for allowing me to testify to avert future Enrons. It is very simple. Make the official U.S. policy to discourage conflicts of interest where necessary.

Thank you, Mr. Chairman.

[The prepared statement of Mr. Cleland follows:]

PREPARED STATEMENT OF SCOTT CLELAND, CHIEF EXECUTIVE OFFICER, THE
PRECURSOR GROUP®

“Conflicts of Interest Are Eroding the Market’s Integrity and the Market’s System of Internal Controls: Enron Is Not Unique, But Part of a Growing Pattern of Missed Warning Signs”

I. Introduction

Mr. Chairman, thank you for the honor of testifying before your Subcommittee and for the Subcommittee’s interest in the perspective of an *independent investment research broker-dealer*.

My testimony includes:

- An explanation of the Precursor Group® perspective;
- Our assessment of why the system was surprised by Enron’s demise; and
- Our recommendations help prevent future Enrons from happening again.

II. Precursor Group® Perspective

I am Scott Cleland, founder and CEO of the Precursor Group®, an independent research broker-dealer, which provides investment research to institutional investors. A year and a half ago, my partner, Bill Whyman, and I founded the Precursor Group® very intentionally as an *independent* firm in order to better serve our investor clients’ interests and not to serve companies’ interests or investment banking interests. We see a real market opportunity for pure investment research uncompromised by company conflicts of interest. We also have learned that the investment research marketplace is thirsting for trust; and our business is trying to quench a part of that thirst.

Our business is simple. We work for institutional investors; they pay us research commissions on their trading to the extent that we help improve their investment performance.

- If our research helps investors identify opportunities or avoid pitfalls, we get paid in trading commissions.
- If our research does not help investors, we do not get paid.
- We have a market-driven, merit-based business model.

We are unusual in that we are a pure research firm in a business dominated by integrated full-service brokerage firms that bundle investment banking, trading and research. We are exclusively an investors’ broker-dealer, akin to a buyer’s broker in real estate. We are not the traditional sellers’ or company broker-dealer, which tries to represent *both* companies’ and investors’ interests.

We have done our best to align our financial interests with investors’ interests. We are very serious about avoiding conflicts of interest, actual and *perceived*, so we:

- Do no investment banking for companies;

- Do not manage money or own a stake in any companies;
- Do not allow Precursor Group® researchers to trade individual stocks—as a condition of employment (which exceeds NASD rules); and
- Do not trade securities for proprietary gain.
- We get paid through agency trading commissions, which is the primary payment mechanism that institutional investors use to pay for investment research.
- Our contracted-out agency trading is not a conflict of interest because:
 - We do not act as an agent and never as a principal that has capital at risk—so our contracted-out agents execute stocks for others at their request, but we never actually own a stock of a company.
 - Our clients have complete freedom to choose which of our four contracted-out trading clearing firms they want to use.
 - Our institutional investor clients completely control whether and how we get paid with their shareholder or pension fund resources.
 - This arrangement eliminates any financial conflict.

We are a pure research firm because we do not believe one firm can well serve different masters at the same time: investors *and* companies. We strongly believe *true independence yields better research.*

III. The Problem: Conflicts of Interest Erode the Integrity of Markets

(a) Systemic Conflicts of Interest

The U.S. capital markets system is playing with fire—effectively ignoring rampant conflicts of interest—and investors are getting burned. The U.S. capital markets system clearly failed thousands of Enron investors, pension holders, creditors, employees and customers. I believe it is clear that *the system will continue to fail investors, until the root cause—rampant conflicts of interest throughout the system—are brought under control.*

Hopefully Congress and regulators will hear the Enron collapse and the tech bubble bursting as *wake up calls, alerting us that the market's system of internal controls have broken down and are no longer effective.* The system's internal controls are supposed to warn investors, auditors and regulators of financial problems, before they get out of hand and become an Enron.

Conflicts of interest abound where they should not:

- Companies routinely pay consulting fees to the audit companies that are supposed to keep the company honest.
- Auditors are increasingly doing the companies' inside audit work and the outside review of it—essentially grading their own papers or hearing their own appeal.
- Through the investment banking backdoor, companies effectively pay for most of the research departments, providing research on their company, of most all of the prominent brokerage firms that offer research to most Americans.
- It is common for analysts to have a financial interest in the companies they are expected to cover objectively.
- Credit agencies may have an indirect financial interest in the companies that they rate.
- Most payments for investment research is routinely commingled with more profitable and dominant banking and proprietary-trading commissions, effectively subordinating research for investors to the promotion of company interests.
- Analysts seeking investment banking are more susceptible to company pressure to emphasize the company's preferred pro-forma financial reporting.
- And companies routinely “beat the expectations” of a consensus of research analysts that seek their banking business.

Systemic conflicts of interest are more pervasive and corrosive than either Congress, regulators, investors or the press appreciate. Conflicts of interest are eroding the integrity and resilience of our capital markets, because they *undermine the objectivity, integrity and accountability of the “watch dogs” and the early warning systems that markets depend on* to prevent Enron-type situations from escalating to disasters.

Congress and regulators should be very concerned because the breathtakingly swift collapse of Enron is no isolated incident that can be dismissed as unique, brushed under the rug and ignored. During the last two years, the bursting of the dot.com and tech bubble produced dozens of mini-Enron shareholder disasters (such as Excite@Home this past month) that cost investors hundreds of billions of dollars, while the capital markets routinely either ignored or missed the signals of their demise. Unless the integrity of the financial checks and balances in the system are restored, the Enrons and dot.com collapses will happen again and again.

Millions of trusting American investors have lost big in the markets in recent years in part because the system has become so conflict-ridden that the *system no longer effectively serves investor interests but primarily serves company interests*. It appears that the oversight mood has now shifted to an “investor beware” attitude from an “investor protection” attitude. An investor protection system keeps investors adequately informed; identifies problems early; protects investors from misrepresentation and fraud; and ensures fairness in information dissemination.

As the Baby Boomers age, our Nation increasingly will depend on market vulnerable 401(k)s and company pension plans to supplement Social Security and adequately fund Americans’ retirement. *Now more than ever, we need the internal controls capital markets rely on—auditors, research analysts, and boards of directors—to function with integrity to ensure the protection of investors’ financial security.*

(b) *A Pattern of Conflicts*

The system failed investors at multiple levels because conflicts of interest have spread like a disease throughout the system of checks and balances, and undermined independent voices and public watchdogs.

- **Auditors:** The integrity and functioning of the entire capital markets system depends on investors trusting publicly reported numbers. However, auditors now routinely work as consultants to the companies they are supposed to be objectively auditing for investors. This is analogous to expecting a judge to always be fair when judging someone who directly pays half of his or her salary.
- **Investment Banks’ Research Analysts:** Research analysts of all types are supposed to be objective, have an expert understanding of the companies and identify material problems *early*. However, it is now the norm that equity and debt analysts’ pay comes primarily from companies, not investors, through investment banking and proprietary trading. About 95% of the firms in the Wall Street Journal’s “Best of the Street” research rankings have investment banking conflicts of interest. Conflicts of interest are pervasive on the Street. (See attached survey.) Analysts also routinely have another conflict in that they often have financial stakes in the companies they are covering. (This is analogous to the prohibited practice of an athlete betting on the outcome of the game they are playing in.)
- **Role of the Press:** The press exacerbates the corrosive effect of rampant conflicts of interest by tacitly and unwittingly condoning them. The press routinely headlines “pro-forma” or “spin” numbers that can’t be relatively compared to anything else, rather than headlining Generally Accepted Accounting Principles or GAAP results that are readily compared to every other investment. In essence, regulators and the press are allowing companies to define their own success, and run from an accountable benchmark. Further, the press routinely plays along with the Street’s “expectations game,” where the spin ignores actual performance and redirects focus to how the company still exceeded the “consensus expectations” of like-minded company cheerleaders. *The expectations game tends to decouple a company’s stock performance from its actual financial performance.*

Ask the average American if it is wise to:

- Tempt auditors’ objectivity by letting auditors moonlight for those they audit;
- Have companies pay for most of the investment research done on them; and
- Enable publicly-traded companies to make up their own accounting and decide what liabilities they have to disclose to investors.

Common sense suggests that conflicts of interest breed trouble. Other systems that depend on the public trust discourage conflicts of interest more strongly as the first line of defense against serious problems. Government policymakers must avoid conflicts of interest and our judicial system has very strict conflict of interest rules. The most obvious way to prevent more Americans from being financially devastated by Enron-like fiascos is to strengthen and improve the integrity of the early warning

signals and the structural checks and balances in the system. Just like an ounce of prevention is worth a pound of cure, unsanitary conditions breed disease.

IV. Recommendations: Emphasize Trust—Discourage Conflicts of Interest

I believe that the focus of Congressional and regulatory oversight should be on how to improve the current system and prevent more Enrons from happening in the future. I recommend some common sense changes that can strengthen the integrity and functioning of U.S. capital markets, and protect the financial retirement security of all investing Americans.

(a) Officially discourage conflicts of interest.

Wherever possible, policies should encourage alignment of financial service provider interests with investor interests, or at a minimum, make it much more transparent when a person or an entity is *not* working primarily for investor interests. Investors must be better informed of the *extent* of the conflicts of interest. The Senate could pass a Sense of the Senate Resolution reaffirming the importance of protecting the integrity of capital markets by discouraging financial conflicts whenever possible.

I don't believe it is wise, necessary or practical to prohibit *all* conflicts of interest, but it sure is necessary to make it U.S. policy to discourage financial conflicts of interest and not create economic incentives that reward these conflicts through laws, regulations, structure or oversight processes.

Self-regulatory organizations can be effective, if combined with the strong discouragement of conflicts of interest in order to build checks and balances that can actually work as designed. Self-regulation combined with condoned conflicts of interest equals a recipe for more Enrons.

(b) Prohibit auditors from consulting for companies they audit and from conducting independent audits of their own internal audits.

Even better, encourage auditors to be only auditors. The public trust in the accuracy of public financial reporting is so critical it is not even worth the *perception* of a conflict of interest. Judges and U.S. government employees cannot moonlight for those that they have a public trust to police. Would it be a good idea for IRS divisions to do paid tax consulting for the companies they audit on the side? Mixing auditing and consulting is such a blatantly bad idea, it is amazing that it is officially tolerated. Moreover, auditors are increasingly conducting the outsourced internal audit function of the company, essentially acting as contract employees while also being responsible to investors for the outside audit to assure investors that all is well financially. The government is allowing organizations to essentially grade their own papers or handle their own appeals. There are probably *no more corrosive and counter-productive conflicts of interest* in the U.S. capital markets than these. The system is just asking for more Enrons to happen, because it appears that it is no longer in some auditor's primary interest to protect investors from fraud and misrepresentation.

(c) Strengthen the overall objectivity of the investment research system.

Discourage the bundling of banking, trading and research. The commingled nature of commissions without transparent and official separate accounting among trading, research and banking services has the practical effect of rewarding conflicts of interest and discouraging research objectivity. Investment funds go to great lengths, including third party evaluations and industry self-regulation, to get best trading execution for investors. Yet, there is surprisingly little systematic effort to get "*best research execution*" for investors. This could be encouraged through disclosure of what percent of trading commissions are spent on conflicted vs. non-conflicted research.

(d) Discourage analysts owning a financial stake in companies they cover.

Industry standards should be fostered and enforced so that analysts that present themselves to the investing public as "*objective research analysts*" should not have a financial interest in the company they are covering. Many in the industry condone the practice of analysts having "skin in the game" so they think like investors themselves. This is analogous to saying it is a good idea to condone athletes betting on the outcome of the games they play in. The extent to which analyst compensation is linked to investment banking should also be examined.

(e) Increase awareness and vigilance of the press to stock manipulation.

When the press headlines or gives prominence in a story to a company's "proforma" financial results, the press tacitly lends credibility to a serious conflict of interest, because *public companies should not be making up their own accounting re-*

sults or creating a public perception of their financial performance that can't be compared or checked objectively. The whole rationale behind GAAP is to create a transparent market, instilling investor confidence that reported earnings are actually earnings. Pro-forma reporting at its best is "spin" or partial truth; at its worst, it is misrepresentation. Pro-forma reporting has become more commonplace because the press has so frequently played along.

The press also perpetuates and lends credibility to conflicts of interest by being "spun" and playing along with the companies and the "Street" in the quarterly "expectations game." The companies and their potential investment banking firms have an interest in the stock going up regardless of whether the financial performance warrants it. The quarterly "expectations game" is one of the subtlest manifestations of conflicts of interest. By headlining or leading a financial story with how a company "beat expectations," the press lends objective credibility to the company sell-side cheerleading corps that has a strong financial interest in the stock going up. The press can limit the impact of this conflict of interest through an editorial policy of reporting "expectations" after actual earnings results are reported or by putting sell-side expectations in context with the consensus expectations of independent analysts.

V. Conclusion

To avert future Enron-type disasters and protect public confidence in the integrity and resilience of U.S. capital markets, Congress and regulators need a policy to re-emphasize integrity and trust in U.S. capital markets. Congress can take a big step in that direction by officially discouraging conflicts of interest within the system of watchdog groups, auditors, analysts, and independent board members, which the system depends on to protect investors. Conflicts of interest are becoming so common and pervasive that they are becoming the norm not the exception. Sadly, this could mean that investor disasters like Enron could increasingly become the norm as well.

Thank you again Mr. Chairman for the honor and opportunity to testify on this important matter.

Attachments

Precursor Group® Survey Shows Conflicted Investment Research is Systemic and Pervasive

July 30, 2001

Washington, D.C.—A new survey by The Precursor Group®, a Washington-based independent investment research firm, shows that almost all of the top investment research firms in the country have multiple structural conflicts of interest that undermine research credibility and investor confidence. In recent weeks, two top firms, have announced new policies that restrict their analysts from owning stock in the companies they cover. While analyst ownership of companies they cover is the most obvious conflict, the deeper, more important conflicts are investment banking and proprietary trading, according to Precursor.

"The problem of conflicted investment research is more systemic and pervasive than most investors appreciate," said Scott Cleland, chief executive officer of Precursor, an independent research firm based in Washington. "Almost all of the top investment research firms have structural financial conflicts of interest that undermine research objectivity. At least 95% of *The Wall Street Journal's* top 2001 stock picking firms and 100% of *Institutional Investor* magazine's 2000 All-America Research firms have multiple conflicts of interest."

Survey of Research Conflicts:

Precursor's survey (attached) of top investment research firms shows that almost all have *structural financial conflicts of interest* that create actual and perceived research conflicts and undermine research objectivity: either through investment banking representation of companies or through direct ownership of a company through proprietary trading and money management.

- Ninety-five percent of the 82 firms ranked by *The Wall Street Journal* (June 26, 2001) as the "Best Stock Pickers on the Street" have line of business research conflicts: investment banking, proprietary trading and money management (<http://interactive.wsj.com/public/resources/documents/best2001-firms.htm>).
- And 100% of *Institutional Investor's* 2000 top investment research firms have line of business research conflicts: investment banking, proprietary trading and

money management (<http://www.iimagazine.com/activecontent/report.asp?rt=leaders&teamid=1&iyear=2000>).

- The survey builds upon the two of the most-widely respected and followed rankings of investment research quality. Each of these well-respected business publications publishes their rankings of investment research firms every year. Additional details can be obtained at the source/website address for each firm included in the survey results.

Precursor conducted the survey after Cleland testified before the House Subcommittee on Capital Markets. The Congressional Subcommittee's interest in part was prompted by the deterioration in the capital markets over the last year. Many people questioned how U.S. companies could plummet without more warning from investment research analysts who are charged with watching market trends and making investment decisions for their clients.

"How could American shareholders and pension plan beneficiaries lose four trillion dollars in the NASDAQ when only 1% of analysts' recommendations were 'sell'?" Cleland asked. "One seldom-heard explanation is that the *entire brokerage system is structurally skewed* to put company interests before investor interests."

In addition, Cleland pointed out that almost all of the largest and best known brokerage firms that most Americans rely on for their investment research have structural business conflicts of interest which discourage the production of research that could have a negative investment outlook for a company.

"More specifically, if a brokerage firm is either in the investment banking business or owns stocks through proprietary trading or money management, that firm has a financial interest in companies' stocks going up, *not* down," Cleland added.

Precursor conceived of the survey to measure conflicts of interest among investment research firms when it became obvious that conflicted research was more pervasive throughout the industry than most people realize.

"The real issue here is that the conflicted research problem is systemic," Cleland said. "The primary and most profitable purpose of the brokerage industry is to raise capital and provide liquidity for companies. So the structure, economics, compensation, and regulation of the industry reinforce and perpetuate the purpose of selling companies to investors. In a bull market there may be better alignment of interests between companies and investors; in a bear market there is often a stark divergence of financial interests between companies and investors," he concluded.

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The Wall Street Journal's "Best on the Street" Stock Pickers—95% of These Top 82 Firms Have Research Conflicts'

Wall Street Journal Ranking June 26, 2001	Investment Banking	Proprietary Trading	Money Management	Source
1. Salomon Smith Barney	X	X	X	www.salomonsmithbarney.com
2. Merrill Lynch	X	X	X	www.ml.com
3. Morgan Stanley	X	X	X	www.morganstanley.com
4. Lehman Brothers	X	X	X	www.lehman.com
5. Goldman Sachs	X	X	X	www.gs.com
6. A.G. Edwards	X	X	X	www.agedwards.com
7. Credit Suisse First Boston	X	X	X	www.csfb.com
8. J.P. Morgan Chase	X	X	X	www.jpmorgan.com
9. Bear Stearns	X	X	X	www.bearstearns.com
10. Banc Of America Sec's	X	X	X	www.bofasecurities.com
11. UBS Warburg	X	X	X	www.ubs warburg.com
12. Deutsche Banc Alex Brown	X	X	X	www.deutsche-bank.com
13. William Blair	X	X	X	www.wmblair.com
14. McDonald Investments	X	X	X	www.key.com
15. SG Cowen Securities	X	X	X	www.sgcowen.com
16. Prudential Securities	NO	X	X	www.prudential.com

17. ING Barings	X	X	X	X	www.ingbarings.com
18. First Union Securities	X	X	X	X	www.firstunionsec.com
19. CIBC World Markets	X	X	X	X	www.cibcwm.com
20. ABN Amro	X	X	X	X	www.abnamro.com
21. Robertson Stephens & Co	X	X	X	X	www.robertsonstephens.com
22. Needham & Co	X	X	X	X	www.needhamco.com
23. Dain Rauscher Wessels	X	X	X	X	www.dainrauscherwessels.com
24. Raymond James	X	X	X	X	www.raymondjames.com
25. BMO Nesbitt Burns	X	X	X	X	www.bmonesbittburns.com
26. Wit SoundView	X	X	X	X	www.witcapital.com
27. Wasserstein Perella	X	X	X	X	www.wassersteinperella.com
28. Morgan Keegan	X	X	X	X	www.morgankeegan.com
29. SunTrust Equitable Sec's	X	X	X	X	www.suntrust.com
30. Keefe, Bruyette & Woods	X	X	X	X	www.kbw.com
31. Ferris, Baker Watts	X	X	X	X	www.fbw.com
32. Buckingham Research	NO	X	X	X	New York ph# 212.922.5500
33. Tucker Anthony	X	X	X	X	www.tucker-anthony.com
34. Robinson-Humphrey	X	X	X	X	www.robinsonhumphrey.com

The Wall Street Journal's "Best on the Street" Stock Pickers—"95% of These Top 82 Firms Have Research Conflicts"—Continued

Wall Street Journal Ranking June 26, 2001	Investment Banking	Proprietary Trading	Money Management	Source
35. Barrington Research	X	X	X	www.brai.com
36. D.A. Davidson	X	X	X	www.dadco.com
37. Stifel Nicolaus	X	X	X	www.stifel.com
38. Fahnestock	X	X	X	www.fahnestock.com
39. Midwest Research	NO	X	NO	Sarah O'Connor-Compliance
40. First Analysis	X	X	X	www.firstanalysis.com
41. Thomas Weisel Partners	X	X	X	www.tweisel.com
42. Janney Montgomery Scott	X	X	X	www.janneys.com
43. First Albany	X	X	X	www.fac.com
44. Adams, Harkness & Hill	X	X	X	www.ahh.com
45. Jefferies	X	X	X	www.jefco.com
46. Ryan Beck	X	X	X	www.rbeck.com
47. U.S. Bancorp Piper Jaffray	X	X	X	www.piperjaffray.com
48. Sidoti	NO	NO	X	John Zolidis-Sidoti
49. BB&T Capital Markets	X	X	X	www.bbandt.com
50. Pacific Growth Equities	X	X	X	www.pacgrow.com

51. Hibernia Southcoast Capital	X	X	X	X	X	www.hibernia.com
52. Argus Research	NO	NO	NO	NO	NO	www.argusresearch.com
53. Davenport & Co, LLC	X	X	X	X	X	www.davenportllc.com
54. Friedman,Billings,Ramsey	X	X	X	X	X	www.fbr.com
55. H.C. Wainwright	X	X	X	X	X	www.hcwinwright.com
56. Gerard Klauer Mattison	X	X	X	X	X	www.gkm.com
57. Robert W. Baird	X	X	X	X	X	www.rwbaird.com
58. Legg Mason	X	X	X	X	X	www.leggmasoncapmgmt.com
59. Brean Murray	X	X	X	X	X	www.bmur.com
60. Griffiths McBurney	X	X	X	X	X	www.gmponline.com
61. Hoak Breedlove Wesneski	X	X	X	X	X	www.hbwco.com
62. LJR Great Lakes Review	NO	NO	NO	NO	NO	www.ljr.com
63. RBC Dominion Securities	X	X	X	X	X	www.rbcds.com
64. Gruntal	X	X	X	X	X	www.gruntal.com
65. Lazard Asset Mgmt	X	X	X	X	X	www.lazardnet.com
66. Wedbush Morgan Sec's	X	X	X	X	X	www.wedbush.com
67. Credit Lyonnais	X	X	X	X	X	www.creditlyonnais.com
68. Hilliard Lyons	X	X	X	X	X	www.hilliard.com

The Wall Street Journal's "Best on the Street" Stock Pickers—"95% of These Top 82 Firms Have Research Conflicts"—Continued

Wall Street Journal Ranking June 26, 2001	Investment Banking	Proprietary Trading	Money Management	Source
69. Advest Group	X	X	X	www.advest.com
70. Sandler O'Neill	X	X	X	www.sandleroneill.com
71. Stephens Capital Mgmt	X	X	X	www.stephens.com
72. Fox-Pitt, Kelton	X	X	X	www.foxpitt.com
73. Miller Johnson	X	X	X	www.stockwalk.com
74. Josephthal	X	X	X	www.josephthal.com
75. Simmons	X	X	X	www.simmonsco-intl.com
76. WR Hambrecht	X	X	X	www.wrhambrecht.com
77. Frost Securities	X	X	X	www.frostsecurities.com
78. Johnson Rice	X	X	X	New Orleans 504.525.3767
79. Kaufman Brothers	X	X	X	www.kbro.com
80. Wells Fargo Van Kasper	X	X	X	www.fsvk.com
81. Pacific Crest Securities	X	X	X	www.pacific-crest.com
82. Southwest Securities	X	X	X	www.swst.com
Totals	76/82=93%	79/82=96%	79/82=96%	

Source: The Precursor Group, July 30, 2001.

Institutional Investor Magazine's "2000 All-America Research Team"—100% of These Top 16 Firms Have Research Conflicts

Institutional Investor Magazine Ranking	Investment Banking	Proprietary Trading	Money Management	Source
1) Merrill Lynch	X	X	X	www.ml.com
2) Morgan Stanley	X	X	X	www.morganstanley.com
3) Salomon Smith Barney	X	X	X	www.salomonsmithbarney.com
4) Credit Suisse First Boston	X	X	X	www.csfb.com
5) Donaldson Lufkin Jenrette	X	X	X	www.dlj.com
6) Goldman Sachs & Co	X	X	X	www.gs.com
7) Bear Stearns & Co	X	X	X	www.bearstearns.com
8) Lehman Brothers	X	X	X	www.lehman.com
9) PaineWebber	X	X	X	www.painewebber.com
10) J.P. Morgan Securities	X	X	X	www.jpmorgan.com
11) Prudential Securities	NO	X	X	www.prudential.com
12) Sanford C. Bernstein & Co	NO	X	X	www.bernstein.com
13) Banc of America Securities	X	X	X	www.bofasecurities.com
14) Deutsche Banc Alex. Brown	X	X	X	www.deutsche-bank.com
15) ISI Group	NO	NO	X	www.morningstar.com
16) Robertson Stephens	X	X	X	www.robertsonstephens.com
Totals	13/16=81%	15/16=94%	16/16=100%	

Source: The Precursor Group, July 26, 2001.

White Paper: What Ails Investment Research?

Precursor Group®, May 2001

Introduction

Why is there so much market volatility? Why are investors so often surprised by companies? In large part because the “sell-side” investment research system is so biased toward the company view. The Wall Street firms that produce most “investment research” are *rife with potential financial conflicts of interest*. There is precious little quality, *independent* investment research that serves as a *source of new ideas* or as a *check and balance* on the “Street/Company” spin.

What Ails Investment Research?

Bundled Services: Most investment research is not sold separately, but as part of a bundle of services including access to investment banking and trading liquidity. As part of a financial bundle, research functions largely as advertising for other more profitable lines of business—banking and proprietary trading. Without separate pricing, *low quality research is concealed in the bundle of services*. Consequently, there is *little accountability or measure of research value* in the marketplace, and *little incentive to improve* the quality and objectivity of research. This suggests the current research system simply does not value research much.

Conflicts of Interest: Investment research is compromised by financial dependence on other lines of business with very different masters than investors. Investment banking and proprietary trading heavily subsidize Wall Street research, creating both real and perceived financial conflicts of interest. Since a research analyst’s compensation is often largely driven by investment banking deals, *there exists a stark conflict between the analyst’s responsibility to investors and responsibility to the firm’s corporate finance clients*. The evidence of this conflict of interest is powerful: according to First Call, of the 28,000 U.S. stock recommendations, only 1% are “sells.” This suggests it is not in the interest of most investment research to warn investors in advance of problems.

Expedient to Depend on Company Information: *Companies are the easiest source of information*, and are also *highly sophisticated in managing their investment “story”* through investor-public relations and lobbying firms. Because original research is difficult, time-consuming, costly and risky, it is simply easier to adopt the company’s world view and version of the facts. Securities & Exchange Commission (SEC) fair disclosure regulations also give companies wide latitude to manage information flow tightly—as long as they are equally stingy to all parties. This suggests the investment research system implicitly reinforces the *incorrect assumption* that companies know all, see all and share all.

Rehash Rather than Research: Since an underlying purpose of most investment research is to sell companies to investors, *Wall Street markets the positive and does not fully research the negative*. The large conflict between company and investor interests tends to produce a superficial rehash of public company information or benign commentary on industry developments. The result is a Wall Street system focusing more on “re” than “search”—more backward-looking reporting and reformatting, and not much forward-looking *searching* for what is new and original in the market, the core value of research to investors. This suggests most investment research has become an echo chamber for the company line.

Conclusion

Former SEC Chairman, Arthur Levitt calls the problem with investment research a “web of dysfunctional relationships.” The result of a dysfunctional research system is biased and poor investment research. This increases market volatility and surprises that blindside investors, skews the market toward investment banking at the expense of investor interests, and doesn’t fully help investors anticipate change, capture opportunities and avoid risk.

Quotes from the Industry & Academics

Bundled Services

“Research analysts have become integral members of the investment banking units . . . [their compensation is tied importantly to the fee revenue that they generate for the investment-banking unit.]” Samuel Hayes, professor emeritus at Harvard Business School, June 20, 2000, *Wall Street Journal*.

“Research analysts have become either touts for their firm’s corporate finance departments or the distribution system for the party line of the companies they follow.” Ste-

fan D. Abrams, Chief Investment Officer for Asset Allocation, Trust Company of the West, December 31, 2000, *New York Times*.

"[Y]ou can't get paid for research anymore, because the commissions have been whittled down; you have to look elsewhere for money. . . . Today, it's investment banking—looking for deals to do." Chuck Hill, Research Director, First Call Thompson Financial, August 14, 2000, *Interactive Week*.

Conflicts of Interest

"I see . . . a web of dysfunctional relationships—where . . . the analyst attempts to walk the tightrope of fairly assessing a company's performance without upsetting his firm's investment banking relationships." Arthur Levitt, Former SEC Chairman, April 6, 2000, Remarks at the Economic Club of Washington.

"Analysts must bring in deals, and there is an inherent conflict of interest. . . . Quality becomes a function of the deal calendar. It's only natural that the credibility of sell-side research falls as banking steps up." Andrew Barth, U.S. Research Director, Capital Guardian Trust Co., October 1, 2000, *Institutional Investor*.

"[A]nalytists affiliated with the lead underwriter of an offering tend to issue more optimistic growth forecasts than unaffiliated analysts. . . . [T]he magnitude of the affiliated analysts' growth forecasts is positively related to fee basis paid to lead underwriters." Patricia Dechow & Richard Sloan, *University of Michigan*; and Amy Hutton, *Harvard Business School*, June 1999, Research Paper: "The Relation Between Analysts' Forecasts of Long-Term Earnings Growth and Stock Performance Following Equity Offerings."

"[T]he way an analyst can get fired is to damage an existing investment banking relationship with a company or sour a future investment banking relationship." Mitch Zacks, Vice President of Zacks Investment Research, December 31, 2000, *New York Times*.

Expedient to Depend on Company Information

"They (analysts) get spoon-fed the information by investor relations officers and they have a very strong tendency to put a positive swing or twist on everything. . . . And like sheep they follow." Hugh Johnson, Chief Investment Officer, First Albany Corporation, September 24, 2000, *Reuters*.

With the SEC Fair Disclosure regulations, "nobody's going to have the inside dope. Analysts now will distinguish themselves more on scholarship and analytical ability rather than connections and relationships." Ted Pincus, CEO, Financial Relations Board, October 1, 2000, *Institutional Investor*.

Rehash Rather Than Research

"[W]e find there's a lack of initiative; they rarely really aggressively question what the company is telling them. What we get instead of research is reporting." Gary Langbaum, Fund Manager, Kemper Total Return Fund, December 11, 1997, *Wall Street Journal*.

"Our findings . . . [suggest] that analysts mostly react to changes in market values rather than cause them." Eli Amir, *Tel Aviv University*; Baruch Lev, *New York University* and Theodore Sougiannis, *University of Illinois*, September 2000, Research Paper: "What Value Analysts?"

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Senator DORGAN. Mr. Cleland, thank you very much.

Mr. Andrews, when you indicated that there were some mistakes in judgment, might I ask about Jedi? That partnership kept Enron debt off its books, but Enron was improperly at risk for its own Jedi stake. And the Chewco SPE had the same problems, where it was used to hold Enron's debts off Enron's books, but there were improprieties in its ownership. Is that what you are referring to when you talk about mistake in judgment by the accounting firm, by your firm?

Mr. ANDREWS. Senator, the Chewco investment is actually the one that I referred to that is the subject of the 10A reporting. That was actually an illegal act. The other SPE is the one that was a mistake in judgment, the smaller of the two that accounted for 20 percent of the restatement, and essentially what occurred there is that dated back till 1997, the information that our team reviewed in 1997 concluded that it met the requirements of the SPE's, which not to get technical on it, but if you have 3 percent, if an outsider has 3 percent and control you are allowed to, in fact required for that entity to be off your books. We believed it met that test. The company believed it met that test when it was set up.

Subsequent information, actually in October of this year, was that it was revealed that we made an error in judgment. It was not information that was withheld from us, but it was an error in judgment. When we realized that error, we pointed it out to the company and the company made that correction.

Senator DORGAN. How big was that correction?

Mr. ANDREWS. That correction was 20 percent of the restatement amount. I do not have the exact dollar amount, but it was 20 percent of the restatement amount.

Senator DORGAN. Let me ask, should it raise a red flag for an auditor if a firm is setting up a special purpose entity such as Jedi and Chewco? When a firm is setting up special purpose entities for

transactions in its own firm's stock, should that raise a red flag for auditors?

Mr. ANDREWS. Senator, special purpose entities are structured in accordance with the accounting rules. Generally accepted accounting principles are, in fact, what provide the guidance for those entities themselves, and you have to comply with the structure of those rules. Obviously, those are rules that the profession has that demand compliance.

Senator DORGAN. But you are answering a question I did not ask. I am asking whether an auditor should see some areas of concern if a firm is setting up a special purpose entity for transactions in its own stock.

Mr. ANDREWS. Well, the company—

Senator DORGAN. I am asking for your judgment.

Mr. ANDREWS. The company should report it in accordance with those rules, and it is our responsibility as auditors to review that.

Senator DORGAN. Should it raise a red flag for the auditor if the chief financial officer of a company is personally involved in complex financial transactions in their own firm? This was the case with Mr. Fastow, who had a personal stake, as I understand it, in the success of these SPEs and was compensated in that manner. Should that concern an auditor, and did it concern Andersen?

Mr. ANDREWS. Senator, as it pertains to related party transactions, again the accounting and disclosure rules required that related party transactions be reviewed and disclosed, where they would be material to the financial statement. In this case, that related party transaction was disclosed in the footnotes to the Enron financial statement.

Senator DORGAN. Do you have those footnotes with you?

Mr. ANDREWS. Mr. Chairman, I do not.

Senator DORGAN. The reason I ask is, I have read some of those footnotes, and I think it would have been impossible for even the most experienced analyst to understand what those footnotes meant, and that is of concern.

Did Arthur Andersen in any way participate in structuring or designing any of these special purpose enterprises for limited partnerships that were the subject of the restatements of earnings?

Mr. ANDREWS. Mr. Chairman, we performed our work as auditors. We did not design or structure the transactions.

Senator DORGAN. Let me ask a question raised by Mr. Cleland. I raised it in my opening statement. An accounting firm that is reviewing the books in a fair manner for a company and then represents that review to investors and others, if that company is also under contract for other consulting services—let us say they are paid \$25 million for auditing services and have a \$27 million consulting contract. Is that not an inherent conflict of interest?

Mr. ANDREWS. Mr. Chairman, we believe we are independent of Enron and we accept the responsibility and the importance of maintaining our independence and integrity. The rules related to what an auditor can do and cannot do are subject to regulation, and we conform and abide by those.

As I said, mentioned in some of my testimony, my opening statement at least, the \$27 million we were paid in terms of consulting, a significant part of that actually was for work that an auditor

really must do or has to do. For example, we performed the work related to Enron's registration statements, corporate letters, the tax work, things of that nature that really an auditor has to do the disclosure as to what goes into which pot, if you will.

As to what is called an audit fee versus a nonaudit fee is subject to the regulation of the proxy disclosures that the SEC passed last year, and many audit-related services actually go in the nonaudit-related category in that disclosure.

Senator DORGAN. Mr. Cleland, did I get any of my questions just answered?

Mr. CLELAND. It goes back to if it is tolerated, if it abides by the letter of the regulation, then it is not necessarily a violation of public trust. I think there is a question of the letter of the law and the spirit of the law, and what I am urging is, we need to get back to the spirit of the integrity of markets and investor confidence in the system, and that goes beyond the letter of the law.

Senator DORGAN. Senator McCain.

Senator MCCAIN. Following up on Senator Dorgan's comments, Mr. Andrews, do you believe that being paid for consulting as well as auditing creates the appearance of conflict of interest?

Mr. ANDREWS. Senator, again we believe we were independent in terms of the appearance of conflict of interest, as I said, and I believe it is important for us to have the public trust and if public trust is shaken by the confidence of that it is our responsibility to restore that.

Senator MCCAIN. Do you believe it creates an appearance of a conflict of interest?

Mr. ANDREWS. Many people have stated that it creates an appearance of conflict of interest.

Senator MCCAIN. Mr. Cleland, after reading your full statement that was submitted for the record, which is a very powerful statement, the next time I watch Lou Dobbs as a guest, or someone on MSNBC or CNBC or Bloomberg, some so-called expert that is recommending I purchase a stock, is it very likely that that person has some financial interest in the stock they are recommending?

Mr. CLELAND. You betcha, and the reason why I think we were asked to testify is we are a telecom tech research firm, and this happened in the telecom tech. This is *deja vu*. I mean, if you look in *Fortune Magazine* this week, there is a little thing that said, dot-com death watch, and there are 591 dot-coms that died, so Enron is a spectacular, huge hit, but this has been happening for the last year, hundreds of times.

Senator MCCAIN. And it may even be likely at the IPO stage these individuals made a whole lot of money?

Mr. CLELAND. A ton of money.

Senator MCCAIN. That was the history of the stock. It would go way up, and they had the initial purchases. Again, speaking of the press, perhaps those guests who sound so convincing, and are handsome men and women, very bright (smarter than anybody I know), do you think that before they make these great recommendations, including their overall confidence in the future of the stock market (starting some 6 months ago), that they should at least reveal any conflict of interest so that the viewer with re-

gards to television, or their radio or print audience as well, would know?

Mr. CLELAND. Certainly there should be greater disclosure, but disclosure has kind of been viewed as the cure, and it papers over the problem. The problem is, when people call them research analysts, the connotation that the average American has when they hear research, they think objective, they think scientific, they think analytic, and they think conflict-free. That is the connotation we are taught when we are in school of what the definition of research is. That is not what investment research is today.

Senator MCCAIN. Do you believe that any auditing corporation who receives consulting money, as well as auditing money, creates an appearance of conflict of interest?

Mr. CLELAND. Without question, it creates an appearance of conflict, and from my years in the Government, at the Treasury Department, the Office of Management and Budget, the State Department—and you all know in the public eye the appearance can be as damaging as the actual conflict, so that is why in the Government policy the people that have the public trust, you are supposed to avoid even the appearance of conflicts of interest.

Senator MCCAIN. Let us talk about SPEs for a second, Mr. Andrews. Clearly, you say there was one illegal act and one, “error in judgment.” Why would your people not detect something like this? As I understand it, it was a fairly large amount of money—about \$172 million, I believe. How do you miss something like that?

Mr. ANDREWS. Senator, an audit, of course—well, first of all, Enron is a large, complex company that had over 3,000 subsidiaries. It was at one point seventh on the Fortune 100 list, so a large complex company, and an audit, of course, is performed on a sample of transactions to provide reasonable assurance that the financial statements are not materially misstated, so an audit does not look at every transaction.

In the case of Enron, they had a number of special purpose entities, and the two that you mentioned, or two of those were called into question. On one of those, the smaller of them, when our team reviewed the information originally they did not detect an element of that that would have required that entity to fail that SPE test. It was an honest mistake in judgment. When we found out about it subsequently we brought it to the company’s attention and they corrected that error.

The second one, which is the one you refer to as an illegal act, actually information came to us, actually in early November. We do not know if an illegal act has been performed, but information came to us that would have required the accounting for that item to be different than it was originally done. Originally it was not recorded on the books, and it needs to be consolidated with the entity.

We do not know why we did not have that information. That was referred under 10A to the audit committee of the company, and it is currently under investigation.

Senator MCCAIN. How many SPEs did they have?

Mr. ANDREWS. I do not have the exact number, but there were several hundred.

Senator MCCAIN. Were there several hundred SPEs?

Mr. Cleland—and Mr. Andrews, I understand you are the messenger here today, and I appreciate you coming forward to testify and help us understand this situation. I thank you for being here today.

Mr. Cleland.

Mr. CLELAND. Just as a comment on that, the thing that I think all of us should be just stunned and amazed at is, this was a problem that should have been caught in 1997, in 1998, in 1999, and in 2000. That is what a system of internal controls is supposed to be about.

Mistakes are made, but we have a system that they cannot cascade hopefully more than 1 year, and when something cascades for 4 years on top of each other you have an Enron, and hopefully that is what you are gleaning from all of this, is that the system that is supposed to catch these things and fix them so they maybe Enron got a stock battering, but all these people on the first panel did not need to be here. They might have had a lower nest egg, but they would have still had a nest egg.

Senator MCCAIN. Efforts to reform the system of controls have been stymied in several areas of government. Do you have any comment about that?

Mr. CLELAND. Well, I think that—you know that the legal process—you all know better than anybody that if you try and do it through legislation, there are all sorts of ways that it can get stopped. I have simple suggestion. The U.S. Senate should do a resolution that says, we stand up for the integrity of the investment system. We think conflicts of interest are not a good idea.

You ought to suggest to your House colleagues to do that, and I will bet it is 100–0 and 435–0, and all of a sudden you get a sense of the Congress real loud and clear that says yes, integrity of the public markets is a good idea, and yes, conflicts of interest tempt people in ways we should not tempt them.

Why do I make sure that none of our research analysts may own an individual stock? I do not want to tempt them. Human nature is something in this. Now, why is Wall Street the way it is? They have been tempted with not millions, we are talking tens of millions, hundreds of millions of dollars. You are tempted with that amount of money and there are all sorts of reasons why you would look the other way.

Senator DORGAN. I am going to call on Senator Wyden, but I want to follow up just for one moment on the point Senator McCain made. Just to focus on one piece of this: Mr. Fastow, as I understand it, received \$30 million in management fees for these off-the-books partnerships, and we do not know what the ownership stake was, but the \$30 million was just for management fees.

Now, this was an officer of the company making a substantial amount of money in management fees and perhaps an ownership stake. When questioned about who were the other investors in these partnerships, the answer is: they are private. So among the answers we are requesting is, let us allow some sunshine to come in here and find out who owned these SPEs. How did they profit? When did they profit? How much did they profit? That is what we are trying to get to, and I think that is what Senator McCain was alluding to as well.

I would just ask Mr. Cleland the same question I asked of Mr. Andrews. I do not think I got an answer, but do you think it is an inherent conflict of interest for a CFO of a company to have an ownership stake in these off-the-books partnerships and be paid commissions for running them and so forth?

Mr. CLELAND. Yes. That is a no-brainer. It is an unbelievable conflict of interest, because one thing is public and the other is private, and so there is no accountability. That is why it is a conflict.

Senator DORGAN. Senator Wyden.

Senator WYDEN. I participated in more than thirty hearings regarding the accounting profession as a member of the House. Those hearings were chaired by John Dingell, and after the hearings I wrote a law with Mr. Dingell's assistance that was designed to prevent this kind of problem. Everything about what we did was designed to do what Mr. Cleland talked about which was to set off those early warning lights. I'm going to take you through that statute and have you tell me what your company was doing to, in effect, comply with the law. I'm just going to go through it step by step.

The first part of the law says that every single audit has to have procedures in place to detect illegal acts. What did you have in place and, in particular, did you revise those procedures as more and more evidence came to light, suggesting that there was a problem there?

Mr. ANDREWS. Senator, as you know I'm not the individual that actually managed the individual Enron engagement, so I don't have all the details of what we did on the audit. But our audits on this engagement were performed in accordance with the professional standards. I think our people did the appropriate work, which includes, within that scope, the appropriate consideration of establishing your audit scope to take into account the responsibility for illegal acts.

Senator WYDEN. But did you change it over time? I mean, my knowledge at this point is that it would be one thing to have a set of procedures at the beginning, but as Mr. Cleland said, then all this evidence starts flowing in. You've got a law on the books that would suggest to me that the procedures should have changed over time. Did they?

Mr. ANDREWS. Senator, I do not know how our procedures changed over time but I do want to make, point out one thing that if my testimony in any way was misleading, is we, at this point, have one item that came to our attention in November that we have reported to the audit committee under 10A, as required. We do not know if that was an illegal act or not. So at this point in time we do not know if we have any illegal acts at the company.

Senator WYDEN. Let's continue to go through the law. The second part of the law goes right to the heart of what all of my colleagues are talking about. These related party transactions are just a breeding ground for financial hide and seek and conflicts of interest. The current law says that there have to be procedures to identify related party transactions that are material to the financial statements. What procedures did you have so as to again identify those related party transactions early on as Mr. Cleland is talking about?

Mr. ANDREWS. Senator again, our audit procedures incorporated the audit steps, if you will, to identify related parties and to discuss related parties and to see that related party transactions, that the company disclose those related party transactions in accordance with generally accepted accounting principles. The responsibility for related party transactions, first to identify them and to disclose them, is foremost the company's and it's our responsibilities as auditors to do appropriate auditing procedures related to that. Again, a related party transaction is not wrong as long as it's accounted for, approved properly and disclosed.

Senator WYDEN. Well, again, it just seems to me that at this point there is just the vaguest, most skimpy information out there about these partnerships and if you look at section two of this law that John Dingell and I wrote, it sure looks to me like there wasn't a whole lot of disclosure of those related party transactions.

Now the third part of the law says that when illegal acts occur or may have occurred, you're supposed to bring it to the attention of the authorities. You've described bringing it to the attention of the authorities years after the warning lights should have gone off. Years after the warning lights should have gone off. Why did that happen?

Mr. ANDREWS. Senator, the particular transaction that you're referencing, again if I have in any way been unclear on that, that was a transaction that was entered into a few years ago in which we did not have, the company did not provide us with all the information to reach the right conclusion on that transaction. It was actually November, early November of 2001 that upon a request for additional information that the special committee of Enron's board had, we got a package of information that contained information we did not previously receive when that transaction was recorded. When we got that information, it was, it was crystal clear to us that the accounting for that transaction had been incorrect and within twenty-four hours we took that information to the audit committee and asked that the company appropriately investigate it and report those findings back to us so that we could consider then our responsibilities beyond that.

Senator WYDEN. Well again, it just looks to me that the firm moved after all the horses were out of the barn, and we wrote a law that was designed to have the firm move years and years earlier. Now let me, because time is short, ask you about just a couple of other matters.

It's my understanding that Andersen served not only as Enron's in-house auditor, but also as the outside auditor as well. So in effect, it looks to me like Andersen is auditing its own work. Do you think that's appropriate for an internal in-house auditor to also serve as the outside person?

Mr. ANDREWS. Senator, in the case of Enron we did not audit our own work and we certainly concur that we should not audit our own work. What we did at Enron, actually our services that are referred to as internal audit services, are actually part of the external audit fee that, part of the \$25 million. We rendered two reports on Enron. One is a financial statement audit, if you will, the opinion on the financials, and the second is a report on internal controls, which many have advocated. That's actually, that responsi-

bility is codified under the AICPA guidelines, so that's an external audit activity. The only internal audit activity we did in 2000 really related to a request that Enron asked us to review a system, the controls around the system, that another big five firm had actually installed.

Now prior to 2000, in the 1994 to 1998 period, we did perform internal audit services for Enron. But beginning in 1998 they rebuilt their internal audit department and since that time what we have done is really render those two reports, which are external audit activities and occasionally, when they would request it, we would do additional services. But we do not, we do not audit our own work.

I certainly concur with your statement that it's inappropriate for an external auditor to audit its own work.

Senator WYDEN. This is eye-glazing stuff, you know, Mr. Andrews. I mean, I sat through thirty accounting hearings and I saw just how this is sort of like prolonged root canal work. But I will tell you, at the end of the day, people get hurt when auditing firms take years to do what that law, which went into effect several years before all of this went on, could have brought to light.

Now let me ask you about a couple of other matters. In testimony before the House the CEO of Andersen said it wasn't clear why relevant information about one of the big special partnerships was not provided to you. Under the Financial Fraud Disclosure Act who bears the responsibility for obtaining the relevant information?

Mr. ANDREWS. Well Senator, as an auditor we expect all relevant information to be provided to us. In the case of these transactions we believe that it's quite clear what relevant information would be appropriate for us to review as well as for the company to review. In this case, we don't know why, as he stated in his testimony, as I did today, we do not know why we did not have a component of that relevant information. Again, when it came to our attention, we reacted instantly to take the appropriate actions under, under 10A.

Senator WYDEN. But again, under the law, shouldn't you have been bearing down to get that relevant information? I mean, what I am struck by is that, and I am sure we're going to run a lawyer's full employment program and argue about this for some time, there may have been a technical compliance here, but all of this seems to me to be maneuvering that is different than what the Congress intended when we passed that law. When we passed that law it said you had to have all the relevant financial information. I don't know how you certified the accuracy of their books for years and years. How could you have certified the accuracy of their books when you couldn't get the information?

Mr. ANDREWS. Well Senator, obviously we do not know what we do not know. We did not realize in this particular case, in this one transaction, we did not realize that we did not have the information. Again, an audit looks at a sample of transactions, does not audit every transaction, and it is our professional responsibility to do that. And when we obtained the information, we reacted to it as required under 10A.

Senator WYDEN. The point really is that the law changed, Mr. Andrews. The law changed when we passed the law to detect and disclose financial fraud on the books. But you all are acting like

very little has changed. When you say we did not know what we did not know, the whole point was when you saw suspicious activity you were supposed to set off the red warning lights. The watchdogs were supposed to wake up from their slumber and get it to the attention of the proper authorities and it just seems to me, in this case, years were taken before that was done. I thank you Mr. Chairman.

Senator DORGAN. Senator Wyden, thank you very much. You are raising questions about an area that is critically important. In fact, the number of restatements of earnings, very substantial restatements of earnings, in this country today ought to cause alarm here in Congress and across the country. I do not understand how, what can happen after the fact is for the best minds in the country could say: oh, we made, we made a mistake of \$100 million or a half a billion dollars. It's happening all too often and maybe is the subject of another hearing at another time. Senator Fitzgerald.

Senator FITZGERALD. Thank you, Mr. Chairman. Mr. Cleland, I wanted to thank you for your testimony. I thought it was superb and I would like to work with you implementing some of your recommendations.

Mr. CLELAND. Thank you Senator.

Senator FITZGERALD. And thank you for being here today. And Mr. Andrews, I want to compliment your firm for having the courage to come before our Committee and take your lumps. I think you are being very forthright here in doing so. I would have to say too that it really appears to me that your restatement of the earnings seems to have caused Enron ultimately to go into collapse, because once the earnings got restated then people—creditors—really started questioning the company and then it evolved into a liquidity crisis where they couldn't get more credit and they couldn't keep going forward without filing bankruptcy, and I think actually, your forcing them to restate their earnings brought this whole thing to light ultimately.

Now you did earn a lot of fees from Enron but I guess I would want to ask, what are the overall fees that Arthur Andersen earns in a year and what percentage would \$52 million that Enron paid you last year, what percentage of your total revenues for the firm would that be?

Mr. ANDREWS. Well, our firm is approximately a \$10 billion business, so \$52 million into \$10 billion would be the relative size of that.

Senator FITZGERALD. It wouldn't seem that it is really a sizable fraction of your overall revenues and so, I guess it would be hard for me to put all the blame on your firm because it is hard for me to believe that your firm, because of that \$52 million, would have been compelled to cover up things in Enron's financial statements and risk your whole firm.

Mr. ANDREWS. I think, Senator, I think that's an excellent point. I'd like to comment on that and also one comment on the restatement if I could.

We are confident we are independent of Enron and I think the illustration that you just cited is an example of why I think the public should be confident that we are as well. But we are independent and our team performed professionally.

As it pertains to the restatement, I want to make sure I clarify actually what took place there. We of course audited Enron. The last audit we actually did was December 31, 2000. It was subsequent to the third quarter of 2001, of course, which we have not audited, that Enron concluded it would restate its prior year statements.

We really, at this point, have not audited the restatements and, in fact, we have withdrawn our opinion on the prior restatements. So it's really Enron's restatement, and actually, that occurred in early November, 2001 and really was not part of the October 10Q at that point. It was filed actually in November, 2001 but we have not audited those restatements.

Senator FITZGERALD. I guess I have a question in my own mind, Mr. Cleland. Say that all of these SPE transactions had been properly disclosed since 1997 through the future. I guess all these analysts out there, my suspicion is, would still have had buy recommendations on the stock. When you look at the annual report of Enron and see pages and pages and pages of their subsidiary corporations, 3,000 of them, and then they have I don't know how many of these SPEs, you have an impenetrable financial statement, that only maybe a handful of people in the country with Ph.Ds in accounting would even have the slightest possibility of understanding.

And whenever you see stuff like this, at least in my own mind, growing up as I did in a banking family, my father was a small town community banker, if he ever saw something, somebody came into him with a deal he could not understand, he said bye-bye. He stayed away from anything that he could not understand.

Well, I think the fact of the matter is that you had bankers that were lending to Enron, we have some big banks, Citibank, JPMorgan Chase or, I have got to be careful, I am not sure. I know Citibank was involved with over \$500 million in unsecured debt here. I wonder how many of the people at Citibank even understood these financial statements. You had analysts all over the country pumping the stock, and I do not know that greater disclosure somewhere in the bowels of these 10K or 10Q's would have made any difference.

Mr. CLELAND. You're exactly right. See, the problem isn't whether it's disclosed, it's that you want some part of the system to be totally aligned with investor interests. So essentially, they are paid and have the responsibility and earn an income for finding these things, and right now, we did a survey earlier in the year where 95 percent of the Wall Street Journal's top research firms had investment banking conflicts of interest.

So all the brand names that everybody comes to understand have these conflicts of interest. So, and also they all say well, everybody does it, so how can it be wrong? Well, it's only when you look at it in totality and you realize that virtually all the research is done from a company perspective, no one's checking their work. No one is assuming that there might be something wrong. And no one is paid by the system to assume something's wrong. We're a small firm. We're focused on that. We're aligned totally with investor interests and in a telecom text base, we do spot these things.

Senator FITZGERALD. Well, do you think we should require analysts be separate from the investment banks or how would they get paid? Who would pay for the services?

Mr. CLELAND. I think, you know, I am not a pro-regulatory guy in this. I think what you need to do is fix the system which is commingled. If you put banking, trading and research chits all in the same till, the one that has the most profits and the one that generates the most, they rule the house.

And so, a very simple thing you all could do, and this is not very regulatory, is what we're suggesting is say trading should be trading. That's what best execution is all about in our system and banking, we have all sorts of banking rules that say the banking commissions need to be a certain way. We have very little that says we want to encourage research to be research, because until you allow research to be paid for just research, you're not going to have very much of it, because if it's commingled, the bankers go, no, no, no, we don't want that kind of research because that research might make a stock go down. That is not in our interest.

And so, the best research execution would be a good idea. If you want to have a disclosure, you could also have a disclosure where public companies would have to say what type of research are they using? Maybe not specifically, but in general. Are they buying conflicted research or they're buying independent research.

Senator FITZGERALD. And you also believe, and this is my final question, you also believe that auditors should not be able to provide consulting services for their auditing clients?

Mr. CLELAND. I think that auditing is such a public trust, just like working for the government is such a public trust, that there needs to be a higher standard and auditors ought to be auditors, just like tax examiners should be tax examiners. We wouldn't want IRS guys moonlighting on the side. We don't want a judge moonlighting on the side for somebody they might be judging. I think it's common sense. It begs problems if you have conflicts of interest.

Senator FITZGERALD. Now, Mr. Andrews you don't agree with that and generally the big accounting firms don't agree with that, is that correct?

Mr. ANDREWS. Well, that is correct. I mean, there are rules that guide what we can do and what we can't do, and we certainly are very responsive to abiding by those rules. I will say that, as I've said in my statement, we're very open. We think we have a responsibility, the profession has a responsibility, Andersen has a responsibility to restore public trust. So we recognize that reform is needed in both the regulatory process and the disciplinary process and we're open-minded as to what that reform could be.

I think we have to look at it in its total context and if it does two things I think we would be receptive to considering any changes. Those two things are: Does it in fact build and restore public trust and does it improve the quality of audits? And if we can achieve those two objectives, we certainly are open to consideration of a variety of alternatives, but we do believe they should be looked at in the total context.

In the Enron situation, we did not have a conflict of interest, we were independent and I believe our team did its professional job.

Senator FITZGERALD. Thank you.

Senator DORGAN. The Senate will begin two votes at 12 o'clock. Those votes will last a period of time, so that means we have about another half an hour here before we are going to have to go and vote. I very much want to hear the other three witnesses and Senator Wyden has a brief question prior to asking the other witnesses to come forward.

Senator WYDEN. Just one question. It sort of sums it up for me, Mr. Andrews. Enron's board was allowing all of these partnerships and all of these exotic financial entities that were basically keeping the debt off Enron's books. That's what it did, kept the debt off Enron's books. What was Arthur Andersen doing during this whole period? This went on for years. Again, it goes right to the question of why there weren't any warning lights blaring?

Mr. ANDREWS. Well, Senator I think it runs to the basic issue of, you know, why do entities like SPEs, why are there rules within generally accepted accounting principles that allow, not only allow, but require compliance as to where an investment is or isn't. Is it on the books or is it off the books? Is the debt on the books or off the books?

Those rules are the rules that exist within generally accepted accounting principles. Neither the company nor ourselves have the luxury of deciding which of the rules we will follow. Those rules are there and I think your point is, all right, as I listen to it, is that those rules are unclear and un-complex and perhaps don't result in the disclosure that you would like to see.

Senator DORGAN. Mr. Andrews, time will tell whether those rules were bent or broken. I find it hard to believe that somehow it's operating within the rules to have a CFO of a company be involved in off-the-books partnerships with a financial stake in them, making \$30 million a year on commissions. I think that is a preposterous situation. It's full of conflict, and I think a lot of folks in this country get hurt. They lose their life savings as a result of it and Senator Wyden's inquiring, as I think most of America would inquire about, where were the watchdogs and where were the auditors?

Your appearance is appreciated. Some have chosen not to appear. Your company has. We appreciate that. We, as I have indicated, will have another hearing on February 4th. Mr. Lay, we are told, will be available to testify at that hearing. We will ask Mr. Skilling and Mr. Fastow to be present as well.

Mr. Cleland, we would like to be in further touch with you.

Mr. CLELAND. Thank you.

Senator DORGAN. I appreciate your testimony. I think it is very valuable to us, and we will excuse both of you and ask the three final witnesses to come forward.

We are asking Mr. John Coffee, Adolf Berle Professor of Law at Columbia University to come forward, Mr. Bill Mann, Senior Analyst of The Motley Fool, and Mr. Damon Silvers, Associate General Counsel of the AFL-CIO.

Let me say that I appreciate your patience and your willingness to be with us during this period. If you will come forward. I want to get your testimony before we break in order to vote, because that will take a block of time and I think you have waited some lengthy period of time already this morning.

Mr. Coffee, you are a Professor at the Columbia School of Law.
Mr. COFFEE. Actually this semester I'm a Professor at Harvard Law School. I just want to make the dean happy by indicating that I'm a visiting professor there this semester.

Senator DORGAN. I see. So you're not exactly disavowing Columbia, you're simply giving credit to Harvard.

Mr. COFFEE. I'll go back to Columbia in January. I'm very loyal to Columbia.

Senator DORGAN. Both schools have now profited from this public disclosure.

[Laughter.]

Senator DORGAN. We appreciate you being with us, Mr. Coffee and why don't you proceed.

**STATEMENT OF JOHN C. COFFEE, JR., ADOLF A. BERLE
PROFESSOR OF LAW, COLUMBIA UNIVERSITY SCHOOL OF
LAW AND JOSEPH FLOM VISITING PROFESSOR OF LAW,
HARVARD UNIVERSITY LAW SCHOOL**

Mr. COFFEE. Well, when a debacle like Enron occurs, the critical question for Congress and for regulators is to ask, as you have been beginning to ask, where were the gatekeepers? Where were the watchdogs? By gatekeepers I mean the independent professionals whose job it is in American corporate governance to analyze, verify and examine the financial statements and the financial transactions that the company is engaged in. That's both the auditors, the audit committee, the securities analysts and the bond rating agencies.

Here all failed, and all failed fairly abysmally. This is a pathological symptom. Now I do not want to overstate, I do not purport to know whether Enron's auditors were complicit in securities fraud. I think no one can tell at this stage, there's not enough information and frankly I would be quite surprised if we have a case of outright fraud. But I do know that this is a case in which all the earmarks and symptoms are present of a gatekeeper who was too conflicted to be an effective watchdog on whom investors can confidently rely.

Arthur Andersen just told you they made an error in judgment and I'm not accusing them of more than that, but I will say that there are more errors of judgment made when you're subject to serious conflicts of interest. Rationalizations are much easier, particularly in the very gray world of accounting principles, which are seldom black and white and which always give enormous amounts of discretion to the professional gatekeeper.

We heard earlier that \$50 million was not that big for Arthur Andersen. But I should remind you that auditing firms are a lot like law firms, Partners are compensated on what I'll call an eat what you kill basis, and for the Houston office of Arthur Andersen this was a very, very big client. In fact, it's much more than a \$50 million client because within the profession of auditing today, the growth is not on the auditing side, the growth is on the management advisory services side.

In their own literature, their own professional journals tell them over and over again that auditing is a portal of entry, a way to get inside the client and then market the much more lucrative consulting services. So an Enron is really a potential market of \$100

or \$200 million to a firm that's auditing it, because they're looking at what the future growth was if Enron had remained solvent, and that does create a serious conflict problem.

Most importantly, this case is not unique. Accounting irregularities are now alleged in the majority of securities class actions that are filed each year. The old days of stock drops and missed projections, they're gone. They can't be sued anymore because the Private Securities Litigation Reform Act has basically closed down that type of litigation. Enron is really no different than Cendant, Sunbeam, HBOCMcKesson, Livent, Mercury Finance, Waste Management, Rite Aid. All of these were large corporations with real assets that managed either to conceal shortfall in earnings for several years, or to postpone cost recognition for several years. Enron is simply the decimal point moved two times to the right but the same underlining fact pattern. In Yogi Berra's phrase, it's *deja vu* all over again.

Now the best evidence of this is ironically a study by Arthur Andersen, which I think you may have been referring to earlier. Arthur Andersen has reported this year that the number of accounting restatements by publicly held companies has gone up sharply over the last 3 years, and this is not anecdotal data, this is significant data. In 1998 there were 158 accounting restatements of earnings by publicly held companies. That's a lot. But last year that number was up to 233. That's over a 2-year period. It's a 47 percent rise. Something is going on behind that. What is happening? I want to offer two generalizations, and I'll be brief on both of these. First of all, the legal threat that auditors and accountants face for securities fraud liability has sharply decreased over recent years for a variety of reasons. It's partly the Private Securities Litigation Reform Act. It's partly the preemption of state litigation, and it's even more the Supreme Court's elimination of aiding and abetting liability, because that's traditionally what accountants were sued on—aiding and abetting liability, and that was abolished by the Supreme Court in a judicial decision.

Now, I'm not suggesting that the answer here is simply to maximize the legal threat. I think there can be too much liability as well as too little liability. But, the pendulum has swung sharply, to the point today that auditors are very uninviting targets. They do get sued, but the cases against them usually are dismissed or they settle for fairly small damages, except frankly, in these highly publicized cases—like Enron may prove to be. That's trend one.

Trend two is the incentive to acquiesce and to defer to management has increased as the accounting profession has transformed itself from old-fashioned staid auditors into complex, diversified, management advisory conglomerates, which view, again, auditing as basically a point of entry, a mechanism by which you can maximize cross selling and by which you can use auditing as a kind of loss leader to market more lucrative services. Very briefly, what can be done? I won't take you through a detailed legal analysis, but I would suggest there are two things that you should focus on.

One is the current auditor independence rule is inadequate. How do I know that? Last year the SEC proposed a much, much tougher rule that would have largely prohibited auditing firms from marketing non-audited services to their audit client. The SEC thought

that was the right rule. The SEC got a fire-storm of resistance and the SEC, under an aggressive and bold chairman, who I great respect, was unable to get that rule through. And he got, frankly, great resistance from Congress and others.

I think the time has come to recognize that Chairman Levitt may have been right. There has been, as he publicly said, a decline in the quality of financial reporting, and that it is partly attributable to both the game of earnings management, which is fairly pervasive, and the conflicts of interests as auditors have transformed themselves into diversified, financial conglomerates.

I think we should go back and re-examine that rule. And, that's an SEC rule, which is much easier to change than trying to go back and pass legislation or, God forbid, re-examine the Private Securities Litigation Reform Act, which was probably the most controversial legislation that I've seen over the last 10 years. That's something that's manageable.

The other thing that I think can be done and should be done is a serious system of industry self-regulation. Let me focus on a basic contrast. I want to contrast the broker-dealer industry and the auditing profession. Both involve firms that specialize in human capital and professional services, broker-dealer advice or auditing.

Broker-dealers are regulated by the National Association of Securities Dealers, the NASD, a self-regulatory body subject to some SEC oversight. That body is tough, independent, and since it was reformed in the mid-1990's, I think a very effective agency that is not a captive agency.

Last week, they and the SEC imposed over a \$100 million dollar fine on Credit Suisse First Boston. That's not the ear-mark of a captive agency. They impose thousands of penalties on broker-dealers every year, literally thousands. And, they impose penalties that are not trivial.

In contrast, on the accounting side, we have the AICPA and a byzantine, convoluted system of regulation. But, the one thing it does not do is ever impose discipline. None of the regulatory agencies, the AICPA, the Public Oversight Board, or any other agency of that sort, is empowered to impose discipline. That's delegated down to the states where very little happens. Enron is not a local problem. It's a problem on a national level and we need a national, self-regulatory body.

Ultimately, the choice for the accounting profession is between developing on their own, with Congressional assistance and Congressional insistence on strong, independent directors—so this wouldn't be a captive agency—a powerful, self-regulatory agency that can impose real discipline, modeled after the NASD which does work. Or, the alternative is that over time in our common law system the courts will begin to change the common law and impose much more punitive liability through the tort system. That will take a long time. It won't benefit any of the investors that were here today who are going to receive nothing, frankly. But, the choice for the industry is serious self-discipline or expect that over time the tort system will gradually change the rules and we'll have discipline through the class action.

Of the two, I would say that intelligent self-regulation would be the far more sensible, far shrewder answer, if the industry, pushed by Congress, were to pursue that. Thank you.

[The prepared statement of Mr. Coffee follows:]

PREPARED STATEMENT OF JOHN C. COFFEE, JR., ADOLF A. BERLE PROFESSOR OF LAW, COLUMBIA UNIVERSITY SCHOOL OF LAW AND JOSEPH FLOM VISITING PROFESSOR OF LAW, HARVARD UNIVERSITY LAW SCHOOL

**The Enron Debacle and Gatekeeper Liability:
Why Would the Gatekeepers Remain Silent?**

The sudden and unexpected bankruptcy of Enron has generated understandable concerns about our system of corporate governance—and, in particular, about the integrity of financial reporting systems. Although publicly held companies in the United States are subject to uniquely high disclosure obligations, the Enron example shows that the much vaunted transparency of the American securities markets can sometimes prove illusory and that sometimes very material information can be concealed behind opaque accounting.

When this happens, the inevitable question arises: Why didn't the gatekeepers stop them? By "gatekeepers," I mean the independent professionals who verify and analyze the disclosures of publicly held companies. These include the corporation's outside auditors, the securities analysts that follow its stock, and the bond rating agencies that review its bonds. Because these professionals have considerable reputational capital, which can be damaged by involvement in a corporate fiasco, because they face the prospect of legal liability for securities fraud, and because they have much less incentive to lie or acquiesce in fraud than do the corporate insiders, gatekeepers are the primary safeguards on whom investors rely to assure that accurate and meaningful disclosures reach the market. Yet, in the Enron case, all these protective mechanisms failed: the accountants certified financial statements that overstated Enron's financial results by over \$500 million; the security analysts continued to recommend Enron's stock (in some cases with a "strong buy" recommendation) right up to virtually the moment of Enron's bankruptcy filing, and the credit rating agencies did not detect that Enron's off-balance sheet financing hid very high leverage.

Who is to blame? It would be premature at this point to even attempt to attribute responsibility. Possibly, Enron's auditors were deceived, and possibly they may have been lax and acquiescent. One simply cannot conclude from the outside on the evidence now available. What can be said, however, is that the Enron case does not stand alone. In particular, cases involving accounting irregularities have proliferated over just the last several years. Some of these cases have made it to the front of the business page and the nightly T.V. news: Cendant, Sunbeam, HBOCMcKesson, Livent, Mercury Finance, Waste Management, and Rite Aid.¹ Some of these cases have resulted in criminal prosecutions and convictions, others in SEC enforcement proceedings, and all in large settlements of private class actions. The increase in accounting irregularities is not simply an anecdotal impression. A study by Arthur Andersen has found that the number of restatements of earnings by publicly held companies has risen steadily and dramatically over the past four years from 158 in 1998 to 233 in 2000—or, a 47% increase over this brief period.²

That corporate insiders will sometimes commit fraud and suppress adverse information is not terribly surprising. After all, they benefit from it. That securities fraud escapes the attention of the professional gatekeepers may be more surprising—and alarming. Yet, former SEC Chairman Arthur Levitt concluded in a famous 1998 speech that there had been "an erosion in the quality of earnings and therefore the quality of financial reporting."³ Specifically, Chairman Levitt focused on a variety of what he termed "accounting gimmicks" that enabled companies to exploit the flexibility of accounting rules to obscure actual financial results and risks. Since the time of that 1998 speech, a small library of academic and empirical

¹A fuller list of recent "accounting irregularity" cases can be found in Michael Young, *ACCOUNTING IRREGULARITIES AND FINANCIAL FRAUD: A Corporate Governance Guide* (2000).

²See Jonathan Glater, "Flood of Lawsuits Puts Underwriters in Cross Hairs," *New York Times*, December 2, 2001 at Section 3, p.4.

³See Arthur Levitt, "The Number Game," Sept. 27, 1999 (Speech Given at NYU Center for Law and Business).

studies of the phenomenon of “earnings management” have been published, most of which confirm that earnings management is pervasive.⁴ During his tenure, Chairman Levitt made accounting reform a major priority, and, the SEC formulated a series of new accounting rules and interpretations during the late 1990’s, to restrict earnings management; it also established a “blue ribbon panel” to improve audit committee performance and persuaded both the NYSE and Nasdaq to adopt its recommendations. Finally, in a bruising battle with the accounting profession, the SEC revised its critical rule on “auditor independence.” All of these measures were to varying degrees controversial, and the last—the SEC’s proposed auditor independence rule—proved to be politically unobtainable, as the Commission was forced to accept a considerably weaker compromise that left auditors free to engage in most forms of consulting work for audit clients.⁵

Nonetheless, the Enron episode and the general increase in accounting restatements suggests that the SEC may not be winning its war against accounting irregularities. What could explain this apparent decline in the quality of financial reporting? A good case can be made that both (1) the legal threat confronting the auditor has been sharply reduced over recent years by a series of recent judicial and legislative developments, and (2) the incentives for the auditor to acquiesce in questionable accounting practices have grown, as the nature of the industry has changed. I do not suggest that this hypothesis has been proven beyond a reasonable doubt or that it fully explains the Enron debacle, but I do suggest that Congress should be aware of these developments and not view Enron as an exceptional case. Enron is different only in that it is larger. Otherwise, it is in Yogi Berra’s immortal words “deja vue all over again.” Both the diminished threat facing auditors and their increased incentive to acquiesce are briefly reviewed below.

A. *The Diminished Legal Threat*

Auditors have long been subject to suit under Rule 10b–5 when they certify that the financial results reported by an audit client comply with generally accepted accounting principles (“GAAP”). Indeed, auditors are named as defendants, in the majority of securities class action lawsuits filed in recent years.⁶ To prevail in such a suit, however, the plaintiffs must demonstrate not only that a materially false statement was made by the auditor, but that the auditor acted with the requisite “scienter”—that is, a mental state embracing both an intent to defraud or a reckless indifference to the truth or accuracy of the statement made. The term “scienter” is defined somewhat differently in different federal circuits, but the prevailing definition defines scienter as:

“A highly unreasonable omission, involving not merely simple, or even inexcusable negligence, but an extreme departure from the standards of ordinary care, and which presents a danger of misleading buyers that is either known to the defendant or so obvious that the actor must have been aware of it.” *Sunstrand Corp. v. Sun Chem. Corp.*, 553 F.2d 1033, 1045 (7th Cir. 1987).

The scienter requirements has long been a primary defense for accountants in securities fraud litigation, who can escape liability if they can convince the fact finder that they were merely negligent (even if grossly so). But the protection of this defense has been recently and greatly enhanced by the following more recent developments:

1. *The Enhanced Pleading Requirements of the Private Securities Litigation Reform Act of 1995 (the “PSLRA”).* Under Section 21D(b)(2) of the Securities Exchange Act of 1934, which added by the PSLRA, a complaint in a securities fraud case must:

“state with particularity facts giving rise to a strong inference that the defendant acted with the required state of mind.”

In a Rule 10b–5 suit, this requires the plaintiff to plead with particularity facts giving rise to a “strong inference of fraud” on the part of the specific defendant. This pleading must be made at the outset of the litigation before the plaintiff has obtained any discovery. In practice, this provision is far more protective of auditors than of other defendants. For example, in the Enron case, plaintiffs can plead that

⁴Many of these studies are available on the SSRN Electronic Network. See, e.g., Mark Nelson, John Elliott and Robin Tarpley, “Where Do Companies Attempt Earnings Management, and When Do Auditors Prevent It?” (SSRN no. id= 248129, October 22, 2000).

⁵The final Commission rule is set forth in Securities Act Release 33–7919 (November 21, 2000). An earlier and tougher rule was proposed in Securities Act Release No. 33–7870 (June 30, 2000).

⁶See Glater, supra note 2.

the corporate officers at Enron withheld material information in order to permit them to sell their large stock holdings before the Enron market price collapsed. Evidence of such insider sales may (if they are large enough in percentage terms) satisfy the plaintiff's obligation to plead with particularity facts giving rise to the requisite "strong inference of fraud" on the part of Enron's insiders. But the same pleading cannot be made with respect to the auditors, who by definition do not own stock in an audit client. Although auditors may have been subject to conflicts of interest or may have been pressured into accepting improper accounting presentations, these facts will rarely be evident at the outset of the case. Hence, the auditor benefits far more from this pleading requirements than do other defendants, because the case against it must be dismissed if such facts cannot be plead prior to discovery.

2. *Proportionate Liability.* Section 21D(f) of the Securities Exchange Act of 1934, which was also added by the PSLRA, substituted proportionate liability for joint and several liability as the normal standard of damages in securities litigation. This change works particularly to the advantage of auditors, who, even if culpable, are usually much less so than members of management. As a practical matter, an accounting firm now knows that, so long as its actual knowledge of the fraud is not proven, its maximum exposure to damages has shrunk from joint and several liability for 100% of the losses to a likely much lower percentage, probably below 25%.⁷

3. *Eliminating RICO Liability for Securities Fraud.* The PSLRA also ended the use of the private civil RICO statute as a means of seeking treble damages in securities fraud cases. Where once a RICO claim was a standard feature in securities class actions, because it increased the potential damages by a factor of three, the PSLRA denied plaintiffs the ability to assert a RICO claim in any case that could have been pled as a securities fraud claim in connection with the purchase or sale of a security.

4. *Aiding and Abetting Liability.* Even prior to the PSLRA, the Supreme Court's decision in *Central Bank of Denver, N.A. v. First Interstate Bank of Denver, N.A.*, 511 U.S. 164 (1994), eliminated liability for aiding and abetting a securities law violation as a potential cause of action that an auditor could face in private litigation. This theory of liability had been the preferred weapon of the plaintiffs' bar in Rule 10b-5 litigation against accountants, because typically auditors aid the issuer in the preparation of its financial statements (particularly its quarterly statements). Although the SEC has regained the right to sue for some "aiding and abetting" violations pursuant to the PSLRA, private parties have not.

5. *Preempting State Litigation.* Although securities fraud litigation in state court became a substantial risk for accountants in the late 1990's, that risk was effectively ended in 1998 by the passage of the Uniform Standards Act, which preempted class actions and certain consolidated actions that assert causes of action, based on either state law or the common law, that allege a misrepresentation or omission of a material fact in connection with a purchase or sale of a security.⁸

The bottom line is that, although litigation involving accounting irregularities remains common, accounting firms themselves are unlikely to be held liable for more than a nominal percentage of the losses—except in cases where their behavior has been egregious.

B. Organizational Changes Within the Auditing Profession

Auditing firms have long marketed three general types of services to their clients: (i) auditing, (ii) tax services, and (iii) management advisory services. The last category—management advisory services (or "MAS")—has expanded dramatically over roughly the last decade in a manner that has transformed the accounting firm from the traditional firm of accounting professionals to a multi-disciplinary service organization. In 1981, MAS accounted for only thirteen percent of the Big Five's total

⁷There are two major exceptions to this generalization: (1) the auditor is subject to "joint and several" liability if it made a knowingly false statement, and (2) to the extent that a judgment against another co-defendant is uncollectible, the auditor may be required to pick-up a portion of that unsatisfied liability (up to 50% of its original liability). This last point has special relevance in the instant case, because Enron is insolvent and cannot be held liable.

⁸Section 28(f) of the Securities Exchange Act of 1934 precludes any "covered class action based upon the statutory or common law of any State or subdivision" that alleges "a misrepresentation or omission of a material fact in connection with the purchase or sale of a covered security." A similar provision is set forth in Section 16(b) of the Securities Act of 1933. Neither provision preempts an individual suit, standing alone, but the term "covered class action" includes any "single lawsuit in which . . . damages are sought on behalf of more than 50 persons." Hence, sizable consolidated actions are also barred.

revenues, but that figure has grown to fifty percent or more by 2000.⁹ Over the period from 1993 to 1999, the average annual growth rate for revenues from management advisory and similar services has been twenty-six percent, while the comparable growth rates for audit and tax services has been only nine percent and thirteen percent, respectively.¹⁰ In short, MAS has been growing at roughly three times the rate of the traditional audit service. Finally, in 1999, the U.S. revenues for management advisory and similar services for the Big Five amounted to over \$15 billion.¹¹

A more ominous transition involves the relative balance between audit fees and MAS fees. Not until 1997 did the percentage of audit clients who paid MAS fees in excess of their audit fees to Big Five firms exceed 1.5%.¹² Yet, by 1999, this figure had grown from 1.5% to 4.6%—an over 200% increase in only two years.¹³ Moreover, average MAS fees received by the Big Five firms came to ten percent of all revenues in 1999.¹⁴ Today, for at least some audit clients, the amount of non-audit revenues paid to their auditor already exceeds their audit fee. At least in the case of these clients, intransigence by the audit partner with regard to some “aggressive” accounting treatment proposed by the client could expose the firm to the loss of much greater non-audit revenues, which the client could presumably purchase (or threaten to purchase) elsewhere.

The danger lies in where these trends are taking us. Not only are non-audit revenues received by auditors from their audit clients beginning to exceed audit fees from the same clients, but the SEC’s noted in its latest Release on auditor independence that some audit firms may be pursuing a marketing strategy under which the firm “low-balls” the audit fee (even offering to perform it at a loss) “in order to gain entry into and build a relationship with a potential client for the firm’s non-audit services.”¹⁵ Once auditing becomes a de facto “loss leader” for the multi-services consulting firm, there is less reason for such a firm to resist questionable accounting practices. To be sure, some threat of liability to third parties remains, but in considering resignation, the auditing firm must now balance the threat of liability against not only the loss of its audit fees, but also the loss of far larger present and expected future non-audit revenues from the client. Other things being equal, this implies that the threat of liability (even if it were undiminished) would less often be adequate to deter.

The Enron fact pattern again illustrates this shift in the source of client revenues. According to press reports, Enron paid more to Arthur Andersen in consulting fees during its last fiscal year than it paid in audit fees. In addition, it paid over \$50 million in total fees to Arthur Andersen last year.¹⁶ Put simply, this is a very different relationship than the traditional relationship between auditor and client because historically no single client would have been financially material to the auditor. Hence, the rational auditor would not risk its reputation for an audit fee that was small in percentage terms to its overall earnings. But, as the individual client becomes material to the auditor, the auditor unfortunately becomes less independent of its client.

C. Implications

In sum, a credible story can be told that auditors today are subject to less of a legal threat than a decade ago and are, correspondingly, subject to a greater temptation to defer to management with regard to questionable accounting policies. Whether this story truly explains the Enron debacle is, of course, uncertain, and no suggestion is here made that we yet know whether Enron’s auditors did acquiesce improperly (as opposed to being themselves deceived by Enron).

But even if this story does fit the instant case, the policy prescriptions that should follow from it are at least equally debatable. The PSLRA was an intensely lobbied statute, and there seems little likelihood that Congress would wish to repeal or seriously modify its provisions. Even if the SEC’s current auditor independence rules seems inadequate, it also seems unlikely that the SEC will wish to revisit it only

⁹ See Securities Act Release No. 33-7919 at p. 18; see also Securities Act Release No. 33-7870 (June 30, 2000) at Appendix 13, Tables 1 and 2.

¹⁰ *Id.* at p. 18; see also Securities Act Release No. 33-7870 at Table 1 in Appendix B.

¹¹ *Id.*

¹² See Securities Act Release No. 33-7870 at Table 3 in Appendix B; see also Securities Act Release No. 33-7919 at p. 19.

¹³ *Id.*

¹⁴ *Id.*

¹⁵ Securities Act Release No. 33-7919 at 27.

¹⁶ Last year, Enron paid Arthur Andersen \$25 million in audit fees and \$27 million for non-audit services. See Jerry Hirsch and Thomas Mulligan, “Auditors, Execs Target of Enron Creditors,” Los Angeles Times, November 30, 2001 at Part 3-1.

a year after reaching a hard fought compromise with the industry. Finally, reliance on class action litigation to discipline auditors may not be the optimal remedy. Prior to the PSLRA, the very solvency of some auditors was coming into doubt.

What other avenues of reform are then available? Here, a noteworthy contrast can be drawn between the accounting industry and the broker-dealer industry. Broker dealers are subject to close supervision and professional discipline by a self-regulatory body—the National Association of Securities Dealers (“NASD”). Nothing remotely comparable exists in the convoluted structure of accounting regulation, and professional discipline is rarely imposed.

In this light, the most conservative reform might be the creation of a truly independent, self-regulatory body, modeled after the NASD and with independent directors that did not come from the industry, to monitor and enforce self-regulatory rules for the accounting profession.¹⁷ Although the industry may not welcome such a development, it represents far less of an intrusion into their affairs than would any attempt to expose them to greater antifraud liability.

Ultimately, the increasing frequency of accounting irregularities faces the accounting industry with an unpleasant choice: implement a serious and reliable system of self-regulation and professional discipline or expect that the courts and/or Congress over time will return to a system of punitive tort liability.

Sen. Dorgan: Professor Coffee, thank you very much. We appreciate your testimony. Next we will hear from Bill Mann, Senior Analyst with The Motley Fool. Mr. Mann, why don't you proceed?

**STATEMENT OF WILLIAM H. MANN, III,
SENIOR ANALYST, THE MOTLEY FOOL**

Mr. MANN. Good morning, Mr. Chairman, I wanted to thank you. I am William Mann from Motley Fool. It's not very often that someone who purposely calls himself a Fool gets to address the U.S. Senate. So, I am honored by the invitation. I'm sorry about the situation about which I am testifying today. I have listened to the testimonies in the first panel, as you all did, and my heart bleeds for these people. They are innocent in what will go down to be one of the largest, most destructive company failures of all time.

Let me say at the outset, what was missing in the case of Enron was skepticism. Individual investors, institutional investors alike, piled millions of investment dollars into the company. They were mesmerized by its rate of growth and completely sold on what seemed to be an insurmountable business advantage. Even though Enron emitted plenty of hints about impropriety for several years, few people, from Wall Street analysts to individual investors, stopped to ask the tough questions. And that's one of the reasons we're here today. I'd like to discuss some of those hints, the questions, and what I believe is the mechanism that allowed Enron to fall through the cracks.

The Motley Fool's message was not adopted in a vacuum. Our founding was predicated on the fact that there was no one who really had an incentive to tell people the truth about money and their investments. Part of the reason that we began teaching about the stock market was the amount of poor and self-interested advice that was being given by brokerages and their analysts. We believe that price targets and analyst ratings are, frankly, things that are made with several masters in mind, none of whom is the individual investor. In a similar fashion, sell-side stock analysts are generally

¹⁷I have made a detailed proposal along these lines in an article available on the Social Science Research Network (“SSRN”) website. See Coffee, “The Acquiescent Gatekeeper: Reputational Intermediaries, Auditor Independence, and the Governance of Accounting” (May 21, 2001) (SSRN identification number = 270944).

compensated based on the overall profitability of their firms, not on the quality or the accuracy of their analysis. In the end, analysts have minimal structural incentives to be accurate in their predictions; rather, their built-in incentive is to be as favorable to the corporate clients as possible. It's a well-worn joke that there apparently is no word as infrequently used in Wall Street as "sell."

In the case of Enron, in September there were 17 analysts who covered the company. Sixteen had a "buy" or "strong buy," one had a "hold," and none had a "sell" or a "strong sell" rating. This was true after Enron's CEO suddenly resigned and the stock had already dropped more than 60 percent in the year.

I don't want to blame Wall Street analysts for the Enron implosion. The blame for the billions of dollars and the hundreds of thousands investors have lost lies almost entirely with the senior management of Enron. The problem lies in the fact that these analysts have much greater incentive to focus upon the positive of a company than to root out the risks and the negatives. And, their employers value their ability to generate investment banking business much more than they do proper analysis.

I wish as a personal—as an individual investor, that I could say that I'd sniffed out the trouble at Enron when I did my analysis in 2000. I was really intrigued by this company. I really didn't want to miss out on what I thought was a really pretty spectacular growth story. But what I found in the company's filings was just plain confusing to me, and there were a few items that made me extremely uncomfortable. In particular, Footnote 16 in the Form 10-K, under the heading "Related Party Transactions," where Enron disclosed that it had entered into a deal with LJM Cayman Corporation stating that a senior officer in Enron is the managing member of LJM's general partner.

When James Chanos, a famous short-seller, began asking questions that needed to be asked about these statements, none of the analysts followed up. When Enron routinely failed to provide a balance sheet along with its earning releases for the company conference calls, none of the analysts voiced much of a complaint. Or, if they did, it was not reflected in the ratings of the stock. Enron was a "black box" company, where no one, not the analysts nor any of the institutional or individual investors was really sure how the company made money.

There is no "smoking gun" with Enron. The financials look great and even now there is no single item that we could look back and say that's the "tip-off" that this "company was going to implode." However, the more important issue to my mind is whether or not analysts have any incentive at all to do the analysis and to ask these tough questions. It strains credulity to say that, of the 17 analysts who covered Enron, none of them had any idea that related party transactions could be used to massage earnings or to hide debt. Enron's business was complicated enough, its financials convoluted enough, its disclosures opaque enough, and its sales growth spectacular enough that there ought to have been some pointed questions from analysts so that they could provide knowledgeable guidance to their shareholding clients, which thus begs the question, "Why weren't there?"

Goldman Sachs analyst David Maccarrone and David Fleischer issued a report on October 24, 2001, following Enron's conference call to address investor concerns. One of the quotes in the report were as follows, "Lack of Disclosure and Transparency—A Long-standing Enron Hallmark." "New disclosure about related party transactions and structured off-balance sheet transactions occurred some 18 months ago. . . ." "However, an undercurrent of concern began and questions remained unanswered. . . ." "We do not believe that management has done anything wrong. . . ." Despite a lack of visibility and some pretty important risk factors, Goldman's analysts continued to keep Enron on its "recommended list," Goldman's highest rating.

At the same time, Lehman Brothers, covering Enron, put out their own version of the conference call. He called it, "an inadequate defense of the balance sheet," but then concluded, "despite the disappointing call we continue to think that the stock should be bought aggressively at these levels." Lehman Brothers also kept their highest rating on the stock.

I don't think analysts should be taken to task for being wrong. In an environment where people are expected to take past and current trends and predict the future, getting things wrong would be an inevitable reality of the business. As Yogi Berra once noted, "It's hard to make predictions, especially about the future." The issue here is that the analysts who were covering Enron, despite the company's long-standing policy of withholding key information, and despite knowledge of the fact that there was an unknown level of debt being hidden from them, remained nearly uniformly positive on the company until it was clear the company would collapse.

Both Lehman Brothers and Goldman Sachs have provided significant investment banking services to Enron. Both provided financial services or sold or managed Enron commercial paper, managed a public offering of the stock, all within the last 3 years. Additionally, a Lehman Brothers employee is an Enron director.

Enron collapsed because its management got caught up playing in Wall Street's estimates game, promising and delivering big revenue and profit growth, regardless of the debt and other balance sheet contortions it took to get there. Looked at this way, the pursuit of hyper-growth seems to have caused Enron's executives to take undue risks with shareholder funds. Maintaining Enron's darling status in the investment world apparently caused these same men to take the short walk across the aisle from being aggressive with company assets to being downright deceptive by hiding information individuals and institutional investors must have to make good investment decisions.

At The Motley Fool, our advice to investors is and has always been to ignore the "noise" that comes from Wall Street, and to treat any specific recommendations for stock purchase with skepticism. We teach investors to think like business owners, not renters or passive pushers of paper. It's our genuine hope that investors seek to buy companies that they truly understand and would be willing to hold for a lifetime. If there's one lesson that individual investors must learn from Enron, it is this: You must buy what you know. Enron's CEO Ken Lay has admitted that he himself did not fully understand the inner workings of Enron, and we can assume that

he at least had all the information. Even with full disclosure, Enron would have been a tough company for the majority of all investors to understand. The company was unapologetic in its refusal to provide information about its equity and debt structures for many years before it actually blew up. My hope is that investors take the lesson offered by Enron and remain healthy skeptics in the future.

There's a simple calculus that investors use in valuing a company. A company is fairly valued by all of its future profits, discounted for risk. Obviously, the greater the risk to profits the higher the discount should be; and the less valuable every expected dollar of future profits would be right now. Over the last twelve months, 233 companies have had to restate their earnings. And not surprisingly, none of these restatements have made the company's operating results look better. Getting away with falsifying earnings over a long period of time is difficult. It is much easier to falsify levels of risk, and this in the end is what Enron, and by extension its auditors and analysts, have done—by commission or omission.

We hope to see that the work that has been done by the SEC and Congress to implement improvements, such as Regulation Fair Disclosure, will go even further to ensure that individual investors are protected. Thank you for your attention and I look forward to the opportunity to answer questions.

[The prepared statement of Mr. Mann follows:]

PREPARED STATEMENT OF WILLIAM H. MANN, III, SENIOR ANALYST,
THE MOTLEY FOOL

Mr. Chairman, Members of the Committee, and esteemed guests:

Good Morning. I am William H. Mann, Senior Analyst for The Motley Fool. As it is not often that a Fool gets the chance to address the United States Senate, I am honored by the invitation to speak before you today about Enron—an situation that will no doubt go down in history as one of the largest, most destructive company failures of all time.

The Motley Fool was founded in 1993 with a mission to educate, amuse and enrich individual investors. Our work is driven by our belief that average people—you and I—ought to take a more active interest in our management of money. In order for individual investors to effectively engage themselves, they need education about how the financial system works, access to information, and opportunities for open dialogue. That's what we provide. We teach people the fundamentals of long-term financial management; we highlight online and offline information resources for them; and we manage a 24-hour open network of communication on the topic of money shared by people in more than 100 countries around the globe.

In addition, individual investors need to have trust in the marketplace. Congress and the SEC have actively supported education programs and disclosure practices that have helped to strengthen the confidence that individual investors have in the public markets. One statistic that should make us all proud is that while in 1990 less than a quarter of all American households directly owned stocks, today that number has grown to more than 50%.

Let me say at the outset that what was missing in the case of Enron was skepticism. Investors—individual and institutional alike—piled millions of investment dollars into the company, mesmerized by its growth rates, and completely sold on what seemed to be an insurmountable business advantage. Even though Enron emitted plenty of hints of impropriety for several years, few people, from Wall Street analysts to individual investors stopped to ask tough questions. I'd like to discuss those hints, the questions, and what I believe is the mechanism that allowed an Enron to slip through the cracks.

The Motley Fool's message was not adopted in a vacuum. Our founding was predicated on the fact that there was no one who had an incentive to tell people the truth about money and their investments. Part of the reason that we began teaching about the stock market was the amount of poor and self-interested advice that was

being issued by brokerages and their analysts. To this day, the majority of stock-brokers are compensated on the number of trades their customers make, not on the returns they generate for them or on the quality of the advice they provide. We believe that the price targets and analyst ratings are made with several masters in mind, none of whom are the individual investor. In a similar fashion, sell-side stock analysts are generally compensated based upon the overall profitability of their firms, not the quality or accuracy of their analysis. In the end, analysts have minimal structural incentive to be accurate in their predictions; rather their built-in incentive is to be as favorable to their corporate clients as possible. It is a well-worn joke that there is no word as infrequently used on Wall Street as “sell.”

An April 1999 speech from U.S. Securities & Exchange Commission Chairman Arthur Levitt cited a study that found sell recommendations account for just 1.4 percent of all analysts’ recommendations, compared to 68% of all recommendations being buys. In the case of Enron, in September there were 17 analysts who covered Enron, and of them, 16 had a “buy” or “strong buy” rating, one had a “hold,” and none had a “sell” or a “strong sell”. This was true after Enron’s CEO, Jeff Skilling, suddenly resigned, and the company’s stock had already lost some 60% of its value from its high of the year.

I do not wish to blame the Wall Street analysts for the Enron implosion. The blame for the billions of dollars that hundreds of thousands of investors lost lies almost entirely upon the senior management of Enron. But Enron was playing a game that is utterly corruptible in ways that are not transparent to retail investors, and the playing field is dominated by Wall Street firms, their analysts serving as the public face. I submit that every single gross mis-pricing in equities over the last decade has come with analysts cheering it on the way up and maintaining silence as it dropped. I use the word corruptible because, for all of the exhortations of The Motley Fool that investors ignore analyst ratings, there can be no question that people remain deeply influenced by them. The problem lies in the fact that analysts have a much greater incentive to focus upon the positive of a company than to root out the risks and the negatives, and their employers value their ability to generate investment-banking income much more than they do proper analysis.

I wish that I could say that I had sniffed out trouble at Enron when I did my analysis in 2000. I was really intrigued by the company, and did not want to miss out on what already was a spectacular growth story. But what I found was just confusing, and there were a few items that made me uncomfortable. In particular, Footnote 16 in their 2000 Form 10-K, under the heading “Related Party Transactions,” where Enron disclosed that it had entered into a deal with LJM Cayman Corporation, stating that “A senior officer of Enron is the managing member of LJM’s general partner.” Under Generally Accepted Accounting Practices, disclosing a related party transaction is properly done in this fashion. However, related party transactions are also a method that companies use to “groom” their financials, so I would generally insist upon a high level of disclosure for the risks and benefits to shareholders that such a transaction would provide. Related party transactions are ideal vehicles for companies to hide risk, to get debts off of the balance sheet by using Special Purpose Entities (SPE’s).

In Enron’s case, the disclosures were minimal. When James Chanos, a famous short-seller, began asking questions that needed to be asked about these statements, no analysts followed up. When Enron routinely failed to provide a balance sheet along with its earnings releases for company conference calls, none of the analysts voiced much complaint, or if they did, it was not reflected in their ratings of the stock. Enron was a “black box” company, where no one, not the analysts nor any of the institutional or individual investors was really sure how the company made money.

There is no “smoking gun” with Enron. The financials looked great, so even now there is no single item that one can look at and say, “that was the tip-off,” or “there is the sign that the company was going to implode.” However, the more important issue is whether or not analysts have any incentive at all to do the analysis and to ask the tough questions. It strains credulity to say that, of the 17 analysts who covered Enron, that none of them had any idea that Related Party Transactions *could* be used to massage earnings or to hide debt. Enron’s business was complicated enough, its financials convoluted enough, its disclosures opaque enough, and its sales growth spectacular enough that there ought to have been some pointed questions from analysts so that they could provide knowledgeable guidance to their shareholding clients. Which thus begs the question, “Why weren’t there?”

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transactions and structured off-balance sheet transactions occurred some 18 months ago . . .” “However, an undercurrent of concern began and grew as questions remained unanswered . . .” “We do not believe that management has done anything wrong . . .” Despite a lack of visibility into some pretty important risk factors at Enron, Goldman’s analysts continued to keep Enron on its “recommended list,” Goldman’s highest rating.

At the same time, the Lehman Brothers analyst covering Enron put out his own version of the conference call. He called it “an inadequate defense of the balance sheet,” but then concluded “despite the disappointing call we continue to think the stock should be bought aggressively at these levels”. Lehman Brothers also kept their highest rating on the stock.

I do not believe that analysts should be taken to task for being wrong. In an environment where people are expected to take past and current trends and predict the future, getting things wrong would be an inevitable reality of the business. As Yogi Berra once noted, “It’s hard to make predictions, especially about the future.” The issue here is that the analysts who covered Enron, despite the company’s long standing policy of withholding key information, and despite knowledge of the fact that there was an unknown level of debt being hidden from them in off-balance sheet SPE’s remained nearly uniformly positive on the company until it was clear the company would collapse.

Both Lehman Brothers and Goldman Sachs have provided significant investment banking services to Enron. In the case of Goldman Sachs, the company provided financial services, sold or managed the sale of Enron commercial paper, and managed a public offering of its stock, all within the last three years. Lehman Brothers, for its part, also managed a public offering in Enron stock, plus a Lehman employee is an Enron director.

These investment banking activities comprise a much larger component of Lehman Brothers and Goldman Sachs revenues and profits than do their retail brokering activities. Story after story in the media have shown that these analysts are having their compensation much more closely tied to the ability of their banks to provide these investment banking deals. Morgan Stanley analyst Mary Meeker, for example, had an “outperform” rating on all of the Internet stocks in December 2000, though they were down by an average of 83% from their highs of the year. The vast majority of these companies had received investment banking services from Morgan Stanley.

JP Morgan’s head of equity research, Peter Houghton, sent a memo to the bank’s equity analysts in March of this year stating that the analysts were required to consult both the company concerned and Morgan’s investment banker before publishing research that regarded one of Morgan’s corporate clients.

This environment ought to call into question the integrity of analyst research. The Enron collapse is neither the first nor the most expensive loss of shareholder capital that came while analysts maintained cheery ratings on a company. It’s only by virtue of the fact that the loss on Enron shares has approached 100% for shareholders that made it the most noteworthy.

Lucent’s struggles, although less apocalyptic so far, reinforces my point about sell-side analysts’ failings. In January 2000, Lucent Technologies had a market capitalization well in excess of \$240 billion. It was, by a significant margin, the most widely held stock in America. You only needed to understand one simple principle of financial analysis to see that trouble was coming for Lucent—namely, that growth in inventory and accounts receivable should be no faster than growth in sales. For four consecutive quarters in 1999, both receivables and inventories at Lucent were growing at double, triple, even four times sales. And yet, of the 38 analysts who covered Lucent in January 2000, 32 had “buy” or “Strong buy” ratings on the stock, 6 had “hold,” and none had a “sell” rating. Many of these analysts are employed by investment banks that had generated significant revenues from Lucent’s acquisition and debt placement activities. Not one pointed out that the company’s receivables or inventories were skyrocketing. Lucent’s weak balance sheet has nearly bankrupted the company. This year it has laid off more than 60,000 employees, and in the last 22 months more than \$200 billion of market cap has been erased.

Prior to January 2000, Lucent had never failed to meet Wall Street’s estimates. It would seem that this fact, not the convolutions that Lucent needed to *meet* these estimates, was what was valued on Wall Street. Those convolutions have conspired to nearly destroy the keeper of Bell Laboratories, one of the treasures of American ingenuity.

Enron collapsed because its management got caught up in playing Wall Street’s estimates game, promising and delivering big revenue and profit growth, regardless of the debt and other balance sheet contortions it took to get there. Individual investors lost money, in part, because analysts had limited incentives to look at the com-

pany's financials with critical eyes. Management withheld key information from shareholders, and then, even after the troubles came to light last month, refused to answer questions about the nature of its deals with partnerships that were controlled by Enron executives. Looked at in this way, the pursuit of hypergrowth seems to have caused Enron executives to take undue risks with shareholder funds. Maintaining Enron's (and its managers') darling status in the investment world apparently caused these same men to take that short walk across the aisle from being aggressive with company assets to being downright deceptive by hiding information individual and institutional shareholders *must* have to make good investment decisions.

Enron's management walked the fine line between keeping analysts happy and providing good information to their shareholders for years. Then Enron's management apparently made the conscious choice to place the appearance of high-profits, high-growth and low-risk—things held dear by Wall Street—over proper disclosure of risks and realities to their shareholders.

At The Motley Fool, our advice to investors is and has always been to ignore the "noise" that comes from Wall Street, and to treat any specific recommendations for stock purchase with skepticism. Meaning that things such as one-year price targets, which are the language of sell-side analysts, ought to be of no interest to an individual investor. We teach investors to think like business owners, not renters or passive pushers of paper. It is our genuine hope that investors seek to buy companies that they truly understand and would be willing to own for a lifetime. If there is one lesson that individual investors must learn from Enron, that is: Buy What You Know. Enron's CEO Ken Lay has admitted that he himself did not fully understand the inner workings of Enron, and we can assume that he at least had all of the information. Even with full disclosure, Enron would have been a tough company for the majority of all investors to understand. The company was unapologetic in its refusal to provide information about its equity and debt structures for years before it actually blew up. My hope is that investors take the lesson offered by Enron and remain healthy skeptics in the future: when a company fails to treat shareholders as co-owners, one should assume that those components which are hidden from view do not contain good news.

Conclusion

There is a simple calculus that investors use in valuing a company. A company is fairly valued by all of its future profits discounted for risk. Obviously, the greater the risk to profits, the higher the discount should be, and less valuable every expected dollar of future profits would be *right now*. Over the last 12 months 233 public companies have had to restate their earnings, and not surprisingly, none of these restatements have made the companies' operating results look *better*. Getting away with falsifying earnings over a long period of time is difficult. It is much easier to falsify levels of risk and this, in the end, is what Enron, and by extension, its auditors and the analysts have done, by commission or by omission.

Individual investors have seen great strides in the level of protection afforded in the U.S. stock markets over the last decade. Information technology and the Internet went a long way toward making public documents, including SEC filings, available at an instant to the vast majority of shareholders. Regulatory improvements such as Regulation Fair Disclosure have gone even further to ensure that companies provide fair and equal access to information vital for people to make investing decisions. We hope to see that work continued and support all efforts to increase financial education in America.

In a pari-mutuel environment such as a stock market, where every decision to buy, sell, or do nothing has a small effect on every other participant in the market, there is little chance that anyone will be able to provide absolute protection from bad information, whether intentionally or accidentally disseminated. However, the markets are built on trust, and there is a reason far beyond the power of American commerce that causes more than 48% of the world's equity capital to be represented here: investors the world wide know that their financial interests are better protected in the U.S.'s relatively transparent markets than in any other country on earth. It is in our best interest to ensure that we eradicate corruption and keep our markets strong.

Thank you for your attention. I appreciate the opportunity to address the Committee, and I would be happy to answer any questions.

Submitted for further consideration:*

- 10/24/2001 Goldman Sachs Research Report
- 10/24/2001 Lehman Bros. Research Report
- 3/21/2001 "JP Morgan Reins in Analysts," The Times, London.
- 11/30/2001 "Enron as Icarus," by William Mann.
- 1/13/2000 "Lessons From Lucent," by Matt Richey, Tom Gardner and William Mann.
- Comments from Individual Investors in Enron, submitted by members of The Motley Fool Community.

Sen. Dorgan: Mr. Mann, thank you very much. And now we will hear from Mr. Silvers. Mr. Silvers is Associate General Counsel of the AFL-CIO. Mr. Silvers, welcome.

**STATEMENT OF DAMON A. SILVERS,
ASSOCIATE GENERAL COUNSEL, AFL-CIO**

Mr. SILVERS. Thank you Chairman Dorgan, and thank you particularly for the opportunity to appear here today with Enron employee investors. It is truly an honor to share this podium with them. The labor movement today is trying to do everything we can possibly do to get the people who you saw this morning their money back. I'm afraid that is a long shot, frankly, but we are trying to do everything we can, and, also to prevent another Enron.

We began this effort in early November when the AFL-CIO wrote to Enron's board and frankly begged them to act, to get responsible and respected people on the board and to make full disclosure before it was too late. The letters we sent are attached to our testimony, but tragically they were, frankly, ignored. Since then, worker benefit funds have sued Enron, its board and Arthur Andersen. Union members have sued the trustees of the 401(k) plan. The AFL-CIO has followed Professor Coffee's advice and asked the Securities and Exchange Commission to issue rules embodying the strong proposals that Arthur Levitt carried forward unsuccessfully last year and, in addition, to issue rules ensuring that corporate boards will be genuinely independent.

Finally, the AFL-CIO, together with worker funds, is right now engaging in a dialog with Wall Street money managers about the effect of their conflicts of interest on worker funds and their losses in Enron. My written testimony contains a detailed review of the behavior of Enron's sell-side analysts over the last year, as well as a general discussion of the problems of the conflicts of interest that surrounds sell-side investment analysts. We've heard a bit about this from other witnesses. The conclusion of our review is quite simple. No sell-side analysts whose firm was underwriting, advising or lending to Enron or Dynegy ever recommended that its clients sell their Enron stock, not even on the day Enron filed for Chapter 11.

Analysts without those conflicts, and in particular independent investment news letters, were bearish on Enron starting last spring. Some people, it seems, don't like to put money in black boxes. In our opinion, conflicted analysts irrational exuberance over Enron was a substantial contributor to this catastrophe, but really not the only one or the root of the problem.

*The information referred to was not available at the time this hearing went to press.

The root of the problem lies here. At various times in the last several years Enron's executives faced a fateful choice. They could have done what the law required and reported disappointing results on various transactions and lines of business. This would have been to do what many executives do every day, and frankly suffer some pain for doing. Instead, Enron's executives chose a different path, the path of using complex subsidiary structures to hide liabilities and exaggerate revenues, and apparently, to also funnel company assets to themselves.

This choice to hide bad news is at the heart of what went wrong with Enron. From the moment that choice was made, the people who you heard from today, who were not in on those decision, began paying more for Enron securities than they should have. Credit rating agencies and energy market participants began to participate in deals whose risk they were being misled as to the full nature of that risk.

Of course, many of the very insiders involved in designing and approving this financial trickery were getting multi-million dollar management fees from those same partnerships. And, at the same time as the Chairman has reminded us today, Enron executives were selling close to a billion dollars in their own holdings in Enron common stock at the inflated prices that appear to have been maintained by their false financial reporting. If our capital markets were functioning properly, the fact that some Enron executives wanted to hide the true state of Enron's finances from the financial markets should not have automatically resulted in a massive, persistent inflation of the companies stock price and credit rating, and the subsequent complete collapse of the firm when the truth became know.

If the system were working, an audit committee of the board of directors, an outside independent audit firm, vigilant Wall Street analysts, and institutional money managers all would have stood between the desire of Enron managers to artificially maintain a high stock price, and the victims—the individual investors, the pension funds, and Enron employees—that ended up paying that high price—that they were frankly suckered into paying. But, as we have learned, the audit committee directors were not really independent, and they appear to have let the managers do whatever they wanted with the firm's books. You've heard from the outside directors today—the outside auditors today. In some ways I think they speak for themselves, but I will point out that the obviously signed off on an audit with inadequate or inaccurate information as its basis, and allowed liabilities to be wrongfully excluded from Enron's books.

Today's testimony from Andersen raises some very clear questions, and obvious questions. And they are: what did they do for the \$27 million that first they said was internal audit and then they said wasn't internal audit? What was it? Second, why did they not tear apart these transactions when they were brought transactions that were with insiders and that involved these complex structures that it seemed that no one understood? Finally, as I note, the buy-side analysts for their part appear to have forgotten that the word sell is part of the English language, and we've heard a lot about that from the prior witness.

And finally, oddly enough, the money manager alliance capital that bought the most Enron stock over the last 6 months—like Lehman Brothers—shares a director with Enron. As a result of these sorts of pervasive conflicts of interests our capital markets, I think this hearing and the hearing in the House last week have shown, are very treacherous places for the unwary consumer. Enron is only the most recent and most dramatic example of this unfortunate fact.

This is, in part, why the labor movement strongly believes that America's working families retirement security should rest on three legs: on Social Security, a defined benefit pension plan, and personal savings. Only one of these legs should be directly at risk in the markets. I think you frankly heard testimony on that proposition, far more eloquently than anything I could say, earlier this morning from people who only had two legs.

Some companies might have been able to withstand—I'm sorry—Enron's executives appear to have intentionally misled investors. But, they were only able to do so because the entire system of private sector investor protections failed. Now the question is how will the public sector respond? The government owes the investing public, and particularly Enron employees and retirees, answers and justice. In particular, the government owes Enron employees and retirees answers that can only be obtained by using the full investigative powers of the Federal Government.

For starters, this Subcommittee and the Congress as a whole, might want to get these questions answered: Who were all of the investors in Enron's limited partnerships and SPEs? Why was it that Enron executives felt confident that they could hide material financial data from the public over a period of years free from regulatory scrutiny? What role did Enron directors play in the creation of the partnerships and SPEs and the decisions not to disclose critical information about their purposes, ownership, management and finances?

What role, and I mean this in detail because obviously there was a cursory exchange about this this morning, what role did Arthur Andersen play in the entire life of the SPEs and partnerships? Who were those SPEs and partnerships own audit firms, if they had them? Was Andersen aware of them when they were first set up? These questions deserve, I think, full exploration.

What were the full terms of the arrangements between Enron, Dynegey, JPMorgan Chase, Citigroup and Lehman Brothers? What were the incentives and conflicts that were pushing those analyst recommendations that waxed so positive in November as these people's money was disappearing? Why did Enron go ahead with changing its 401(k) advisor, apparently on October 17th, when Enron itself was controlling the release of the critical information here that opened the gates—the loss of \$1.2 billion in equity on October 17th. October 17th is not a coincidental date. It is a critical date. Actually, the 16th was the release of that information, the 17th was the release of the SEC investigation.

And finally, and perhaps most sort of mysteriously, why did Jeffrey Skilling resign? Understanding the answers to these questions, frankly, is not enough though. Congress and the regulators must act, act to protect the investing public and act to protect 401(k)

participants from these kinds of conflicts of interest. The AFL-CIO is ready to work with this Committee to both find out what happened at Enron and see that it does not happen again. Thank you. [The prepared statement of Mr. Silvers follows:]

PREPARED STATEMENT OF DAMON A. SILVERS, ASSOCIATE GENERAL COUNSEL,
AFL-CIO

Good morning, Mr. Chairman, my name is Damon Silvers, and I am an Associate General Counsel of the American Federation of Labor and Congress of Industrial Organizations. The AFL-CIO believes today's hearing on Enron Corporation and the marketing of its stock is a vital contribution to the efforts to both bring to light the causes of Enron's collapse and protect the public and our economy against future events of this kind.

Directly and indirectly, America's working families are the ultimate customers in our securities markets. Defined benefit pension funds that provide benefits to the AFL-CIO's 13 million members have approximately \$5 trillion in assets. These plans include thousands of pension plans sponsored by AFL-CIO member unions, public employee pension plans, and single employer pension plans subject to collective bargaining. Since the passage of ERISA in the 1970's, these funds have increasingly invested in equities. 401(k) and other defined contribution plans, employee stock ownership plans, and union members' personal savings account for further extensive investments in equity markets by America's union members.

Enron's collapse devastated some workers' retirement security. You have heard from some of those workers today and their words speak for themselves. But the collapse of Enron also took money out of the retirement savings of practically every worker in America fortunate enough to have retirement savings.

Most pension funds and institutional investors held some Enron stock. Many of the most popular mutual funds held Enron stock. 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.

This was by and large money that 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 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.

Indexed investing is very attractive to both institutions and individual investors. Indexed investing essentially means you buy the whole market, and do not make judgments about whether any given stock is underpriced at any given moment. Indexed investing entails very low fees and guarantees substantial diversification. But it does assume that the market prices for securities are roughly reflective of the real values of those securities in light of the information known at any given time. The indexed investor is very vulnerable to fraud perpetrated on the markets, because the indexed investor is essentially a price taker. Because of the popularity of indexed investing among institutional investors, when a company artificially inflates its stock price by withholding information from the markets or putting out false information, the victims are not only the unsophisticated individual investors, but some of the largest and most sophisticated funds in the country, investing on behalf of hundreds of thousands of individual investors.

Some have suggested that it is too early to know whether anyone is to blame for the collapse of Enron. While no one has as of today been literally indicted, the AFL-CIO believes that a number of responsible parties have emerged. These parties include the senior management of Enron, the board of directors, Arthur Andersen, the outside auditor, the sell-side analyst community, and perhaps some money managers. These people and organizations made up the web of parties with obligations to Enron, its investors, and the public at large. These are the people and institutions that failed to ensure that Enron's assets were used to benefit the company and that the investing public had the information necessary to make fully informed decisions about whether to invest in Enron and if so at what price.

The Subcommittee has asked me to focus today on how consumers purchasing Enron's securities were misled. The AFL-CIO has done considerable analysis of the behavior of Enron's officers and directors. I have attached to this testimony letters

we and the Amalgamated Bank, a large manager of worker pension funds, sent to Enron's board in early November laying out the details of some of the transactions that led to Enron's collapse and explaining the undisclosed conflicts of interest that in our view crippled Enron's board.

The AFL-CIO also has been a longtime supporter of efforts undertaken by Arthur Levitt when he was chairman of the Securities and Exchange Commission to rein in conflicts of interest affecting auditor independence. Pension funds affiliated with the building trades unions have for several years submitted shareholder proposals seeking to ensure companies they invest in hire truly independent auditors. Last week we submitted a rulemaking petition to Harvey Pitt, Arthur Levitt's successor at the SEC, asking him to act to end the types of conflicts of interest that appear to have compromised Arthur Andersen's ability to carry out its duties as Enron's public auditor. That petition is also attached.

But in the remainder of this testimony I intend to focus on the analysts' role in the collapse of Enron. Let me begin by summarizing briefly what sell-side analysts do. Sell-side analysts work for full-service investment houses. By full-service I mean that these firms underwrite securities, they make markets in securities, they give investment banking advice to companies, they manage money on behalf of clients, and often they trade on their own accounts in the securities markets. Since the rise of integrated mega-financial service firms after the repeal of Glass-Steagall, these firms also make bank loans to companies.

One of the services these full-service firms provide to their clients who trade securities through their brokers is access to research reports written by their research analysts. These analysts are called "sell-side analysts" because their firms do a substantial business selling securities to their clients, and fundamentally the research is paid for by the brokerage fees generated by the firm's sales and trading activity. The research itself is not sold. This business model means that sell-side analysts are eager to share their work with investors generally, through their reports, and through appearances on television, radio and the Internet. As a result, sell-side analysts shape investor opinions out of proportion to their numbers.

Sell-side analysis is widely available to market participants, both directly through the brokerage houses and through services like First Call and Investext. While firms try and keep the most up to date reports available only to clients, relatively recent sell-side analyst reports are widely available at a relatively reasonable price.

Few union members or other individual investors are in a position to master the raw data that informs the financial markets, and even fewer have routine access to insiders in the companies they invest in. Most union members, and the trustees of their pension funds, for that matter, rely on a variety of professionals for their information about the equity markets. Sell-side analyst reports are likely to be the most detailed, critically analytical information the typical small investor has to consult in making investment decisions. For that reason, America's working families have an enormous stake in the honesty of the investment information they receive from the analyst community.

Analysts are investment advisors subject to the Investment Advisors Act of 1940. Under the Act, analysts have a fiduciary duty to their clients. They are not mere marketers, serving the needs of their firms' underwriting business. They owe a duty of loyalty and of care to the investors they advise.

Unfortunately, in recent years the structure of the securities industry has shifted in ways that appear to have compromised sell-side analysts. There is substantial statistical evidence that analysts' decisions whether or not to recommend that investors buy a stock are influenced by whether their firm is an underwriter for the issuer. That is the conclusion of a 1999 study by Roni Michaely of Cornell University as well as a 1997 study by Hsiou-wei Lin of National Taiwan University and Maureen McNichols of Stanford Business School.¹ CFO Magazine reported last year that analysts who work for full-service investment banks have 6% higher earnings forecasts and close to 25% more buy recommendations than analysts at firms without such ties.²

In some ways what we find more persuasive than the statistics are the comments of analysts in the financial press. In the last few months, analysts have been quoted

¹ Conflict of Interest and Creditability of Underwriter Analyst Recommendations. Michaely, Roni and K Wolmak Review of Financial Studies 1999 vol 12 no 4 653-686; Underwriting Relationships and Analyst Earning Forecasts and Investment Recommendations. Lin, Hsiou-Wei and McNichols, Maureen. Journal of Accounting and Economics vol 25 (1) pp 101-127 1997.

² What Chinese Wall?, Barr Stephen, CFO, March 1, 2000.

by name saying such things as “a hold doesn’t mean it’s ok to hold the stock” and “the day you put a sell on a stock is the day you become a pariah.”³

It should not be surprising that this is true given that issuers pick underwriting firms based on their ability to bring effective positive analyst coverage to their businesses. This is the conclusion of a soon to be published paper on why firms switch analysts by Laurie Krigman of the University of Arizona, Wayne Shaw of Southern Methodist University and Kent Womack of the Tuck School Business at Dartmouth College.⁴

In addition, the data cited by CFO Magazine suggests several quite disturbing things. First is that it is not just existing relationships that are affecting analyst recommendations, but also the prospect of future business. The result is a systematic positive bias affecting recommendations across the board. Second, the response from the securities industry that analyst involvement in underwriting helps ensure that the firms only do quality deals at the right price is simply inadequate to explain the distortion in the data affecting all recommendations.

But these conflicts are exacerbated by the ways in which analysts are used and compensated. It has become a common practice for analysts to accompany teams from the corporate finance department on underwriting road shows, and most importantly, analyst compensation has become tied at many firms to analysts’ effectiveness at drawing underwriting business.

In addition, the consolidation of the financial services industry, and in particular the repeal of Glass-Steagall, has created a wide array of further potential conflicts. Issuers are in a position to withhold business from the firms of critical analysts across a wide array of markets, including commercial loans and commercial banking services, pension fund and treasury money management, and insurance contracts. This leverage is particularly powerful when the issuer is itself a financial services company. For example, CFO Magazine reported last year that the troubled financial services giant First Union cut off all bond trading business with Bear Stearns in response to negative comments by their analyst, and Bear Stearns ordered the analyst to be more positive.

At the same time, issuer executive compensation has been linked to issuer stock price, often in ways that give incentives to executives to manipulate short term movements in stock prices. The result is that issuer executives have tremendous personal incentives to use the resources of their companies to pressure analysts into issuing conflicted reports.

The rise in the importance of proprietary trading at major firms also creates further possible conflicts of interest for analysts. A version of this problem has always existed when firms’ trading operations and market making operations lead to a buildup of inventory in particular issuers’ securities. However, the addition of firms investing significant capital in proprietary trading creates a risk of senior executives aware of the positions taken in proprietary trading encouraging research departments to prop up demand for certain securities.

Finally, among the most lucrative business areas for full-service firms is providing investment banking advice to companies going through large mergers and acquisitions. Such deals are typically dependent on shareholder approval or effectively dependent on the price of the stocks of the companies involved remaining within a certain range. These circumstances can give a full-service firm that is advising a participant in a deal a substantial interest in trying to encourage investors to behave in ways that support the transaction closing.

There has been some good news though in the effort to protect analyst independence. Much of the literature in the 1990’s on securities analysts’ behavior noted the ability of issuers to reward and punish analysts by providing and withholding information. This power meant that analysts who were doing their best to be loyal to their customers could not provide customers with the timely information that is the minimum requirement of the job without tilting their recommendations so as to ensure they weren’t on the losing end of the business of selective disclosure.

Earlier this year the SEC promulgated Regulation FD barring selective disclosure. In doing so the Commission recognized selective disclosure not only harmed those not privy to the selective disclosure, it gave issuers power that resulted in warping the behavior of those who *were* the recipients of the selectively disclosed information. The adoption of Regulation FD marked an important step toward restoring analysts’ independence. However, Harvey Pitt has at various times suggested he is not

³ Wall Street’s Secret Code Spoils Investors’ Aim, Noelle Knox USA Today, December 21, 2000; CFO, *ibid*.

⁴ Why do Firms Switch Underwriters? Wayne H. Shaw, Kent Womack, Forthcoming, Journal of Financial Economics.

an enthusiastic supporter of this rule. Regulation FD is an important step toward restoring analyst independence and deserves Congress' continuing support.

The story of the collapse of Enron illustrates the consequences of these conflicts of interest on the larger market environment. Enron was throughout the late '90's a high-flying stock, trading at up to 70 times earnings. Even though its earnings growth as shown in pre-restatement numbers was around 5% per year from 1998 to 2000, Enron's stock price quadrupled over the same period.

During the spring and summer of 2001, Enron's stock price was falling, apparently due to the normal reasons stock prices fall—deteriorating conditions in certain of Enron's markets, and trouble with certain large projects. However, in addition, some journalists were raising concerns that Enron was both opaque and overvalued.⁵

What is noteworthy about this is that during this period Enron executives were engaged in extensive selling of Enron shares. At the same time Enron's CFO was telling the press "We don't want anyone to know what's on those books. We don't want to tell anyone where we're making money." During this period, according to First Call, which surveys sell-side analyst reports, there was clearly insufficient transparency to Enron's financial disclosures to allow an analyst to be able to give an opinion as to whether the company's stock was a good investment.⁶ Nonetheless, as one might expect from the general data we have surveyed, out of 11 sell-side firms tracked by Briefing.Com there were no downgrades of Enron from May 11, 1999 until August 15, 2001.⁷

Compare this record to the independent investment newsletters surveyed by Forbes Magazine.⁸ Of the eight Forbes looked at, six were advising their subscribers to sell Enron, four before May 1st, and two in October. One of the eight advised subscribers to sell until the price hit \$9, then went to a buy, and only one of the eight maintained a consistent buy during the period of Enron's collapse.

On August 15, following the sudden resignation of Enron's CEO Jeffrey Skilling, Merrill Lynch's analyst, downgraded Enron from Near Term Buy/Long Term Buy to NT Neutral/Long Term Accumulate. This may sound like a modest downgrade. But compare it to the firms that were underwriters for Enron. The earliest downgrade among this group appears to be JPMorgan Chase, which went from Buy to Long-Term Buy on October 24, 2001. Strangely enough though, JPMorgan Chase appears never to have downgraded Enron below a Long-Term Buy in the weeks that followed. In fact of the twenty seven firms we could find that covered Enron, the only sell-side firm that actually downgraded Enron to a Sell was Prudential, which downgraded Enron twice in the week that followed the announcement of the \$1.2 billion charge to earnings on October. These results of our research parallels a Forbes Magazine study that looked at 13 sell-side firms and found as of the end of October, two weeks after the initial announcements of the charge to equity and the SEC investigation, only one firm recommended Sell, one firm recommended Hold, and the remaining eleven still had various forms of buy recommendations.

In late October and November, as Enron attempted to sell itself to Dynegy, key firms with an interest in the transaction maintained what appeared to be positive ratings. JPMorgan Chase and Citigroup were Enron's advisors and stood to earn large fees. These fee arrangements have not been disclosed but are likely to have been in excess of \$50 million per firm. Citigroup lent Enron more than \$500 million, monies in part that came from federally insured commercial bank deposits. Citigroup's analyst at Salomon-Smith Barney maintained a Neutral-Speculative rating. JPMorgan Chase lent Enron \$400 million, while its analyst rated the stock a Long-Term Buy all the way through November. Lehman Brothers, the advisor to Dynegy on the Enron purchase, also stood to earn a similarly large fee if the deal closed. Lehman kept a Strong Buy rating on Enron throughout the fall.⁹

What can be concluded from this record. First, though Enron's financials included somewhat cryptic references to the partnership structures Enron's management used to hide liabilities and pass interests in company assets to executives, no analyst appears to have paid any attention to these items until they became widely known in October. Second, with one notable exception in Merrill Lynch, no analyst took action based on Skilling's resignation. Finally, with the exception of Prudential,

⁵ "Is Enron Overpriced?," by Bethany McLean. *Fortune*, March 5, 2001, Pg. 122

⁶ Testimony of First Call CEO before Joint Hearing of House Subcommittees on Capital Markets and Investigations, December 12, 2001.

⁷ The data that follows regarding shifts in ratings by sell-side firms comes from Briefing.com, "Analyst History for Enron Corp.," <http://biz.yahoo.com/c/e/ene.html>.

⁸ "Enron: An Unreported Triumph For Investment Letters." *Forbes.com*, December 7, 2001.

⁹ "Assessing the Role of the Financiers," by Patrick McGeehan, *New York Times*, December 2, 2001, Section 3, page 11.

no analyst thought it worthwhile to actually recommend their clients sell the stock. Interestingly, neither Prudential nor Merrill Lynch were underwriters for Enron or had any part in advising or lending money to either Enron or Dynegy.

One can observe in the analysts' treatment of Enron many of the problems critics of analyst conflicts pointed to before the Enron debacle. These include the linkage between analyst behavior and the investment banking, and now commercial banking, interests of their firms; the use of codes by analysts, where Long-Term Buy may mean Sell, and Hold certainly means Sell; the reliance on company projections and the failure to either look deeply into company financials or to consult outside sources. Taken together, these conflicts seem to have converted the analysts from providers of analysis with a fiduciary duty to their investor clients to simple salesmen for their firms' investment banking clients. And when the investment banking client is defrauding the investor client, too often the analyst, like the auditor, becomes a part of the fraud.

The AFL-CIO believes strongly that Congress, the regulatory agencies, and the self-regulatory agencies need to act in a coordinated fashion to protect the independence of analysts. In particular, we believe that what used to be called the Chinese Wall between research and investment banking in full service houses needs to be rebuilt. The AFL-CIO has submitted shareholder proposals to several full-service financial services companies seeking to have those firms make such changes on their own. However, we believe that short-term competitive pressures are likely to lead to the continued violation of analysts' fiduciary duties unless regulatory action is taken.

Currently, as a result of pervasive conflicts of interest, our capital markets are treacherous places for the unwary. Enron is only the most recent and most dramatic example of this unfortunate fact. This is in part why the labor movement strongly believes that America's working families need retirement security that rests on three legs—Social Security, a defined benefit pension plan and personal savings, only one of which should be directly at risk in the capital markets.

In conclusion, the AFL-CIO believes that systematic problems with the ways in which information flows to and in the capital markets contributed to both Enron's collapse and the severity of the impact of its collapse. While analyst conflicts were not the cause of the collapse of Enron, they contributed to a climate in which Enron's shares were artificially inflated and in which the conduct of management at Enron remained hidden long after it could have been brought to light. Finally, it appears that these conflicts contributed to a false optimism about the success of the Dynegy deal, an optimism that allowed Enron executives to continue to withhold vital information from the markets about Enron's liabilities and demands on its cash until the final collapse of the Dynegy deal.

We commend this Subcommittee for opening the Senate's formal inquiry into these matters. We urge both this Subcommittee and all involved: in Congress, the SEC, the Department of Labor, and the Justice Department to continue to investigate both the actions of particular individuals and firms and the larger structural arrangements that led to the collapse of Enron and the loss of so many peoples' savings. On behalf of the AFL-CIO, we look forward to continuing to work with the Subcommittee on this vital matter. Thank you.

Senator DORGAN. Mr. Silvers, thank you very much. There is a vote occurring in the Senate. I believe there's 5 minutes remaining, so I regret that we're going to have to cut this short. I would like to submit questions on behalf of the Committee to the witnesses. Let me make just a couple of comments.

First of all, the testimony you have presented is really excellent. As I indicated to you earlier, we are going to hold other hearings and I think your testimony sets the stage for the important questions. The first panel today described the heartbreak of losses that people have experienced. I recall the word loyalty described by one of the witnesses. People who were loyal to their company, who did the right thing, worked hard all their lives, saved, were thrifty, only to lose their life savings.

That's part of what motivates us to get to the bottom of this, who profited and who lost? And, what are the lessons to be learned from this? At the next hearing, Mr. Lay will be with us. We will ask Mr. Skilling, Mr. Fastow, and others to appear as well. But I think in

the end, if this is viewed somehow by people as just another failure or just another scandal, then we will have missed the point.

It seems to me there are numerous conflicts with respect to company executives, boards of directors, auditors, and stock analysts. Some in Congress spent a lot of time trying to derail the legislation that would have plugged some of these holes. There just is so much that is in conflict. Yet, if one studies all those conflicts, how can the problems not be apparent to everyone? We have allowed a big auditing firm to get millions and millions of dollars from a company they are auditing and then contract with them to perform other services. It's alright for an investment bank to be giving their analysts the rein to tell the American public about a stock in which they have a significant financial interest and which they would never willingly, I assume, report bad news.

So, there is so much here that we need to consider and investigate, and we will do that. This Committee is going to request substantial information. We will request information about who the investors are in the partnerships that have been off the books and who profited from them. I have been in touch with the company's attorneys and they indicate that they want to provide that information. They're the ones who indicated they will ask Mr. Lay to testify and he has agreed to do that.

So, I think the logical point from this hearing is as we move forward we want to get information. But in the end, we also want to understand what do we do with respect to changes in regulation and changes in law that will prevent this from happening again. Those are the important considerations for us and the testimony of the three of you will be very helpful to this Committee.

I thank you very much for testifying. This Committee is adjourned.

[Whereupon, the Committee was adjourned at 12:30 p.m.]

A P P E N D I X

PREPARED STATEMENT OF STEVE W. BERMAN, HAGENS BERMAN LLP

Mr. Chairman,

I am a partner of the law firm of Hagens Berman, and my office is in Seattle, Washington. We represent hundreds of Enron employees.

Two of my clients, Janice Farmer and Charles Prestwood, have agreed to appear before the Senate Commerce Committee in connection with its investigation of the plight of Enron employees in the aftermath of Enron's decline and eventual bankruptcy.

I am not submitting this testimony to argue the facts or law, but simply to alert this Committee to the fact that my two clients are just the tip of the iceberg. Since we began representing Enron employees, we have fielded over 3,000 inquiries. I have three lawyers and two investigators working nearly full time to handle inquiries. I have been representing victims of financial fraud for twenty years. I cannot recall circumstances that have resulted in such financial devastation.

My primary purpose is to provide just a few examples of the impact of this crisis on the lives and futures of Enron employees in submitting this testimony:

- A Wisconsin woman with Stage IV breast cancer, unable to work, acquired her Enron ESOP stock as a divorce settlement after a 10 year battle with her former husband describes watching in horror as her account dropped from \$ 250,000 to virtually nothing during the company's lockdown of employee investment accounts. The stock was her most valuable asset and her hope for future cancer treatments, income, and her children's college educations.
- A 54-year-old lineman with Portland General Electric, a subsidiary of Enron, suffers from significant health problems (arthritis and sarcoidosis, a lung ailment) and was looking forward to retirement in 4 or 5 years. He maximized his 401(k) contribution year after year. The bulk of his investment was in Enron stock, both because it was swapped into his account from the PGE stock he had owned for most of his career and because the Company continually promoted Enron stock as safe and secure. He watched helplessly as the Enron stock - and his retirement plan - were wiped out during the Company's lockdown of the retirement plan. His plans to retire by age 59 are shattered as he begins to rebuild the assets he lost.
- An Oregon couple in their late 50's who both had retirement accounts with Enron stood by helplessly during the company's lockdown of their accounts as their financial stability and dreams for retirement were destroyed by the drop in Enron stock. The couple now faces selling property which has been in the husband's family for more than a century to support themselves.
- A retired oil and gas worker in California watched his financial future crumble as his \$ 1 million savings plan with Enron disintegrated into nothing. Unable to return to work in the oil and gas industry, the financial consequences have forced him to take work making garbage bags twelve hours a day to support himself.

We appreciate you and the other Committee members taking the time to hear Ms. Farmer's and Mr. Prestwood's stories and to investigate the drastic impact of Enron Corporation's acts on the lives and financial futures of its employees. Please let us know if we can provide additional information.

ENRON: LET US COUNT THE CULPRITS

Business Week, December 17, 2001

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Enron Corp.'s bankruptcy is a disaster of epic proportions by any measure—the height from which it fell, the speed with which it has unraveled, and the pain it has inflicted on investors, employees, and creditors. Virtually all the checks and balances designed to prevent this kind of financial meltdown failed. Unless remedied, this could undermine public trust, the capital markets, and the nation's entire equity culture. Even now, no one really knows what liabilities are buried inside dozens of partnerships or the role ex-CEO Jeffrey Skilling played in creating a byzantine system of off-balance-sheet operations. A culture of secrecy and a remarkable lack of transparency prevented any realistic assessment of the company's financial risk. Nothing less than an overhaul of the auditing profession is now required to police accounting standards. Wall Street, mutual funds, and the business press would also do well to rethink why each, in its own way, celebrated what is now revealed to be an arrogant, duplicitous company managed in a dangerous manner (page 30).

What is increasingly clear is that Skilling, a former McKinsey & Co. consultant and Harvard Business School grad, tried to craft Enron as a new kind of virtual trading giant, operating outside the scrutiny of investors and regulators. Enron's numerous partnerships were shrouded in secrecy, tucked away off the balance sheet. They were used to shift debt and assets off the books while inflating earnings. The chief financial officer ran and partly owned two partnerships, a clear conflict of interest. Enron leveraged itself without a reality check by any outsider. ASLEEP. Hardly anyone inside the company was urging caution, certainly not chairman Ken Lay. The independent auditing committee on the board of directors was clearly asleep. Given Enron's arcane financial engineering, the committee probably relied on Arthur Andersen, the auditor, for information. But Andersen didn't blow any whistles. No surprise there. It made more money selling consulting services to Enron last year than it did auditing the company. Criticizing Enron's books might have jeopardized consulting work. Similar conflicts of interest stopped Wall Street analysts from pulling the plug on Enron. Even as Enron slid toward bankruptcy, "buy" recommendations were being issued by analysts whose firms were doing investment-banking business with the company, or were hoping to.

Did anyone really know what was going on inside Enron? The rating agencies, Moody's Investor Service and Standard & Poor's, presumably had better access than average investors, but neither downgraded Enron's credit rating to below investment grade until the bitter end. The rating agencies argue that had they downgraded Enron sooner, they would have simply pushed the company into bankruptcy earlier. Here's a flash: So what? Moody's and S&P have one basic job—assessing risk for investors. If they couldn't penetrate Enron's complex financial engineering, the rating agencies should have said so.

The business press, including *BusinessWeek*, did no better. It celebrated Skilling's vision of Enron as a virtual company that could securitize anything and trade it anywhere. The press blithely accepted Enron as the epitome of a new, post-deregulation corporate model when it should have been much more aggressive in probing the company's opaque partnerships, off balance sheet maneuvers, and soaring leverage. TRAGIC. Enron's fall is made all the more tragic because of the pain inflicted on its thousands of employees. Not only are many losing their jobs, but some 12,000 are also losing most of their retirement savings. In perhaps its most egregious risk-management error, employees mostly held Enron stock in their 401(k)s, yet the company prevented them from selling until they reached the age of 54. People could only watch as the stock plummeted from \$89 to a dollar. Diversification, particularly in retirement accounts, is the cardinal rule in managing risk. Enron broke that rule, as have other companies.

Enron's tale is a clarifying event. It reveals key weaknesses in the financial system that must be corrected as the U.S. moves forward in the 21st century. If America is to have an equity culture in which individuals invest in stocks and provide the capital for fast economic growth, the market must be able to correctly value companies. This requires making financial data readily available and easily comprehensible.

To restore public confidence, several steps should be taken. After accounting disasters at MicroStrategy, Cendant, Lucent, Cisco, and Waste Management, it is clear that self-regulation is not working. Conflicts of interest within auditing firms remain widespread. Investors can ignore analysts on TV who work for investment firms. But someone has to play the role of the honest watchdog. Unless the Big Five auditing firms clean up their act, they will wind up with a federally chartered over-

sight body. It is equally clear that current standard accounting rules aren't sufficient. Loopholes allowed Enron to fool everyone, making a mockery of public disclosure.

Regulators should also insist that corporations give their employees choice in their 401(k)s. Some 30% of assets held in 1.5 million 401(k) plans are in the stock of the company sponsoring the plan. This lack of diversification puts too many people at risk.

In the end, the Enron story is about a secretive corporate culture that failed in its primary business mission: to manage risk. Had the Federal Reserve and other central banks not flooded the global economy with liquidity in recent months, Enron's collapse could have posed a deep threat to the financial markets. It's past time to fix the system.

ENRON: THE LESSONS FOR INVESTORS;
HINDSIGHT, SHMINDSIGHT. THERE'S MUCH TO LEARN WHEN A STOCK LOSES \$67
BILLION IN VALUE.

Byline: Lisa Gibbs, Jeff Nash and Nick Pachetti

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It seems hard to believe now, but Enron (ENE) used to be the envy of corporate America. In less than a decade, the Houston company transformed itself from stodgy gas-pipeline operation to natural gas and electricity trading powerhouse. Dazzled by sizzling earnings growth, giddy investors bid up Enron's shares 312% in two years to a high of \$90.75 in 2000. Then someone turned out the lights. Beset by marketplace woes and management mishaps, the stock already had tumbled 53% when chief executive Jeffrey Skilling stunned investors by resigning last August. After that, the bad news came at hyperspeed: \$1.2 billion in shareholder equity zapped by risky hedging deals, a Securities and Exchange Commission probe, a last-chance merger with rival Dynegy called off and, finally, a bankruptcy filing. By the end of November, the stock had plummeted to 26[cents], obliterating \$67 billion in market cap—a shocking fall for a company that just last year occupied the No. 7 spot on the Fortune 500.

Perhaps most incredible, however, about the Enron debacle is how long investors hung on to the belief that everything would turn out fine. As recently as MONEY's October issue, our Ultimate Investment Club's Abby Joseph Cohen of Goldman Sachs was calling Enron a "good value." If pros like Cohen got it wrong, how could the average investor have discerned the disaster in time? Sure, hindsight is marvelous. But along Enron's fast track to penny stock, there were red flags for informed shareholders that all was not as it seemed.

Out-of-control valuation. In 2000, investors levitated Enron's stock to a lofty price/earnings ratio of 69 times that year's earnings on the belief that forays into sexy-sounding online energy trading and broadband businesses could sustain supercharged earnings growth. Skilling was telling Wall Street that Enron's broadband biz alone deserved \$37 a share, and investors seemed to buy it, despite the fact that the unit was unproved and unprofitable. His outlandish valuation of broadband drew an early "hold" rating from analyst Andre Meade of Commerzbank Securities in March 2000. "An energy company trading at the multiple Enron was," Meade explains today, "should have been cause for eyebrows to be raised."

The lesson? Pay attention to the P/E even after you buy a stock. Whenever the valuation starts to climb, you should stop and question whether the company can sustain the sales and earnings growth expected of it.

Insider selling. In 2000, then CEO Kenneth Lay netted \$66.3 million from exercising stock options and selling the shares, while Skilling scored \$60.7 million, roughly double the amounts the year before. By the end of June 2001, 16 members of Enron's top management had sold \$164 million in shares, reports Thomson Financial Network. While insider sales don't automatically spell trouble for a company—executives often have valid reasons for raising cash—the selling at Enron was prolific. And the fact that selling persisted even as the stock fell throughout 2001 was a "screaming red flag," says Thomson analyst Paul Elliott. If **Skilling** and Lay believed the stock was **undervalued**—as they repeatedly told investors—then why were they cashing in? Executive stock trades are easy for ordinary investors to follow: The Wall Street Journal regularly publishes insider trading tables, and websites such as Yahoo Finance (finance.yahoo.com) list insider trades for each stock.

Obfuscations. Enron's trading business is extremely complex, and analysts admit they didn't always understand what Enron was doing. That said, the company seemed to go out of its way to obfuscate. "I've never seen such complicated disclosures," says Michael Heim, an A.G. Edwards energy analyst. "It was hard to follow the movement of money."

When pushed to reveal more, management was often tight-lipped and unprofessional. During one famous conference call last April, Skilling called an analyst an "asshole" for complaining about the company's failure to provide a balance sheet with its earnings announcement. Prudential Securities' Carol Coale points to rumors in late September of an SEC investigation. "When I asked Enron about an investigation, they said there was no investigation," says Coale. Once it was revealed that the SEC was conducting an inquiry, she says Enron returned to her with a feeble excuse: "They said, 'Well, you didn't ask about an inquiry.'"

The typical investor isn't privy to such conversations, although more and more company conference calls are in fact being opened to the general public. But the larger point (famously stated by Warren Buffett) is this: If you don't understand what a company does, don't invest in it. There's a corollary to that too: If management refuses to fill in holes and keeps investors in the dark, run.

Fishy filings. Investors who read Enron's quarterly SEC filing in the summer of 1999 would have noticed a new entry under the heading "Related Party Transactions." The item noted that Enron was doing business with a private partnership whose general partner was led by a "senior officer of Enron." A proxy filed in May 2000 revealed that the senior officer was Enron CFO Andrew Fastow, and that not one but two partnerships existed.

Possible conflicts of interest—is the CFO looking out for Enron or himself?—should have turned heads. But even professional money managers like those at Janus, enthralled by Enron's opportunities, overlooked the partnerships as the funds built up their stakes. As late as Sept. 28, with Enron at \$27.25, Janus owned 41.3 million shares, which it has since dumped.

To be fair, Enron revealed little about the partnerships and their function—to divert from Enron's balance sheet the debt from new acquisitions—as well as the extent to which the companies were in bed together. Besides, back then the stock was going gangbusters and earnings looked great; the partnerships seemed like small potatoes. Even the stock's few critics weren't paying much attention. Recalls Meade of Commerzbank: "It was difficult to see that there were significant liabilities associated with this."

Attitudes began changing after Enron filed its first quarterly report of 2001, which said it was entering into complicated and risky derivatives transactions that involved an \$827 million loan to one of the partnerships. Whoa, some analysts said. "You started to see in the footnotes some pretty large sums of money," says Tara Gately, energy analyst for Loomis Sayles funds. "It raised questions, and there were really no good answers."

Yes, this is complicated stuff and, yes, there wasn't enough information, but you don't have to be a big-deal financial analyst to know that the CFO in a side business is smelly stuff.

Executive departures. When the chief executive—someone who spent a decade moving up the ladder and building the company's core energy-trading business—flees after just six months at the helm, you've got a problem. Skilling, 47 at the time, called it a "purely personal" decision. "That was the worst excuse I've ever heard," scoffs John Hammerschmidt, a fund manager at Turner Investments. If top management resigns for unclear reasons, consider selling. Hammerschmidt didn't even hesitate in this case: "As soon as I heard that, I dumped my shares."

One red flag does not necessarily a disaster make. More often it's a succession of little somethings that ultimately tells you: It could get real ugly here. The trick is to put aside your enthusiasm for a stock. That's probably the hardest thing for any investor to do. But as Enron's meltdown shows, the homework isn't over once you buy the stock.