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United States Senate

COMMITTEE ON
GOVERNMENTAL AFFAIRS

WASHINGTON, DC 20510–6250

October 7, 2002

The Honorable Harvey L. Pitt
Chairman
Securities and Exchange Commission
450 Fifth Street, NW
Washington, DC 20549

Dear Chairman Pitt:

We are writing to ask you to review and respond to a report recently submitted to us by the staff of the Senate Governmental Affairs Committee, entitled *Financial Oversight of Enron: The SEC and Private-Sector Watchdogs*. The report contains the results of Committee staff's investigation into the actions of the Securities and Exchange Commission (SEC or Commission), Wall Street stock analysts, credit rating agencies and others who monitored the financial activities of Enron Corp. in the years prior to its collapse.

When Enron filed for bankruptcy last December, thousands of people lost their jobs and many more, both inside and outside Enron, collectively lost billions of dollars that they had invested in the company. In many cases, these investments represented substantial portions of individuals' retirement savings. The many investors who placed their trust in our market system and put their hard-earned money into what was then the seventh-largest company in the country would never have guessed that it was a house of cards waiting to collapse. When it did collapse, it triggered a crisis of confidence in the U.S. financial markets. This crisis of confidence lingers even today, nearly a year later, sustained by the parade of corporate debacles that have followed – WorldCom, Global Crossing, and Tyco, to name just a few. Each of these involved billions of investor dollars, misappropriated and misaccounted for in a way that endowed corporate chieftains with enormous wealth and left shareholders with stock certificates worth not much more than the paper on which they were printed. With more than 50 percent of the American public investing in the stock market, many of these investors were average Americans who were counting on the promise of these supposedly successful, stable companies to help support them through their retirement or to help pay for their children's education. In many cases, these dreams were dashed because the greed of a few was left unchecked and unchallenged.

In January 2002, the Senate Governmental Affairs Committee began a wide-ranging review of the activities of various public and private watchdogs that were supposed to protect the public from these sorts of calamities. The Committee looked at a range of entities that monitored the financial activities and health of Enron and purported to give the public accurate and objective information about Enron's financial condition. These entities included the company's

Board of Directors and auditors, stock analysts and credit rating agencies, and the most important watchdog of all – the SEC. The Committee examined how well these watchdogs did their jobs and whether different actions by them could have prevented – or at least detected earlier – Enron's problems.

As detailed in Committee staff's report, the investigation revealed a story of systemic and catastrophic failure – a failure of all the watchdogs to properly discharge their appointed responsibilities. Despite the magnitude of Enron's implosion and the apparent pervasiveness of its fraudulent conduct, virtually no one in the multilayered system of oversight and controls relied on by the public detected Enron's problems; or, if they did, they did nothing to correct them or alert investors.

Indeed, not one of the watchdogs prevented or warned of the impending disaster: not Enron's Board of Directors, which asked few, if any, probing questions of Enron's management and which authorized various related-party transactions that facilitated many of Enron's fraudulent practices; not Enron's auditor, Arthur Andersen, which certified the apparently fraudulent financial statements; not the investment banking firms, which structured and sold securities and other financial products that appear to have allowed Enron to obfuscate its financial position; not the attorneys, whose opinions and work were critical to certain transactions that may have been central to Enron's collapse; not the Wall Street securities analysts, many of whom continued to recommend Enron as a "buy" up until the bitter end; not the credit rating agencies, who rated Enron's debt as investment grade up until four days before the company filed for bankruptcy; and not the SEC, which did not begin to seriously investigate Enron's practices until after the company's demise became all but inevitable.

The Committee staff's report addresses these failures, and provides recommendations with respect to how the future performance of the SEC, stock analysts and credit rating agencies can be improved.

The SEC

The SEC calls itself "the investor's advocate," and it should be. Committee staff in their report, however, finds that the SEC's investor protection efforts in the case of Enron fell far short of that "advocacy." According to Committee staff, the SEC was, or should have been, aware of mounting problems in recent years among the private-sector gatekeepers. Restatements of financial statements filed with the Commission had greatly increased in number and the former Chairman of the SEC had warned of the declining quality of financial reporting and the conflicts and lack of diligence that afflicted many of those charged with protecting the integrity of a company's reported numbers. Committee staff has concluded that the SEC did little to react to these vulnerabilities and ultimately failed to fulfill its mission to protect investors.

One of the first lines of defense the SEC employs to ensure clear and accurate disclosure – to bolster market integrity and investor confidence – is the regular review of the filings of all public companies. In the case of Enron, however, our staff found that investors were left defenseless. SEC staff failed to review any of Enron's annual reports after its 1997 filing. As a result, the SEC missed its best opportunity to focus on the red flags in those documents, such as the opaque and questionable references to transactions with entities run by the company's own Chief Financial Officer. If the SEC had pressed Enron about those and other troubling disclosures when they first appeared in Enron's 1999 annual report, some of the enormous losses suffered by workers and investors might have been prevented. It is particularly worrisome that the SEC's failure to review Enron's filings was not a unique circumstance or isolated oversight: Commission staff has reviewed a dwindling percentage of annual reports in recent years. Perhaps more troubling is the fact that the SEC's special criteria for selecting companies for review, intended to identify those firms that might pose special risks for investors, failed to pick out Enron for further investigation, despite indications that Enron was a company that needed to be watched due to its burgeoning growth and its radically changing business. Whatever the reason for the SEC's failure to review filings with sufficient regularity or to use the right criteria for selection – certainly resource constraints and limited technology cannot have helped – the investing public expects and deserves more meaningful protection from the ultimate market watchdog.

In addition, Committee staff finds that although SEC staff set specific limits and conditions on certain allowances or exemptions it gave Enron, the SEC never followed up to make sure that these requirements were being followed. Indeed, the SEC does not even have procedures in place to ensure that its own conditions are being met. One very troubling example of this lack of follow-up relates to the SEC staff's decision in 1992 to allow Enron to use mark-to-market accounting to record the value of certain of its energy contracts. The SEC staff imposed significant conditions on the decision to permit Enron to change accounting methods, but never checked to make sure that Enron was meeting those conditions. There is now evidence that Enron abused this accounting method to substantially inflate its reported revenue and earnings. Aside from the question of whether allowing Enron to use mark-to-market accounting was appropriate, the Commission's failure to examine how Enron implemented this change or to monitor the effects of the change upon Enron's financial statements ill-served investors. The failure deprived the SEC staff's special requirements of their effectiveness and, for all intents and purposes, rendered them meaningless. Had these conditions been monitored to ensure adherence, it is much less likely that Enron would have been able to engage in its abusive practices. Committee staff's report also pinpoints another example of the SEC's failure to follow up on its own pronouncements in connection with its decision to grant Enron an exemption under the Investment Company Act.

Our staff's report also exposes for the first time the SEC's handling of an application Enron filed in April 2000 requesting an exemption from the requirements of the Public Utility Holding Company (PUHCA). In that case, the SEC's lackadaisical approach to the exemption request and its failure to coordinate with the Federal Energy Regulatory Commission (FERC) may have opened yet another door to Enron improprieties. At the time of the request, Enron already was deemed exempt from PUHCA on other grounds, but it sought this seemingly redundant exemption because filing a "good faith application" for such an exemption enabled it to receive certain regulatory and economic benefits from FERC for some of its wind energy projects (certain of which, it turns out, were part of transactions that were the subject of the civil and criminal charges brought against former Enron executives Andrew Fastow and Michael Kopper). With the encouragement of Enron, the SEC did not take (and indeed still has not yet taken) any action on the exemption application, allowing the application to remain open and effectively permitting Enron to retain the benefits under FERC regulations for these projects. At no time has the SEC consulted with FERC (nor has FERC consulted with the SEC) about the validity of Enron's "good faith" application. Indeed, both agencies have suggested that it was the other's responsibility to evaluate whether the application in fact was made in good faith. Our staff's report concludes that Enron has been able to take advantage of the SEC's delay in acting on the application and the lack of coordination between SEC and FERC to obtain regulatory benefits to which it may not have been entitled.

Private Sector Watchdogs

The SEC was not alone in failing to protect the investing public from the effects of Enron's collapse. The system of gatekeepers in the U.S. securities markets also includes private-sector groups that monitor and review the activities of corporations, including Wall Street stock analysts and credit rating agencies – groups on which the public relies heavily in making investment decisions. These groups also failed to fulfill their responsibilities when assessing Enron: neither the analysts nor the credit raters gave the investing public any real warning until it was too late.

On February 27, 2002, the Governmental Affairs Committee held a hearing entitled, "The Watchdogs Didn't Bark: Enron and the Wall Street Analysts." The hearing focused on stock analysts who covered Enron, most of whom recommended that investors buy the company's stock well into the Fall of 2001, even after many of the company's problems had been made public. In that hearing, witnesses testified about the bias for "buy" recommendations among Wall Street equity analysts. In 2001, "buy" recommendations comprised almost two-thirds of all stock ratings, while "sell" recommendations, made up less than two percent of the year's total. Those numbers have remained consistent over the last few years, despite significant fluctuations in the performance of the market and publicly traded companies. Our staff's report addresses this "buy" bias among sell-side analysts, so apparent in the case of Enron, and discusses why this bias exists.

The report concludes that analysts are subject to too many pressures and conflicts to offer the objective and independent analyses that they purport to provide and that the investing public expects. Analysts have often gone so far as to serve essentially as marketers working for the companies they cover rather than advisers to the investors using their research. Enron, like many other large companies, was an active user of investment banking services. Enron officials apparently used the company's business and potential business as leverage not only to convince firms to invest in Enron's questionable partnerships, but also to attempt to influence the ratings of the company's stock by those analysts affiliated with investment banking firms. The enormous investment banking fees Enron and other companies pay to Wall Street firms are incentive to the firms to bend too far to please those clients and potential clients.

The average investor cannot afford the kind of expert investment advice to which institutional investors have access. Hard-working, middle-class people trying to save for their retirement or their children's college educations rely on the analyses and recommendations offered by the stock analysts at Wall Street firms. Those investors deserve the objective assessments that the Wall Street firms purport to provide, and it is and should be the SEC's job to make sure that investors are getting the unvarnished advice they expect. This problem has been overlooked for far too long.

On March 20, 2002, our Committee held a hearing entitled, "Rating the Raters: Enron and the Credit Rating Agencies," to determine how the credit rating agencies could have rated Enron as a good credit risk until just four days before the company declared bankruptcy. As you know, credit ratings from the three major rating agencies carry enormous weight because numerous federal and state statutes and regulations require these ratings for bonds held by many institutional investors (such as insurance companies, banks, or pension funds) and limit or restrict these investors' purchase of the debt of companies with poor ratings. An investment grade rating from the credit rating agencies – indicating a safe investment – means much greater access to capital and liquidity than a lower ("junk") rating. Credit rating agencies therefore have significant market power. In addition, credit rating agencies enjoy greater access to corporate information than virtually any other market participant because they are allowed access to non-public, material information about companies they rate due to their exemption from the prohibitions of Regulation F-D, the SEC regulation that bars companies from selectively sharing with analysts and others material information that the companies do not make available to the public.

Based on the information our staff collected, their report concludes that in the case of Enron, credit rating agencies did not use their legally-sanctioned power and access to the public's benefit. The credit raters instead appear to have displayed a disappointing lack of diligence in their coverage and assessment of that company. Our staff concluded that the credit rating agencies did not ask sufficiently probing questions in formulating their ratings, and instead

generally just accepted at face value what they were told by Enron officials. The rating agencies apparently ignored or glossed over warning signs, and despite their mission to make long-term credit assessments, it seems that they failed to sufficiently consider factors affecting the long-term health of the company, particularly accounting irregularities and overly complex financing structures. In addition, because the credit rating agencies are subject to little, if any, formal regulation or oversight, and their liability traditionally has been limited due both to regulatory exemptions and First Amendment protections afforded them by the courts, there is little to deter them from future poor performance. This cannot be allowed to continue: the public relies on the ratings of these organizations, and must be assured that they are based on diligent, careful work.

Recommendations

The report makes a number of recommendations to the SEC to address the problems identified.

SEC - With respect to the SEC, the report recommends the following:

Review more filings and review them more wisely and efficiently. While many types of fraud cannot be detected simply through an examination of a company's annual report, a greater number of reviews (particularly of the right filings) undoubtedly increases the chances of uncovering information that may lead to the discovery of wrongdoing. The increased likelihood that a company's filings will be reviewed also can deter issuers from engaging in certain misleading reporting practices.

The recently enacted Sarbanes-Oxley Act requires the SEC to review companies' periodic reports at least once every three years (and authorizes increased resources for this and other purposes). In addition, this past year, the SEC decided to review the annual reports of the 500 largest companies in the country that are required to file periodic reports. The report recommends that, when conducting these reviews, the SEC must find new and better ways to identify those filings that most need attention or that present high risk to investors. The current approach, which relies primarily on examination for predetermined selective review criteria as well as certain ad hoc measures, has not proven successful and must be improved in order to address rapidly evolving financial and disclosure matters. In crafting a more sophisticated system, improved technology, in particular, is likely to be a critical component. Computer systems that can rapidly sift through large amounts of corporate data – such as the systems used by auditing firms – can be a valuable tool for SEC staff, enabling them to make more effective use of the available data and freeing staff up for less mundane tasks. Although technology will not eliminate the difficult task of identifying and continually revising the criteria for high-risk filings, if used wisely, it can potentially facilitate this process.

Look for fraud. The report concludes that one of the reasons the SEC did not uncover much of the fraud that has been the subject of recent scandals is that it has not proactively looked for it. The public filing review process is designed almost exclusively to assure compliance with the form of disclosure requirements, not to detect wrongdoing. On the other hand, the enforcement process, though it allows investigators to dig deeply to reveal the details of corporate malfeasance, generally is not invoked until there is already significant evidence of illegality and after much of the harm has occurred.

If the SEC is to play a role in detecting and rooting out financial fraud it will need to make this an explicit goal and develop new processes to support it. As you know, the SEC has taken a more proactive approach in other areas, such as internet fraud, where it has established a group specifically dedicated to finding fraud on the web. Also, the SEC subjects broker-dealers to periodic inspections. Random or targeted audits, in the manner of the IRS, though requiring significant resources, are another possibility for not only uncovering fraud in particular cases, but also identifying emerging trends in how fraud is being committed and developing investigative techniques that can be applied more broadly. Whether any of these models can be applied to cases of complex financial fraud, or whether there is a new, more appropriate model that can be developed is something that we recommend that the SEC explore. Although uncovering fraud will appropriately remain, in the first instance, the province of auditors, the SEC must play a meaningful part in fraud detection if it wishes to fulfill its responsibility to ensure the integrity of the markets.

Follow Up to Ensure that Commission Mandates Are Met. When the Commission or its staff makes a determination – to grant an exemption or to allow an accounting change or in other contexts – there needs to be some institutionalized means of monitoring or following up to determine whether the company is implementing the determination appropriately and meeting any conditions attached to the determination. This is particularly the case when SEC staff initially expresses concerns about a decision or when a company's circumstances have changed. Otherwise what began as useful and appropriate determinations can become the means for later abuse.

Similar issues of follow-up are raised by the Commission's recent effort to strengthen certain disclosure obligations for companies. Such disclosure requirements are potentially very important to investors, but unless Commission staff is able to actually review a meaningful number of these disclosures to ensure that they are clear and accurate, their effectiveness is likely to be limited.

Supplement Aggressive Enforcement with Other, More Proactive Measures. The SEC, to its credit, has taken an aggressive stance with respect to enforcement in cases of

financial fraud. The Commission recently has announced a number of high-profile enforcement actions, and you have emphasized your commitment to "real time enforcement." We strongly support these efforts to hold those who violate the securities laws accountable, and believe that the prompt punishment of wrongdoers is important not only in and of itself but also to deter future fraud.

The SEC's current emphasis on enforcement, however, needs to be accompanied by equally strong action on proactive measures related to prevention and detection of fraud, including those outlined above. Enforcement alone cannot prevent investors from unfairly losing their money, and it can only address those cases in which wrongful practices have already come to light. An approach that combines enforcement with other, more systemic remedies is necessary to fully restore public trust in the market and our system of oversight.

Coordinate Better with Other Agencies. The SEC's jurisdiction sometimes coincides with that of other agencies; for example, in administering PUHCA, the SEC's jurisdiction is interwoven substantially with that of FERC. Accordingly, effective coordination between agencies is essential to ensure consistency in policy development and implementation and to prevent companies such as Enron from exploiting a lack of oversight in areas in which neither agency has taken complete responsibility. Better communication allows all relevant agencies to more fully understand the companies and the context surrounding the transactions that they may be evaluating.

Determine Why the SEC Did Not Act on Enron's PUHCA Application and Ensure that Such Oversights Do Not Happen Again. Under both federal securities law and FERC practice, companies may obtain immediate benefits by filing with the SEC a "good faith" application for a PUHCA exemption. The Commission's failure to act promptly on requests for such PUHCA exemptions can provide significant, and potentially unwarranted, regulatory and economic benefits to companies that submit such applications. The handling of Enron's exemption application described above raises troubling questions about the Commission's treatment of such applications. The Commission should thoroughly investigate the handling of this exemption request to determine 1) whether it represents a pattern of delay that has provided unwarranted benefits to, or been abused by, applicants; and 2) whether, in this specific instance, Commission staff agreed to Enron's request to hold this matter in abeyance in order to facilitate Enron's regulatory goals before FERC. If either is found to be true, it would be very disturbing, and the SEC should take immediate action to correct the problem. Moreover, the Commission should ensure that a consistent practice of prompt review is in place to avoid any similar results in the future.

Stock Analysts - With respect to sell-side stock analysts, the report concludes that the only way to achieve meaningful change is to impose new rules designed to protect analysts from the pressures of their firms' investment banking concerns. Rules to enhance analyst objectivity that were proposed by NASD and the New York Stock Exchange and approved by the SEC in May 2002 were a good first step. The Committee staff's report concludes, however, that these rules did not go far enough. The Sarbanes-Oxley Act, which requires the SEC to issue rules further addressing analyst independence (or to have the self-regulatory organizations do so), has provided the SEC an opportunity to tighten the requirements and to achieve meaningful reform, particularly in disentangling analysts from the investment banking concerns of their firms. The Committee staff's report recommends the following as a part of the SEC's rulemaking efforts as required by the Sarbanes-Oxley Act:

Separate analysts from investment banking influence. The SEC should require a complete separation between investment banking and research to remove the significant conflicts posed by firms' business concerns that hamper analysts' independence. In addition to removing barriers to analyst objectivity, the SEC and the self-regulatory organizations should work to ensure that the Wall Street firms have in place a performance-based compensation and promotion system that provides incentives for analysts to achieve accuracy in their reports.

Prohibit analysts from sharing their reports with the subject companies prior to release. This will assist in protecting analysts from pressure by company management to be more favorable.

Require disclosures about analysts' track records and firm conflicts to be made more widely available than just on research reports themselves. These disclosures emphasize the *quality* of research and the ability of investors to judge the quality of that research. Many who rely on the ratings get their information from other sources, including general financial information websites, and never see the research reports. These disclosures should be available on the firms' websites or on the NASD or New York Stock Exchange websites.

Require disclosure when analysts drop coverage of a stock. In his investigation, New York Attorney General Eliot Spitzer found that analysts simply dropped coverage of a company (with no public announcement of that fact) rather than downgrading their recommendations to a "sell." He found that this was a common practice that was misleading to investors because they were unaware that the firm had abandoned its recommendation until well after the fact. Attorney General Spitzer's settlement with Merrill Lynch includes the requirement that analysts announce that they have dropped coverage and explain why they did so. It should be required of all firms.

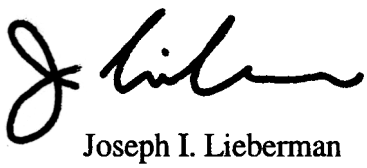
Credit Rating Agencies - We are aware that the SEC is pursuing its own investigation into whether additional oversight of the credit rating agencies is warranted in the wake of Enron's collapse and other large corporate bankruptcies this year. In addition, the SEC is required by the Sarbanes-Oxley Act to author a study about the role and function of the credit rating agencies. Committee staff's report, based on the conclusions drawn about the rating agencies' performance in the case of Enron, makes the following recommendations to the SEC:

> **Place conditions on the NRSRO designation.** As you know, three credit rating agencies currently have the special designation of "Nationally Recognized Statistical Ratings Organization" (NRSRO), a status granted by the SEC. This designation means that the ratings of these agencies carry special weight under numerous laws and regulations. The SEC, in consultation with other agencies that reference NRSRO ratings in their regulations (particularly banking agencies), should set specific conditions on the NRSRO designation to ensure that the reliance of the public on these organizations is not misplaced. Among these conditions should be (1) a set of standards and considerations that credit raters must use in devising their ratings, including accounting issues; and (2) standards for required training of credit rating analysts, so that they have the information and expertise necessary to thoroughly review the companies they rate.
>
> **Monitor compliance with those requirements.** After establishing the conditions on the NRSRO designation, the SEC should ensure that the credit rating agencies are complying with those conditions through regular monitoring. In the event of a future corporate meltdown such as Enron, the SEC should investigate whether applicable requirements and conditions were met.

We hope this report proves helpful to you in your efforts to make improvements at the SEC and to enhance the effectiveness of the private sector watchdogs on which the SEC and the investing public rely to ensure the integrity of the markets. The lows we have seen in the stock market of late are clear signals that investors mistrust the accuracy and value of information they are receiving from corporate America and the diligence of those who are supposed to be keeping the numbers honest. We know you have begun to address some of these issues. However, as this report indicates, there is much left to be done. We must work together to restore America's faith in our system of financial oversight. We await your response to our Committee staff's conclusions and recommendations. We believe most, if not all, of staff's recommendations can

be implemented administratively; please let us know, however, if you believe that the SEC needs additional legislative authority to take any of the actions recommended in the report.

Sincerely,



Joseph I. Lieberman
Chairman

Fred Thompson
Ranking Member

Enclosure
cc: Commissioner Paul S. Atkins
Commissioner Roel C. Campos
Commissioner Cynthia A. Glassman
Commissioner Harvey J. Goldschmid