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Report to the Senate Committee on Banking, Housing, and Urban Affairs and the House Committee on Financial Services

March 2003

INVESTMENT BANKS

The Role of Firms and Their Analysts with Enron and Global Crossing

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Highlights

Highlights of GAO-03-511, a report to the Senate Committee on Banking, Housing, and Urban Affairs and the House Committee on Financial Services.

March 2003

INVESTMENT BANKS

The Role of Firms and Their Analysts with Enron and Global Crossing

Why GAO Did This Study

In the wake of a series of recent corporate scandals and bankruptcies, the Sarbanes-Oxley Act mandated that GAO study the involvement of investment banks with two companies, Enron and Global Crossing. In this report, the term "investment bank" includes not only securities firms but also those bank holding companies with securities affiliates or business divisions that assist clients in obtaining funds to finance investment projects. Since the activities identified in this report are the subject of ongoing and extensive investigations and litigation by competent authorities, it is not our role to determine the propriety of any of the parties' activities. To help the Congress better understand the activities of investment banks with respect to these companies we agreed to provide publicly available information on the roles investment banks played in designing, executing, and participating in certain structured finance transactions, investment banks' and federal regulators' oversight of these transactions, and the role that the banks' research analysts played with Enron and Global Crossing.

www.gao.gov/cgi-bin/getrpt?GAO-03-511.

To view the full report, including the scope and methodology, click on the link above. For more information, contact Rick Hillman at (202) 512-8678 or Jeanette Franzel at (202) 512-9402.

What GAO Found

Certain investment banks facilitated and participated in complex financial transactions with Enron despite allegedly knowing that the intent of the transactions was to manipulate and obscure Enron's true financial condition. The investment banks involved in the transactions we reviewed contended that their actions were appropriate and that Enron had not revealed its true purpose in obtaining their assistance. While investment banks are not responsible for the financial reporting of their clients, if it is proven that the investment banks knowingly assisted Enron in engaging in securities law violations, SEC has the authority to take legal action against them.

Oversight responsibility for the investment banks' part in these transactions lay with both the banks themselves and the federal regulators. Investment banks told us that they had vetted transactions involving Enron through their risk management and internal control systems. Since Enron's collapse, these firms reportedly have been taking some steps to strengthen their internal controls, in part because they are now more sensitive to reputation risk. Federal financial regulators noted that before Enron's collapse they had not viewed structured transactions with investment-grade counterparties as particularly high risk in their exams. They subsequently are refining their approach to supervising structured transactions, and bank regulators now plan to include more transactions in their exams. Regulators are currently conducting targeted reviews of structured finance transactions at large firms and plan to develop guidance or best practices that clarify their expectations for sound control and oversight mechanisms.

In the wake of the scandals, research analysts at investment banks who made favorable recommendations for failed firms have also come under public scrutiny. Investment banks allegedly pressured analysts covering Enron and Global Crossing to give investors favorable or misleading investment recommendations in order to keep or win lucrative work from the companies, creating serious conflicts of interest. Although the investment banks denied the allegations, several have been investigated by regulators and involved in litigation about conflicts of interest between their research and investment banking departments. Certain federal regulators and self-regulatory organizations have all adopted additional regulations addressing such conflicts.

Although investment banks are not typically responsible for their client's accounting, it is a violation of law to facilitate transactions that an investment bank knows will materially misstate the client's financial statements. Since investment banks may be tempted to participate in profitable but questionable transactions, it is especially important that regulators be alert to this and be ready to use their enforcement tools to deter such action. We are encouraged that investment banks and regulators are strengthening their oversight of the appropriateness of transactions, but it is too soon to evaluate the effectiveness of reforms.

Contents

Abbreviations

AC	Analyst Certification
EITF	Emerging Issues Task Force
FAS	Financial Accounting Standards
LJM2	LJM2 Co-Investment, L.P.
NYSE	New York Stock Exchange
OCC	Office of the Comptroller of the Currency
PSI	Permanent Subcommittee on Investigations
SEC	Securities and Exchange Commission
SFAS	Statement of Financial Accounting Standards
SPE	special purpose entity

G A O

Accountability * Integrity * Reliability

United States General Accounting Office
Washington, DC 20548

March 17, 2003

The Honorable Richard C. Shelby
Chairman
The Honorable Paul S. Sarbanes
Ranking Minority Member
Committee on Banking, Housing, and Urban Affairs
United States Senate

The Honorable Michael G. Oxley
Chairman
The Honorable Barney Frank
Ranking Minority Member
Committee on Financial Services
House of Representatives

The publicity surrounding Enron Corporation's (Enron) bankruptcy and the effect on the company's stockholders and employees has generated a debate on the activities of investment banks and their role in Enron's collapse.[1] Publicly available reports describe complex financial transactions among Enron, various investment banks,[2] and a variety of special purpose entities[3] (SPE) that have raised questions about whether investment banks knowingly[4] and substantially assisted[5] Enron in deceiving the public about Enron's true financial condition.

In the wake of this and other recent corporate scandals, the Congress passed the Sarbanes-Oxley Act of 2002 (Sarbanes-Oxley Act), which contains multiple accounting, corporate governance, and other reform requirements. Section 705 of that act requires GAO to study investment banks' involvement in the failures of two particular public companies,

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[1] Enron Corporation is a global energy company.

[2] In this report, the term "investment bank" includes not only securities firms but also those bank holding companies with securities affiliates or business divisions that assist clients in obtaining funds to finance investment projects.

[3] An SPE is a separate entity that is created to carry out a specific purpose, activity, or transaction. An SPE is also known as a special purpose vehicle.

[4] "Knowingly" has been defined by some courts as actual knowledge of a securities law violation or by others as a reckless disregard for the truth.

[5] "Substantially" assisted has been interpreted by the courts as meaning significant assistance to the representations of others or to the fraud of others.

Enron and Global Crossing Ltd. (Global Crossing).[6] This report presents primarily publicly available information on the facts, allegations, and rebuttals concerning selected investment banks' involvement with Enron and Global Crossing. It also presents observations on the issues raised by the investment banks' involvement with these companies and on the actions Congress, regulators, and firms have taken or proposed in response.

This report focuses primarily on five structured finance transactions involving Enron and investment banks for the period 1992 through 2001.[7] We found no publicly available documents on or references to investment banks' involvement in designing or implementing structured transactions used by Global Crossing. Therefore, in this report we discuss other client relationships that investment banks had with Global Crossing, primarily through their research analysts. Through the transactions we describe in this report, investment banks facilitated complex structured finance transactions, despite allegedly knowing that Enron would use deceptive accounting and tax strategies. Complaints filed by the Securities and Exchange Commission (SEC) and individual investors also allege that, through various transactions, Enron and its officers and directors engaged in a scheme to defraud investors by inappropriately reporting the transactions in Enron's financial statements and consequently misrepresenting Enron's true financial condition.

Investigations and litigation are under way in connection with both Enron and Global Crossing, and it was not our objective to assess, nor should this report be construed as assessing, the potential culpability of the parties involved in the transactions discussed in the report. In instances such as these, if we have good cause to believe that any potential violations of applicable laws or regulations have occurred, we refer such matters to the appropriate governmental authorities for their consideration and possible action.

[6] Global Crossing is a telecommunications company that operates worldwide.

[7] In this report, the use of the term "structured finance" is not limited to securitization, which is the isolation of a defined group of assets that serve as the basis of a financing that is intended to be remote, as a legal matter, from the bankruptcy risks of the former owner of the assets. By isolating assets, structured financings can facilitate access to capital markets, vastly expanding the sources of available funding.

After taking the above concerns into consideration, we agreed with the staffs of the Senate Committee on Banking, Housing and Urban Affairs and the House Committee on Financial Services that the specific objectives of this report were to (1) identify the roles investment banks played in designing, executing, and participating in structured finance transactions for Enron; (2) discuss investment banks' and federal financial regulators' oversight of products investment banks design and market to or for their clients; and (3) discuss the role investment banks' research analysts played with Enron and Global Crossing.

To meet our objectives, we reviewed publicly available documents pertaining to investment bank involvement with Enron in structured finance transactions and other client relationships. The five transactions we analyzed exemplify a variety of relationships that Enron had with several different investment banks and were among those in which investment bankers allegedly assisted Enron in manipulating its earnings, but they were not those included in Enron's restatement of its financials for the period 1997 through the second quarter of 2001.[8] Although the investment banks described themselves as passive investors in the restated transactions, we did not confirm or refute their assertions to that effect. We did not conduct any evaluative analysis of the recent reforms Congress, regulators, and some firms have initiated, as not enough time has passed to allow for such analysis.

The five transactions we selected were discussed at hearings of the Senate Committee on Governmental Affairs, Permanent Subcommittee on Investigations (PSI), held in July and December 2002. In completing this work, we spoke with PSI staff and relied primarily on witness statements, hearing transcripts, and supporting documents published by the subcommittee. Throughout this report, we cite several documents used in the PSI hearings that were specifically relied on for allegations that investment banks facilitated the transactions with knowledge of Enron's use of deceptive accounting and tax strategies. In addition, we interviewed federal financial regulators[9] and officials from the three investment banks

[8] We acknowledge that these do not cover all of the transactions these investment banks undertook with Enron, nor do they represent transactions with all of the investment banks with which Enron had relationships.

[9] For purposes of this report, we use the term "federal financial regulators" to refer to SEC (securities regulator) and the Board of Governors of Federal Reserve System and the Office of the Comptroller of the Currency (bank regulators) together. Separately, we may discuss them by their name or type of regulator.

involved in these transactions. We also reviewed available documents provided by regulators and the investment banks. Appendix I contains a full description of our scope and methodology.

We conducted our work in Washington, D.C. and New York, N.Y., between September 2002 and March 2003 in accordance with generally accepted government auditing standards.

Results in Brief

It is alleged that certain investment banks knowingly and substantially assisted Enron in engaging in financial transactions that were intended to manipulate and obscure Enron's true financial condition, thereby defrauding its investors, creditors, and others. If certain allegations are proven true, SEC would have the authority to bring an action against the investment banks for aiding and abetting securities laws violations. Some have concluded that the transactions reportedly involved deceptive accounting or tax strategies and were allegedly designed to help Enron meet year-end revenue targets, inflate operating results, or evade taxes. For example, in some transactions certain investment banks structured transactions to purchase financial assets from Enron. Even though Enron reported these transactions as sales, PSI and the bankruptcy examiner[10] concluded that the substance of the transactions was not sales but secured borrowings (i.e., loans). If this charge is true, they should have been reported as debt on Enron's financial statements. In another example, an investment bank allegedly designed and orchestrated a transaction intended to enable Enron to evade Canadian taxes. If this allegation is true, the transaction ultimately would have improperly inflated Enron's reported after-tax earnings. Further, certain prepay transactions[11] involving investment banks and Enron, which were reported by Enron as energy trades, were allegedly disguised loans to Enron from the investment banks. If these conclusions are proven, Enron's accounting could have misled investors and analysts about Enron's financial condition. The investment banks involved in the transactions we selected for review contended that they had believed their role in assisting Enron

[10] Enron filed for bankruptcy on December 2, 2001. On April 8, 2002, the Enron Bankruptcy Court authorized the appointment of an examiner to inquire into certain transactions that were not reported in accordance with generally accepted accounting principles and requested that the examiner prepare reports regarding these transactions.

[11] A prepay transaction involves paying in advance for a service or product to be delivered at a later date.

was proper and that Enron had not disclosed its true purpose in obtaining their assistance. While investment banks are not responsible for the financial reporting of their clients, if an investment bank knowingly and substantially assisted Enron in engaging in violations of the securities laws, SEC has the authority to bring legal action against the investment bank for aiding and abetting a securities law violation. In February 2003, one of the investment banks, Merrill Lynch & Co., Inc (Merrill Lynch), said that it had agreed in principle to settle a civil complaint with SEC—without admitting or denying any wrongdoing—charging that it aided Enron in fraudulently overstating its earnings in 1999. As of March 14, 2003, this settlement agreement has not been approved by SEC.

Investment banks and federal financial regulators have oversight processes for structured products and transactions that investment banks offer their clients; however, the recent series of corporate scandals has made both investment banks and federal financial regulators more concerned about reputation and legal risks and they report taking steps to strengthen their oversight processes.[12] Investment bankers that we spoke with told us that structured finance transactions are routinely vetted internally through their risk management and internal controls systems. Since Enron's collapse, the investment banks have taken some steps to increase their focus on reputation and legal risks, including making managerial changes, establishing new oversight committees, and strengthening their internal review and transaction approval processes. Federal financial regulators believe that these are positive steps but noted that it is too soon to evaluate how well the new policies and procedures will work in practice. Federal financial regulators are responsible for overseeing different segments of the large, complex financial institutions that engage in structured finance transactions. Federal financial regulators use a risk-focused approach to their examination processes for these financial institutions, identifying the most significant risks to the institution and then determining whether the financial institution has the risk management systems and internal controls in place to identify, measure, monitor, and manage them. Federal financial regulators noted that exams prior to Enron's collapse did not identify structured transactions as a high-risk area that required attention because risk

[12] Reputation risk is the possibility that negative publicity regarding an entity's business practices, whether true or not, will cause costly litigation or a decline in the customer base or revenues. Legal risk is the potential that unenforceable contracts, lawsuits, or adverse judgments will disrupt or otherwise negatively affect the operations or financial condition of a firm.

assessments did not show that such deals posed a material risk of financial loss. In the wake of Enron's collapse, some regulatory officials said they are refining their approach to supervising certain aspects of a financial institution's operations that may cause reputation, litigation, and other operational risks in the area of complex structured transactions. For example, bank regulators plan to more extensively sample transactions in their future exams. Also, federal financial regulators are in the process of performing targeted reviews of the few large investment banks that are active in complex structured transactions and are planning to develop guidance or best practices on ways to ensure the transactions are appropriate.

Investment bankers of certain securities firms allegedly pressured their research analysts covering Enron and Global Crossing to issue favorable or misleading investment recommendations (i.e., buy ratings) in order to keep or obtain lucrative investment banking work from the companies. Conflicts of interest issues such as these have led the public to question the independence and objectivity of favorable investment recommendations research analysts make about public companies and prospects for their equity securities. The primary issue here is the adequacy and effectiveness of barriers between the research and investment banking functions of securities firms that offer both services. In response to these concerns, regulators have taken a number of actions. For example, in May 2002, SEC approved changes to NASD and New York Stock Exchange (NYSE) rules that seek to reestablish the separation between the investment banking and research departments of a securities firm. In December 2002, NASD and NYSE proposed additional analyst rules and according to SEC officials will likely propose further rules this spring in compliance with the directive in the Sarbanes-Oxley Act.[13] During the same month, SEC, the New York Attorney General's office, NASD, NYSE, and state securities regulators reached a "global settlement" in principle with the top U.S. investment banking firms to resolve issues of conflict of interest at these firms. As of March 14, 2003, SEC commissioners have not approved this settlement. In February 2003 SEC adopted a regulation on analysts' conflicts of interest. Among other requirements, the regulation requires brokers, dealers, or certain

[13] The Sarbanes-Oxley Act, which was signed into law in July 2002, among other things, requires SEC or the self-regulatory organizations to adopt rules to address conflicts of interest that can arise when research analysts recommend equity securities in research reports and public appearances.

associated persons of brokers or dealers[14] to include certifications from the research analyst that the views expressed in a research report accurately reflect the analyst's personal views and to disclose whether the analyst received compensation or other payments in connection with any recommendation or views. It is too soon to evaluate the adequacy of these new rules.

This report makes no recommendations. We provided copies of a draft of this report to the Board of Governors of the Federal Reserve (Federal Reserve), the Office of the Comptroller of the Currency (OCC), SEC, and the Department of Justice for their comment. The Federal Reserve, OCC, and SEC provided technical comments, which we have incorporated where appropriate. The Department of Justice had no comments.

Background

Investment banks play an important role in maintaining the smooth functioning of the U.S. economy. In that role, they provide many different services to their clients. In addition to more traditional services such as securities underwriting, investment banks provide advice on and assistance in creating different types of structured finance transactions, including SPE and prepay transactions that are designed to meet the needs of specific corporate clients. Investment banks' duties to their clients depend on the activities in which the investment banks engage. In part because of the complexity of the transactions investment banks engage in, transparency in financial reporting is essential if stakeholders (such as investors) and others are to understand these transactions.

Investment Banks Offer Their Corporate Clients a Wide Variety of Services

Investment banks are an important means of allocating capital in the U.S. economy. In their traditional function of underwriting securities offerings, according to securities industry data, investment banks arranged over half of the total financing provided to U.S. nonfinancial businesses in 2001. The wide variety of services today's investment banks provide to their corporate clients fall into two major categories—-securities/capital markets and advisory services. Table 1 provides a description of services investment banks provide their corporate clients.

[14] Brokers effect securities transactions for the account of others. Dealers engage in buying and selling securities for their own account. Associated persons of brokers or dealers are partners, officers, directors, or branch managers of a broker or dealer or any person controlling, controlled by, or under common control with a broker or dealer, or any nonministerial employee of a broker or dealer.

Table 1: Services Investment Banks Provide Their Corporate Clients

Name of Service	Description of Service
Underwriting	In this role, investment banks are financial intermediaries in securities offerings. They verify financial data and business claims, facilitate pricing, and perform due diligence. Most underwritings are “firm commitment” underwritings in which investment banks purchase the securities from the issuer and distribute them to the public.
Private placements	Investment banks may help corporate clients place securities privately. In these transactions, the banks focus on the direct placement of corporate securities with investors—for example, by drafting the private placement memorandum and contacting and negotiating with potential investors.
Venture capital	Investment banks provide capital and strategic guidance to some companies and may manage venture-capital pools or invest their own capital. They may also provide underwriting services or advice on mergers and acquisitions.
Asset-based financing	Investment banks help clients obtain financing using existing assets and assist with asset securitizations. These transactions involve selling securities backed by cash flows from a pool of financial assets, such as credit card receivables.
Investment management	Investment management operations include managing mutual funds, hedge funds, unit investment trusts, leveraged buyout funds, and private equity funds.
Merchant banking	Merchant banking commits the investment bank’s own capital to facilitate a client transaction such as a bridge (or temporary) loan.
Research	Research analysts at the investment banks analyze public companies and make investment recommendations about the securities of those companies to investors through research reports and other means, such as the media.
Other transactions	Investment banks structure and implement transactions to allow clients to manage a variety of risks. Such transactions may include a variety of derivatives.
Corporate advisory services	In addition to helping with mergers and acquisitions, investment banks assist with corporate reorganizations and advising on other strategic matters. Services related to mergers and acquisitions include conducting due diligence, preparing a valuation of the business, advising the client on the best type of transaction, preparing a selling memorandum, participating in negotiations, and assisting the client’s board of directors with discharge of their fiduciary duties. Investment banks may also facilitate corporate reorganizations by recommending the sale of certain assets, issuing special securities such as convertible stock and bonds, and even negotiating the sale of the entire company. Investment banks may also provide corporate or financial advisory services on other strategic matters such as divestitures, corporate defense strategies, joint ventures, privatizations, spin-offs, proxy and consent solicitations, tender offers, exchange offers, and leveraged buyouts.

Source: J.P. Morgan & Co., SEC, and GAO analysis.

The three investment banks highlighted in this report, like other large investment banks providing services to large companies, had various relationships with Enron or Enron-related entities. The investment banks provided an array of services and products to Enron, including acting as advisors on mergers and acquisitions, lending money for loan syndications,[15] underwriting bond and stock offerings, providing research on Enron securities, providing complex structured finance transactions,

[15] Loan syndication is a form of financing involving a group of banks that agree to advance a portion of the funding.

acting as trading counterparties to derivatives transactions,[16] participating as passive investors (limited partners) in an SPE, and others.

Structured Financing Includes SPEs and Prepay Transactions

Structured finance is designed by investment bankers and others to help clients obtain funding on desirable terms and in some cases with favorable economic, accounting, and tax characteristics. It includes many variants, including transactions that use SPEs and prepay transactions. An SEC official has stated that structured finance plays an important role in the modern business environment and, when used properly, can provide needed liquidity, funding sources, and investment opportunities and facilitate risk dispersion. The official also noted that structured finance transactions have at times been used inappropriately to achieve a specific accounting or tax result. Sometimes this inappropriate use has been achieved by violating existing regulations or accounting standards.

Special Purpose Entities

In the ordinary course of business, many companies use a variety of structured financings that involve SPEs to access capital or hedge risk.[17] An SPE is a legal entity created by another entity (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 often used as a financing vehicle that allows a sponsor entity to transfer assets to the SPE in exchange for cash or other assets the SPE obtains by issuing debt, equity, or both, to third-party lenders or investors. Originators of financial assets such as mortgages and consumer credit have used SPEs extensively; at the end of 2001, such SPEs held over $2 trillion in assets. For example, a sponsor entity could transfer accounts receivable from credit-card holders into an SPE in exchange for cash. In this example, the SPE would obtain the cash by issuing securities backed by the accounts receivable. SPEs may also be established to acquire, construct, or manufacture assets the sponsor entity uses through leases, management contracts, or other arrangements. For example, a sponsor entity could establish an SPE to construct a power plant that was financed through debt issued by the SPE.

[16] Derivatives are financial products whose value is determined from an underlying reference rate, index, or asset. The underlying includes stocks, bonds, commodities, interest rates, foreign currency exchange rates, and indexes that reflect the collective value of various financial products.

[17] Hedging is a financial technique used to mitigate the risk of loss from price fluctuations.

An SPE may take many different forms, including a corporation, partnership, limited liability company, or trust.[18] When the entity is properly structured, an SPE's assets may be legally separate from those of its sponsor, protecting the SPE's assets from the risk of the sponsor's bankruptcy. This arrangement often reduces credit or other risks for lenders and investors and thus lowers financing costs for the sponsor. SPEs may also create certain tax advantages for the participating parties.

Under generally accepted accounting principles and Financial Accounting Standards Board guidance, SPEs meeting certain criteria do not appear on the balance sheet of the sponsoring entity. Thus, transactions that provide financing involving SPEs can be structured so that the assets and liabilities transferred to an unconsolidated SPE can be removed from the sponsor's financial statements. Whether an SPE is consolidated with another entity is a matter of judgment that involves an assessment of the risks and rewards of ownership, as well as control over the SPE's activities. This is important, because an entity could materially misstate its own financial statements by, for example, understating its debt or overstating its sales if it does not properly account for ownership in an SPE. Even though a sponsor of an SPE might not be required to consolidate the assets and liabilities of an SPE in its financial statements, the sponsor is required to either recognize in its financial statements or disclose in the footnotes to its financial statements the nature of its involvement with the SPE; the purpose, size, and activities of the SPE; and the maximum exposure to loss as a result of its involvement with the SPE.

Accounting for Sales of Financial Assets

Ownership interests in an entity, including an SPE, are considered financial assets. When assets of this type are sold or transferred to another entity, Financial Accounting Standards (FAS) 140, *Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities*, provides the accounting guidance related to the transaction.[19] In general, when an entity surrenders control of a transferred financial

[18] SPEs generally do not include registered investment companies—an investment company, such as a mutual fund, is registered with SEC under the Investment Company Act of 1940.

[19] FAS No. 140 became effective April 2001 and provides the accounting guidance used to determine if a transfer "purported to be a sale" should be reported as a sale or a secured borrowing. FAS 140 replaced FAS 125, which had the same name. FAS 140 revised some of the accounting standards for securitizations and other financial assets and collateral and requires certain disclosures, but it carries over most of FAS 125's provisions without reconsideration.

asset, a sale can be recognized. For a sale to occur, the transferred asset should be isolated from the transferring entity and its creditors, and the entity receiving the asset has the right to pledge the asset as collateral or to sell it. Further, the entity transferring the asset is not allowed to maintain control of the asset through any agreement that entitles and obligates it to repurchase the asset. If a transfer of financial assets in exchange for cash or other consideration does not meet the criteria for a sale, then the entity transferring the asset must account for the transaction as a secured borrowing with a pledge of collateral, and the resulting liability and the asset are reflected on the entity's balance sheet.

Prepay Transactions

A prepay transaction involves a contractual agreement between two parties that combines the economics of a debt obligation with those of a forward contract, which is a contract for a service or product to be delivered at a later date. Forward contracts, whether prepaid or not, can be used to hedge against adverse price moves. For example, if two parties enter into a forward contract to exchange 100 gallons of gas for $180 ($1.80 per gallon) in a month, the buyer of the gas is protected against a price higher than $1.80 while the seller is protected against a price lower than $1.80. In a prepaid forward contract, the payment for the gas is made at the time of the contract but the gas is delivered in a month; this provides immediate cash flow to the seller. If this prepay transaction is a loan in substance and intent, its accounting treatment should be that of a loan.[20]

In the energy business, entities commonly enter into forward contracts for the purchase or sale of a commodity. Such activities are generally settled by the physical delivery of the commodity. The contracts are often entered into based on an entity's assessment of market movements either to hedge its position or to speculate on price. Some entities enter into energy contracts for trading purposes and often settle them with cash rather than a commodity. In accounting guidance, "energy trading activities" refers to energy contracts entered into with the objective of generating profits from changes in market prices. The guidance states that determining whether an entity is involved in energy trading activities is a matter of judgment that depends not solely on the terms on the contracts, but also on an assessment of relevant facts and circumstances related to the entity's

[20] To determine the accounting treatment, prepaid forward contracts must be evaluated under the provisions of Financial Accounting Standards Board *Statement of Financial Accounting Standards No. 133*, *Accounting for Derivative Instruments and Hedging Activities*.

activities. However, inherent in that assessment is an evaluation of the entity's intent in entering into an energy contract.[21]

Investment Banks' Duties to Their Clients Depend on the Role the Banks Play

Investment bankers are often retained to advise on a course of action that a board of directors has already determined to pursue. The banker's role in helping the board achieve those objectives is set forth in an agreement known as an engagement letter, and the banker's duties to the client are limited to the terms of that letter. Moreover, the advice that investment banks provide is largely subjective. However, in some cases courts have found that an investment banker owes a fiduciary duty to a company if the investment banker evaluated and considered the appropriateness of unsuccessful financial transactions that caused the company's bankruptcy.[22]

Enron engaged investment bankers to provide advice on and at times to participate in the creation of SPEs. The duties of the investment bankers in such transactions depends on the role the investment bankers played. If the SPE issues securities through a public offering that it sells to investors in order to raise capital, and the investment bank acquires the securities from the SPE with the intent to subsequently distribute them, then the investment bank is acting as an underwriter. As an underwriter, the investment banker would have duties of due diligence and disclosure.[23]

[21] Energy trading activities also include dealing, the activity of standing ready to trade—whether buying or selling—for the dealer's own account, thereby providing liquidity to the market. These contracts would have to be analyzed under the provisions of SFAS 133 (subsequent to its effective date) and Emerging Issues Task Force (EITF) 98-10. The EITF sets forth a framework for concluding which energy contracts should be accounted for as trading contracts. The model set forth generally focuses on an evaluation of the various activities of an entity based on all available facts and circumstances. Further, the model requires that in the event that a contract is entered into outside of a segregated energy trading operation, an entity should analyze contracts at inception based on attendant facts and circumstances and identify each contract as either trading or non-trading. See EITF 98-10.

[22] *In re Daisy Corporation*, 97 F.3d 1171 (9th Cir. 1996) (court refused to grant summary judgment to investment banker when debtor relied upon banker's advice and debtor presented evidence that investment banker's advice eventually led to debtor's bankruptcy); *In re Healthco Intern, Inc.*, 195 B.R. 971 (Bankr. D. Mass. 1996).

[23] Section 11 of the Securities Act of 1933 provides that signers of the registration statements, including underwriters, may be held liable for materially misleading statements or omissions in a registration statement and, therefore, have a duty to independently investigate the statements—in other words, to conduct due diligence.

If investment bankers knowingly or substantially assisted a company—in this case, Enron—in violating the securities laws, SEC has the authority to bring an action for aiding and abetting a securities violation. The action depends on the involvement of the investment banker in the alleged conduct. SEC must prove three elements in an aiding and abetting a securities law violation: (1) that a principal committed a primary violation, (2) that the aider and abettor rendered such assistance knowingly or recklessly, and (3) that the aider and abettor provided substantial assistance to the primary violator. In other words:

- The first legal element of aiding and abetting is the requirement that an independent, illegal act exists to which the aider and abettor can be attached. This independent illegal act or primary violation may be a misrepresentation, omission, scheme to defraud, or fraudulent course of business.
- The second element of aider and abettor liability is either actual knowledge of the primary violation on the part of the aider and abettor or recklessness. However, the law is ambiguous with regard to the level of knowledge needed to prove aiding and abetting liability. Some courts have required SEC to prove that the entity aiding the primary violation had actual knowledge of the violation.[24] However, other courts have found that recklessness is sufficient.[25] In SEC administrative proceedings, liability may be based on less than actual knowledge of the violation.[26]
- The third element of aiding and abetting, "substantial assistance by the aider and abettor in the achievement of the primary violation" has been interpreted as meaning significant assistance to the representations of others or to the fraud of others. Persons may assist primary violators in many ways—for example by repeating their misrepresentations, aiding in

[24] *SEC v. Fehn*, 97 F.3d 1276, 1288 n. 11(9th Cir. 1996); *Hauser v. Farrell*, 14 F. 3d 1338 (9th Cir. 1994). Section 20(e) of the Securities Exchange Act of 1934 (the Exchange Act) provides for aiding and abetting liability against any person who "knowingly provides substantial assistance to another person" who violates the federal securities laws.

[25] *Aiken v. Q—L Investments*, 959 F.2d 521, 526 (5th Cir. 1992).

[26] *SEC v. Graham*, 222 F.3d 994 (D.C. Cir. 2000). SEC may bring administrative proceedings for aiding and abetting a securities law violation against certain regulated persons, such as broker-dealers. See Section 15(b)(4) of the Exchange Act. SEC may also bring an administrative cease-and-desist proceeding against any person who is "a cause of" another person's violation due to an act or omission that the person knew or should have known would contribute to the primary violation. See Section 21C of the Exchange Act.

the preparation of misstatements, acting as conduits to accumulate or distribute securities, executing transactions, or financing transactions.[27]

Thus, if SEC determines that there is evidence to allege that investment bankers provided substantial assistance to Enron in violating the securities laws and that the investment bankers rendered such assistance knowingly, SEC could bring a civil action against the investment bankers that engaged in such conduct. Depending on the forum where the action is brought, reckless conduct on behalf of the investment banker may be sufficient.

However, we have observed that some conflict exists among the courts regarding the level of knowledge required for SEC to bring a claim in court for aiding and abetting liability. Clearly, actual knowledge of the fraud is a more difficult standard to prove. If this standard were to be the requirement, SEC might not be able to successfully pursue all court cases that could involve actions for aiding and abetting a securities law violation.

Transparency in Financial Reporting Is Key to Maintaining Confidence in Capital Markets

In part because of the complexity of many structured finance transactions, transparency in financial reporting is essential to maintaining confidence in capital markets. Off-balance sheet transactions[28] and other relationships with off-balance sheet entities or other persons may have a significant effect on a company's financial condition, revenue or expenses, results of operations, and liquidity. Financial reporting should provide the information that is useful to current and potential investors, creditors, and others in making rational investment, credit, and similar decisions. The information should be comprehensible to those who have a reasonable understanding of business and economic activities and are willing to study the information with reasonable diligence.

Financial reporting should also provide the information necessary to assess the financial condition of an entity, including (1) the amount, timing, and certainty of cash flows; (2) the assets, obligations, and equity;

[27] *Rolf. Blyth, Eastman, Dillon & Co.*, 570 F.2d 38, 48 (2d Cir. 1978); *Cumis Ins. Soc'y v. E.F. Hutton*, 457 F. Supp. 1380, 1386 (S.D. N.Y. 1978).

[28] An off-balance sheet item is a financial contract that can create gains or losses for an entity but is not reported on the balance sheet under generally accepted accounting standards.

and (3) the financial performance during a specified period. Transparent financial reporting depends on reliable information, sufficient disclosures, and fundamental assertions about the information presented. For example, assets are owned and are expected to provide future benefits to an entity; all known obligations of an entity, as a result of prior events, are recorded; an entity's revenues are reported during the period earned; and an entity's sources and uses of cash flows are properly classified. If investors and creditors lose confidence in the financial reporting of an entity, the consequences to the entity and the marketplace can be significant.

Both accounting and auditing standards recognize that an entity's management is responsible for an entity's financial reporting, including the fairness of its presentation in conformity with generally accepted accounting principles. During an audit, audit standards require an auditor to obtain written representations from management indicating, among other things, management's responsibility for the entity's financial reporting. The Sarbanes-Oxley Act reemphasized management's responsibility by requiring that an entity's principal executive and financial officers certify that the financial statements and other financial information included in the report fairly present in all material respects the financial condition and results of operations. The act also imposed possible disgorgement of any ill-gotten gains on the part of principal executive and financial officers when an entity is required to restate its financial statements owing to noncompliance—that is, as a result of misconduct with any financial reporting requirements under securities laws.

The Role of Investment Banks in Enron's Structured Finance Transactions

Investment banks allegedly actively and substantially helped Enron deceive its investors and creditors by facilitating complex structured finance transactions designed to result in misleading accounting and tax outcomes that benefited the company. Enron used structured finance to generate recorded sales, decrease taxes, and facilitate prepay transactions that bolstered operating results and cash flows. Investment banks played key roles in each of the transactions discussed in this report. (See appendix II for a detailed description of these transactions and the roles played by investment banks.) It is alleged that these transactions enabled Enron to manipulate and obscure its reported results or to avoid tax obligations in various ways. If so, SEC can bring action against these investment banks for aiding and abetting securities fraud.

Investment Banks Were Involved in Transactions That Enron Used to Generate Recorded Sales and Reduce Taxes

SPEs are often used for legitimate purposes as a financing vehicle, but they have also been used to inappropriately overstate net income and understate total debt. For example, an entity that transfers control of an asset, including the risks and rewards of ownership, to a properly structured, unconsolidated SPE for cash is generally expected to report the transfer as a sale and record the gain or loss on the transaction. If an entity transfers an asset but not all the risks of ownership to an SPE for cash, then the cash received is generally accounted for as a secured borrowing (i.e., a loan).

It has been alleged that Merrill Lynch knew that its participation in Enron's Nigerian barge transaction[29] aided deceptive accounting by Enron. The form of Merrill Lynch's involvement was an equity investment that would validate a sale by Enron, but it was reported that oral commitments by Enron minimized Merrill Lynch's risks and ensured a specified return, meaning that Merrill Lynch's investment was in substance a loan and that therefore there was no valid sale. Publicly available reports describe a transaction in which Enron reported a gain from selling an interest in three power barges located in Nigeria to Ebarge, LLC (Ebarge), an SPE Merrill Lynch created for this transaction. This transaction occurred 2 days before the year-end closing date for Enron's 1999 financial statements. It was asserted that Merrill Lynch was not at risk for the equity investment in Enron's barges because Enron officials made oral guarantees to arrange for the resale of Merrill Lynch's interest in the barges within 6 months, with a specified return to Merrill Lynch for its involvement in the transaction. A publicly available Merrill Lynch document related to this transaction indicates that prior to entering into the transaction, Merrill Lynch received assurance from Enron that Merrill Lynch's investment would be liquidated within 6 months.[30] After attempts by Enron to sell Merrill Lynch's interest in the barges to an independent third party failed, an Enron-related party purchased Ebarge from Merrill Lynch. Based on the sale price and fees received for the transaction, Merrill Lynch received the allegedly promised return on its equity investment. If, as asserted, Merrill Lynch did not have an equity risk in the

[29] In this transaction, Enron sold interest, or ownership, in Enron Nigeria Barge Limited an entity whose sole assets were the three barges. Ownership interests are considered to be financial assets under FAS 140.

[30] Senate Committee on Governmental Affairs, Permanent Subcommittee on Investigations, *The Role of the Financial Institutions in Enron's Collapse*, Vol. 2, 107th Cong., 2nd sess., 2002, Exhibit 207.

barges through Ebarge but instead had a credit exposure to Enron, then Enron should have reported this transaction as a secured borrowing instead of a gain on the sale of an asset, reducing the company's net income and increasing its debt. If, as alleged, Merrill Lynch knowingly and substantially assisted Enron in violating the securities laws by improperly reporting its debt as net income, and if such reporting is a violation of the securities laws, SEC has the authority to bring an action against Merrill Lynch for aiding and abetting a securities law violation.

Merrill Lynch officials contended that Enron proposed and structured the transaction and that Enron also assured Merrill Lynch that its outside auditors had vetted and approved its accounting for the transaction. Merrill Lynch officials also contended that the firm provided no accounting advice to Enron and that Merrill Lynch in fact was at risk in the transaction because, while Enron orally agreed to make a "best effort" to find another buyer for the asset, this promise was not a legally binding guarantee. Officials told us they undertook the transaction as an accommodation to Enron in the hopes of receiving increased Enron business in the future. In February 2003, Merrill Lynch said that it had agreed in principle with SEC, without admitting or denying any wrongdoing, to pay a fine to resolve civil charges that it aided Enron in fraudulently overstating Enron's earnings in 1999. One of the transactions reportedly included in the settlement was this Nigerian barge transaction.

It has also been alleged that Citigroup Inc. (Citigroup) assisted Enron in executing transactions, despite knowing that the transactions used deceptive accounting strategies, in return for substantial fees or favorable consideration in other business dealings. Publicly available documents describe transactions referred to as Bacchus and Sundance that involved Enron, Citigroup, and several SPEs and took place over a 6-month period beginning in December 2000. PSI and the bankruptcy examiner concluded that the substance of the transactions for Enron was borrowing, which instead of being reported as debt was recorded as a sale with a gain that increased Enron's net income through deceptive accounting. In these transactions, Enron sold its ownership in a pulp and paper trading business to an Enron-created SPE, the Caymus Trust, a transaction for which Enron recorded a gain. Through a variety of agreements, Citigroup was to be at risk for $6 million of equity in the Caymus Trust. However, it has been asserted that Citigroup did not have equity risk because Enron verbally guaranteed that the $6 million equity investment would be repaid.

A publicly available Citigroup document indicates that "Bacchus is a part of a program designed to ensure that Enron will meet its year-end [targets]."[31]

Approximately 6 months after the Bacchus transaction, the Sundance transaction returned Citigroup's investment in the Caymus Trust by redeeming its investment. The Sundance transactions involved the creation of an Enron-Citigroup joint venture that was allegedly designed to ensure that Citigroup had no equity at risk. If Citigroup never had equity at risk in these transactions, then the substance of the transactions was secured borrowing that Enron should have reported as debt rather than as a sale. A publicly available document prepared by Citigroup's Risk Management Group indicates that the group initially did not approve the Sundance transaction because, among other things, "the GAAP accounting is aggressive and a franchise risk to [Citigroup] if there is publicity (a la Xerox)."[32] If Citigroup knew that Enron had improperly recorded these transactions and that the reporting by Enron was a violation of the securities laws, and Citigroup's conduct substantially assisted Enron's violations, SEC would have the authority to bring an action against Citigroup for aiding and abetting Enron's securities law violations.

In response to these allegations, Citigroup officials testified at a December 11, 2002 congressional hearing that Citigroup employees had acted in good faith and had understood that these transactions complied with existing law and the prevailing standards at the time. Although Citigroup's internal review committee had reviewed the transactions, Citigroup officials said that Citigroup had viewed the accounting decisions as decisions that would be made by Enron and its accountants. Citigroup noted that Enron was a Fortune 10 company and that Enron's auditors from Arthur Andersen LLP were presumed to know about the transactions and to have approved their accounting treatment.

Companies such as Enron can use properly structured SPEs to minimize taxes, but SPEs have also been used to create complex transactions

[31] Senate Committee on Governmental Affairs, Permanent Subcommittee on Investigations, *Fishtail, Bacchus, Sundance, and Slapshot: Four Enron Transactions Funded and Facilitated by U.S. Financial Institutions*, 107th Cong., 2nd sess., 2002, S. Prt. 107-82, Exhibit 322d.

[32] Committee on Governmental Affairs, *Four Enron Transactions*, Exhibit 333n.

designed to evade taxes. J.P. Morgan Chase & Co. (Chase)[33] facilitated a transaction for Enron (referred to as Slapshot), despite allegedly knowing that the transaction used deceptive tax strategies. Chase designed the Slapshot transaction, provided the funding, minimized its own risks, and received substantial fees for facilitating the transaction. The Slapshot transaction involved Enron, Chase, other lenders, a Chase SPE, and several Enron affiliates and SPEs in order to refinance an Enron pulp and paper mill and allegedly to evade Canadian taxes. Publicly available reports describe Slapshot as a complex series of structured finance arrangements that all took place during the same day and included a $1.039 billion loan due later the same day and a $375 million loan due in 5 years and one day. In a publicly available Chase document related to the design of the Slapshot transaction, Chase indicated that an advantage of one aspect of the structure of the transaction was that it provided "no road map for Revenue Canada."[34] If Chase knowingly and substantially assisted Enron in evading taxes, resulting in the reporting of incorrect information in Enron's financial statements, and such reporting was a violation of the securities laws, SEC would have the authority to bring an enforcement action against Chase for aiding and abetting Enron's securities fraud.

A Chase official testified at a congressional hearing that Chase's Structured Finance Group had developed the generic form of this transaction and had received opinions from two leading Canadian law firms that the structure and the Canadian tax benefits the transaction provided were legal and valid.

Investment Banks Were Involved in Prepay Transactions Enron Used to Bolster Operating Results

It has been alleged that Chase and Citigroup assisted Enron in its deceptive accounting over a period of years by facilitating several billion dollars in loans disguised as energy trades and allowing Enron to use offshore entities that the investment banks controlled as trading partners. Although prepay transactions are common in the energy industry in general, the Enron prepay transactions were allegedly unique because they

[33] J.P. Morgan Chase & Co. is the successor to J.P. Morgan & Co. Inc. and The Chase Manhattan Corporation, which merged on December 31, 2000. Even though virtually all of the Enron-related transactions were entered into with The Chase Manhattan Bank, the successor assumes responsibility for those deals. Henceforth, for the purpose of the report, GAO will use the name "Chase" to refer to the combined company.

[34] Committee on Governmental Affairs, *Four Enron Transactions*, Exhibit 344. On November 1, 1999, Revenue Canada became the Canada Customs and Revenue Agency. Part of the agency's mission is to promote compliance with Canada's tax regulations.

involved a circular cash flow arrangement among the three parties involved in the transactions.

Publicly available reports describe several prepay transactions among Enron, various investment banks, and usually a third-party SPE affiliated with the investment bank. In these transactions, Enron received cash in advance and promised to deliver a specific volume of oil or gas in the future (or the cash value of the commodity). Enron accounted for these transactions as energy trading activities and reported the prepay transactions as liabilities from price risk management[35] on its balance sheet and as cash flows from operations on the statement of cash flows. However, PSI and the bankruptcy examiner concluded that Enron's accounting for the transactions was inappropriate because the prepay transactions were in substance and intent loans, not trading activities, and should have been recorded by Enron as debt. Reporting them as debt, however, would have weakened some of Enron's key financial ratios, such as its debt-to-equity ratio. Further, the cash Enron received would have properly been reported as cash flows from financing activities on the statement of cash flows and not as cash flows from operations. If it is proven that the prepays were effectively loans, Enron's accounting for the prepay transactions as trading activities could have misled investors and analysts about the scope of Enron's trading activities and the nature of its incoming cash flows.[36] Publicly available Chase and Citigroup documents indicate that the firms participated with other companies in prepay transactions that, like Enron's prepay transactions, often involved an SPE and no price risk.[37] However, we were not able to determine if these transactions involved circular cash flows like Enron's prepay transactions. If the allegations that (1) the firms knowingly assisted Enron in engaging in materially fraudulent transactions and (2) the firms' conduct provided substantial assistance to the fraud are proven true, SEC would have the authority to bring an action against them for aiding and abetting securities laws violations.

[35] Enron's liability for price risk management was the balance sheet line item used to account for trading liabilities. Enron also reported assets for price risk management activities on its balance sheet.

[36] Committee on Governmental Affairs, *Four Enron Transactions*.

[37] Committee on Governmental Affairs, *Role of the Financial Institutions*, Vol. 1, Exhibits 134 and 161.

Publicly available reports describe prepay transactions among Enron, Chase, and an SPE (Mahonia, Ltd.) that was created to undertake transactions for Chase. In these transactions, Enron's accounting treatment of the prepay transactions as trading activities was allegedly improper because in substance and intent the transactions were actually loans. One publicly available Chase document indicated that "Enron loves these deals as they are able to hide funded debt from their equity analysts because they (at the very least) book it as deferred revenue or (better yet) bury it in their trading activities."[38] Between 1992 and 2001, Enron and Chase entered into 12 prepay transactions with a combined value of over $3.7 billion.

In testimony given at a congressional hearing, in an interview with us, and in documents supplied to us, Chase officials said that they understood that Enron, with Enron's auditor's approval, had treated the prepay transactions as trading activities. The officials contended that Chase mitigated risk, as required by banking law, and that the risks of the different transactions and hedges involved in prepays were different from those of a loan. Chase provided us with excerpts from other companies' financial statements that described their prepays as a means of financing, recorded as liabilities for price risk management. However, we have not reviewed these transactions and cannot determine if they were similar to Enron's prepay transactions.

Another example of an Enron prepay transaction involved Enron, Citigroup, and a Citigroup-created SPE, Delta Energy, that served as a third party. The first of these Citigroup prepay transactions in 1993 was similar in structure to the Chase prepay transactions. However, some of the later Citigroup prepay transactions involving Delta Energy were funded by bond offerings to qualified institutional buyers instead of by Citigroup. By raising funds for the prepay transactions in this fashion, the institutional investors rather than Citigroup were at risk if Enron should go bankrupt or default. PSI and the bankruptcy examiner concluded that Enron's accounting for these prepay transactions as trading activities was improper, because in substance and intent the transactions were actually loans. One publicly available Citigroup document discussing the approval of an Enron prepay transaction indicated that Citigroup's "internal approval for the transaction will acknowledge that [Citigroup] was

[38] Committee on Governmental Affairs, *Role of the Financial Institutions*, Vol. 1, Exhibit 123.

basically making a loan."[39] PSI reported that between 1993 and 2001, Enron and Citigroup entered into 14 prepay transactions with a combined value of over $4.8 billion.

Citigroup officials contended the transactions were done in good faith, complied with existing law and prevailing standards of the time, and had been reviewed and approved by their internal review committee. Citigroup officials contended that Enron assured them that its outside auditor had fully vetted and approved its accounting treatment of prepays.

Other Enron and Global Crossing Transactions

The three investment banks highlighted in this report also participated as passive investors in other transactions involving SPEs with Enron. However, we did not confirm or refute whether, as passive investors, these financial institutions participated in the management of the SPE. For example, Chase, Merrill Lynch, and Citigroup were investors as limited partners in the SPE LJM2 Co-Investment, L.P. (LJM2), contributing a total of about $40 million.[40] Merrill Lynch also acted as the private placement agent for LJM2 and in this capacity helped introduce sophisticated (wealthy) investors to the LJM2 partnership. For its work, Merrill Lynch testified that it received about $3 million in fees. Also, the investment bank invested $5 million itself and permitted 96 of its executives to invest about $16.6 million of their own money in LJM2.

Section 705 of the Sarbanes-Oxley Act mandates that we review investment bank involvement in the failure of Global Crossing, "including with respect to transactions involving swaps of fiber optic cable capacity." It has been reported in the press, and plaintiffs have alleged in civil actions, that Global Crossing improperly reported as revenue the proceeds it received from sales of fiber optic capacity and services in transactions with counterparties; however, to our knowledge, no investment banks were involved in these transactions. In these transactions, Global Crossing and its counterparties entered into simultaneous agreements to purchase and sell fiber optic capacity and services. In many of these transactions, the aggregate purchase and sales prices were similar or the same. It also

[39] Committee on Governmental Affairs, *Role of the Financial Institutions*, Vol. 1, Exhibit 188g.

[40] LJM2 is a Delaware limited partnership organized and managed by the then chief financial officer of Enron to make private equity investments in the energy and telecommunications sectors.

has been alleged by plaintiffs that these transactions lacked a legitimate business justification and that, as a result, Global Crossing's financial statements were materially misleading to the investing public. In October 2002, Global Crossing announced that it would restate its financial statements for prior periods based on advice from SEC staff that Global Crossing's previous accounting for these transactions did not comply with generally accepted accounting principles and that the transactions should be recorded on a historical carryover basis. Global Crossing's announcement stated that the company had relied on advice from its independent advisors and an industry white paper in accounting for these transactions.

Investment Banks and Federal Financial Regulators Have Begun Strengthening Their Oversight of Structured Finance Transactions Since Enron's Collapse

According to the investment banks we spoke with, the transactions discussed here were vetted through their internal risk management processes. In the aftermath of their experience with Enron, however, these firms have become more concerned about possible reputation risk and thus have reported taking steps to strengthen their risk management processes. Federal financial regulators saw these steps as positive but noted that it was too soon to evaluate how well the new policies and procedures would work. Federal financial regulators also responded to the issues raised by the Enron collapse. These regulators use a risk-focused approach to oversight, identifying the most significant risks to a financial institution and then determining whether appropriate risk management systems and internal controls are in place. Federal financial regulators noted that before Enron's collapse, structured transactions did not pose significant risks in traditional risk management areas. Since then the regulators have been considering additional legal and reputation risk reviews and are looking at ways to further enhance examination scopes and procedures in this area. In addition, they have confirmed that they will more extensively sample transactions in examinations that raise issues of concern.

Investment Banks Use Risk Management and Other Internal Control Systems to Approve Structured Finance Transactions

In our market-based economy, market discipline and proper disclosure of risks are the primary means of controlling risk-taking behavior. When investors respond to negative information about a company by selling (or not buying) its securities, the company's access to capital may be limited or capital may become more costly to obtain. Investment banks have a similar but more extensive role: they not only make decisions on the provision and terms of capital, but also make decisions in other areas, such as structured finance and whether to participate in and facilitate a client's activities.

Investment banks use a variety of control processes and policies—formal and informal—for reviewing and evaluating whether to enter into a particular transaction, to expand a business line, or enter into a new business or product line. These policies and procedures are also used to establish any conditions, procedures, or parameters applicable to the transactions, new product or business line. The three investment banks involved in the transactions discussed in this report all had internal review and approval processes with independent control processes that were to review transactions for their appropriateness.[41] Control groups and business unit representatives involved in the review process generally operated by consensus. However, in circumstances where the business unit wished to pursue a transaction despite concerns expressed by a control group, senior management (management that is, at a minimum, senior to the business unit directly interested in the transaction) could exercise the discretion to approve the transaction.

In speaking for several large investment firms, a representative of the securities industry told us that all investment firms recognized that the various processes and policies they have adopted for transaction review and approval are fallible. However, these processes and policies were designed not to police compliance by clients with accounting or disclosure obligations, but to ensure that the relevant risks and issues presented by a transaction or new product or business line are identified and evaluated by the appropriate control functions. In their view, an investment-banking firm generally is not in a position to perform an effective policing function vis-à-vis its client for a number of reasons. First, investment banks generally (underwritings present a partial exception to this general principle) will not have access to financial or transactional information that, although unrelated to the specific transaction under consideration, is relevant to determining whether the client's disclosure for a transaction is appropriate. Moreover, investment-banking firms are frequently not in a position to make the relevant materiality determinations or to exercise control over disclosure determinations. Indeed, these determinations are made in many cases subsequent to the execution of the transactions. The investment banks expressed the view that it is a client's senior management, audit committee, and independent auditors who are in possession of the information and decisionmaking authority necessary to exercise an effective gatekeeping role. Therefore, according to these

[41] These committees were usually made up of representatives of the accounting, legal, tax, and compliance departments, among others.

investment banks, as a policy matter, these are the groups who should be viewed, and who should view themselves, as responsible for performing that role.

The transactions that are the focus of this report were reportedly vetted through the risk management processes of the investment banks involved. For example, one investment bank told us that it had been engaging in prepay transactions with Enron for about a decade and that it had closely reviewed the initial transactions but not subsequent prepays, which were not seen as a new type of transaction. The investment bank maintained that because it had not reviewed the later transactions, it had not realized the extent to which Enron had changed from an energy company to a financial company over the years. Another investment bank told us that its risk management reviews of the Enron transactions relied heavily on Enron's assurances that the outside auditor for Enron had reviewed the transactions and considered them appropriate. Representatives of the investment bank also said that, in their view, the decision to approve the transactions was appropriate given the information they had at the time. But they added that if they had known then what they know now about Enron, they would not have done business with the company. A securities industry official told us that risk management decisions regarding the Enron transactions failed not because investment banks did not have internal control processes but because Enron did not provide these firms with the whole picture.

Representatives of some investment banks told us that after Enron's collapse, their firms became more sensitive to risk management issues, such as the possibility that some transactions could involve fraudulent or questionable financial reporting on a client's part. Based on this experience, some investment banks told us they had taken steps to strengthen their risk management, although the processes themselves remained essentially the same. For example, one investment bank created a new policy review office to formalize and strengthen the firm's process for examining transactions and products. According to the investment bank's chief executive officer, the office is intended to help ensure that the firm does not participate in transactions that its clients do not properly disclose. The investment bank's management told us that their risk management process would not presume that transactions with highly rated large U.S. corporations were appropriate without asking more detailed questions. Instead, regardless of the corporation's size and reputation, the investment bank would require a closer look at all complex transactions that could involve fraudulent or questionable financial reporting. Investment bank representatives also said that accounting and tax-driven transactions would now get a more thorough review.

Representatives from another investment bank told us that legal and accounting representations on some transactions would now be obtained from outside sources. Representatives from yet another investment bank said that, based on their negative experiences with Enron, they were now willing to ask more questions about specific transactions. In August 2002, this investment bank announced a new initiative as one of a series of enhancements to the controls it imposes on the execution of transactions that raise legal, accounting, or other reputation issues. This new policy states that if the transaction would be materially significant for the client, the investment bank will proceed only if the client commits to disclosing the transaction's "net effect" on its financial position. Under this policy, the focus will be on the economic reality of the transaction, not just its form. Officials from this firm said that risk management processes do not necessarily discover corporate accounting fraud on the part of clients.

According to bank regulators, since Enron's collapse financial institutions have taken some steps to deal with risk management issues in future transactions. First, the financial institutions have centralized the process for establishing, using, and managing SPEs and conducting separate audits of SPEs' activities. Second, they have strengthened their review and approval processes for complex structured transactions in several ways. For example, management reviews during the approval process now include a broader range of senior managers from various areas of the financial institution and focus more closely on assessing customer motivation and appropriateness. In order to obtain a structured product, customers are required not only to provide information on disclosures and accounting treatment but also to comply with strict reporting standards. Bank regulators said that these are positive steps toward strengthening internal processes but noted that it is too early to evaluate how well the changes will work.

Federal Banking and Securities Regulators Use a Risk-Focused Approach to Overseeing Large Financial Institutions

The Federal Reserve, OCC, and SEC share responsibility for overseeing the largest complex financial institutions. Each regulator is responsible for specific activities. The Federal Reserve regulates bank holding companies and state-chartered banks that are members of the Federal Reserve System; OCC regulates the activities of nationally chartered banks; and SEC regulates activities involving securities and firms (broker-dealers) that trade securities. Banking and securities regulators have different regulatory missions and focus on different operational aspects of the entities they oversee. Because commercial banks accept customer deposits and use those funds to lend to borrowers, banking regulators tend to focus on safety and soundness. Securities regulators focus on protecting investors and ensuring that markets are fair. SEC aims to ensure that public companies fully disclose material information, including the risks associated with their transactions and their financial condition, so investors can make informed investment decisions.

Because risks can manifest themselves in different parts of a large financial institution, it is important for federal financial regulators to be able to assess the overall risk management activities of the entire organization. Most large financial institutions have a firm-wide risk management framework in place to identify and control risk. These institutions can have complex structures, including parent companies, affiliates, and subsidiaries, all of which can be involved in different aspects of risk assessment. The component entities may have one or more federal financial regulators, or, in some cases, none. Banks and their holding companies are regulated on a consolidated basis, but in the securities sectors, SEC-registered broker-dealers are regulated by SEC, even if these entities are part of a larger holding company. Although those parts of a securities firm that are outside the broker-dealer may not be regulated by SEC, SEC has authority to extend its oversight beyond the broker-dealer to assure that activities in the affiliates do not threaten the soundness of the regulated entity.[42] SEC officials said that, when appropriate, they have used this authority to examine the overall risks of affiliates.

The Federal Reserve, OCC, and SEC use a risk-focused exam approach that concentrates on those products, transactions, and services that are considered to pose the greatest risks to an individual firm's overall financial condition or the financial system as a whole. Risk is the potential that expected or unanticipated events can cause a firm to suffer losses that adversely affect its capital and earnings. Table 2 describes selected types of risk.

[42]Although SEC has limited authority to oversee affiliates of broker-dealers, the Market Reform Act of 1990 enables it to collect information about the activities and financial condition of affiliates and parent firms to assess the risks they pose to the regulated entity. Despite its supervisory role, SEC does not have legal regulatory authority to examine or set regulatory capital requirements over the parents or affiliates of SEC-registered broker-dealers.

Table 2: Selected Types of Risks Faced by Financial Firms

Type of Risk	Risk Definition
Credit risk	The potential that a borrower or counterparty will fail to perform on an obligation such as a loan or contract.
Market risk	The risk that adverse movements in market rates or prices—for example, interest rates, foreign exchanges rates, or equity prices—can affect a firm's financial position.
Reputation risk	The possibility that negative publicity regarding an entity's business practices, whether true or not, will cause costly litigation or a decline in the customer base or revenues.
Operational risk	The potential that inadequate information systems, operational problems, breaches in internal controls, or fraud will result in unexpected losses.
Legal risk	The potential that unenforceable contracts, lawsuits, or adverse judgments will disrupt or otherwise negatively affect the operations or conditions of a firm.
Liquidity risk	Arises for the potential that an institution will be unable to meet its obligations as they come due because of an inability to liquidate assets or obtain adequate funding or that it cannot easily unwind or offset specific exposures without significantly lowering market prices because of inadequate market depth or market disruptions.

Source: Federal Reserve.

Under the risk-focused supervision approach, bank and securities examiners identify the most significant risks to a financial institution and then determine whether risk management and internal control systems are in place to identify, measure, monitor, and manage those risks. Because of the complexity of the largest financial institutions and the number of transactions they conduct, bank and securities examiners focus on assessing the integrity and effectiveness of the institutions' overall risk management and internal control systems. As deemed appropriate, bank examiners also test selected transactions, and SEC reviews the policies and procedures firms have in place.[43] Federal financial regulators have an array of tools at their disposal to ensure that regulated entities take corrective steps when problems are identified. These tools range from informal supervisory actions such as issuing a deficiency letter (SEC) or issuing a memorandum of understanding (bank regulators) that details

[43] Transaction testing is used to validate examiners' judgment on the reliability of an institution's internal controls. Transaction testing includes examination of underlying support for transactions and the reconciliation of internal accounting records and financial reports (to evaluate accuracy of account balances), the comparison of day-to-day practices to the requirements of policies and procedures (to assess compliance with internal systems), and all other supervisory testing procedures, such as quality reviews of individual loans and investments.

areas where corrective measures are appropriate to formal enforcement actions such as cease and desist orders and referrals to other regulators or law enforcement agencies for civil or criminal sanctions.

Federal Financial Regulators Did Not Identify Structured Finance As a High-Risk Area Before Enron's Collapse

According to federal financial regulatory officials, only a few large financial institutions offer complex structured transactions such as those involving Enron, although a variety of other financial institutions may conduct isolated structured finance transactions. Federal financial regulators noted that prior to Enron's collapse they had not viewed reputation risk from structured transactions as a high-risk area, primarily because (1) the risk focus was on traditional market, credit, and operational risks; (2) the size and volume of transactions were small relative to the total capital of relevant financial institutions; (3) many such transactions are conducted with investment-grade firms; and (4) with respect to securities firms, many of the activities may have taken place in affiliates outside of the SEC-regulated broker-dealer. Banking agency officials told us that they had each reviewed the accounting for prepay transactions conducted with Enron at one bank in their respective jurisdictions and found it consistent with generally accepted accounting principles. SEC officials noted that their focus is on the policies and procedures the investment banks have in place for assessing risk and approving these transactions and only review select transactions to evaluate whether the policies and procedures have been effectively implemented.

Federal Financial Regulators Have Made Changes to Their Oversight Processes As a Result of the Enron Scandal

Federal financial regulators said that since the Enron scandal they have refined their approach to supervising certain operational aspects of the institutions that are involved in complex structured transactions. In a February 10, 2003 response to questions posed to them by PSI, officials of the Federal Reserve, OCC, and SEC said that staff at their agencies were continuing to review investment banks' participation in the complex financial products, transactions, and practices that have raised significant legal and accounting questions. Further, in carrying out these reviews, the federal financial regulators said that they were collaborating on both specific issues arising from the practices under review and broader issues relating to the internal control and oversight mechanisms investment banks need to oversee structured finance transactions. The agencies were not planning an additional one-time joint review but said they would continue conferring on the investigations and examinations that were already under way. The federal financial regulators said that during 2003 they would review and evaluate the actions individual organizations were taking to strengthen policies and practices in the structured finance business. Based on the results of these reviews, the agencies intend to develop consistent guidance and best practices for the entities within their respective regulatory jurisdictions that they believe are necessary to clarify their expectations for sound control and oversight mechanisms.

In addition, some of the federal financial regulators have altered their policies and procedures examination manuals to improve oversight of structured products and the institutions that use them. In the fall of 2002, for example, the Federal Reserve issued additional examination guidance on supervising structured products and SPEs. Further, SEC officials stated that the agency is drafting a new examination module for structured finance transactions to be used in examining the risk management and internal control systems of broker-dealers. SEC has been conducting risk management and internal control system examinations since 1995, but limited resources have kept the agency from doing as many exams as it considers necessary. An SEC official stated that an anticipated budget increase should allow the agency to increase its staffing and conduct additional examinations.

Recent Rules and Legislation Aim to Make Off-Balance Sheet Transaction Reporting and Disclosures More Transparent

In light of Enron's collapse, legislation and regulations have been adopted that attempt to restore investor confidence by requiring more disclosure and transparency in structured finance transactions. One area that has received particular attention is the disclosure of off-balance sheet transactions in registration statements and periodic filings. In addition, SEC is required to study this issue and to produce a report of its findings.

Registration statements and periodic reports contain a "management discussion and analysis" section for management to explain clearly a company's financial condition. According to SEC, as a response to uncertainty over quality of earnings issues in general, including those raised by the collapse of Enron, SEC issued a release cautioning company management to report in this section full explanations of their "critical accounting policies," the judgments and uncertainties affecting the application of these policies, and the likelihood that materially different amounts could be reported under different conditions or using different assumptions. Structured finance transactions frequently require the application and selection of critical accounting policies.[44] SEC issued a follow-up release proposing rules to codify and expand upon this guidance

[44] Cautionary Advice Regarding Disclosure About Critical Accounting Policies, Release Nos. 33-8040; 34-45149; FR-60 (December 12, 2001).

in May 2002. According to an SEC official, SEC staff are currently reviewing the comment letters and developing recommendations for future SEC action on this topic.[45]

In July 2002, Congress enacted Section 401(a) of the Sarbanes-Oxley Act, which required that by January 2003 SEC issue final rules providing that annual and quarterly financial reports filed with SEC disclose all material off-balance sheet transactions, arrangements, and obligations. On January 22, 2003, SEC adopted rules to implement that section. These rules stipulate that financial reports that public companies are required to file with SEC after June 15, 2003 include an explanation of the company's financial condition disclosing material off-balance sheet transactions, arrangements, obligations, and any relationships the issuer has with unconsolidated entities.[46]

In August 2002, pursuant to Section 302(a) of the Sarbanes-Oxley Act, the SEC adopted rules to require the certification of an issuer's quarterly and annual reports by its principal executive and financial officers. SEC also adopted rules requiring issuers to maintain and regularly evaluate the effectiveness of disclosure controls and procedures. Among other things, the certifications state that the overall financial disclosure fairly presents, in all material respects, the company's financial condition, results of operations and cash flows. A "fair representation" of an issuer's financial condition and results of operations and cash flows encompasses the selection of appropriate accounting policies, proper application of appropriate accounting policies, disclosure of financial information that is informative and reasonably reflects the underlying transactions and events, and any additional disclosure necessary to provide investors with a materially accurate and complete picture of an issuer's financial condition and results of operations and cash flows. Such certification forces the executive officers to not only certify whether the company's financial statements are prepared in compliance with generally accepted accounting principles, but also whether the financial statements and other financial information fairly present in all material respects the financial condition and results of operations and cash flows of the company.

[45] Disclosure in Management's Discussion and Analysis about the Application of Critical Accounting Policies, Release No. 33-8098 (May 10, 2002).

[46] "Disclosure in Management's Discussion and Analysis about Off-Balance Sheet Arrangements and Aggregate Contractual Obligations," Release No. 33-8182 (January 27, 2003).

In addition, Section 402 of the Sarbanes-Oxley Act requires that SEC complete a study by January 2004 to determine not only the extent of off-balance sheet transactions and the use of SPEs but also the degree to which the economics of such transactions are transparently conveyed to investors. The act also requires that SEC report to the President, the Committee on Banking, Housing, and Urban Affairs of the Senate, and the Committee on Financial Services of the House of Representatives 6 months after the study is completed on the following:

- public companies' off-balance sheet transactions and use of SPEs,
- the extent to which SPEs are used to facilitate off-balance sheet transactions,
- the extent to which current rules and accounting principles result in financial statements that are transparent with respect to SPEs and off-balance sheet transactions,
- the extent to which current accounting principles result in the consolidation of issuer-sponsored SPEs when the issuer carries most of the SPEs risks and receives most of its rewards, and
- recommendations for improving the transparency of reporting off-balance sheet transactions in public companies' financial statements.

In response to controversies related to Enron's use of SPEs, the accounting guidance related to SPE financial reporting was clarified in January 2003 when the Financial Accounting Standards Board released Interpretation No. 46, *Consolidation of Variable Interest Entities*.[47] In general, this new guidance requires that an SPE be consolidated with another entity if that entity is the primary beneficiary[48] of the SPE—that is, if it absorbs the majority of the risks and rewards of the SPE's operations. Specifically, an SPE would be consolidated with its primary beneficiary if the outside equity investment was not at least 10 percent of its total assets[49] and is not greater than its expected losses, or if the outside equity holders in the SPE lack (1) the ability to make decisions about the SPE's

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[47] This guidance refers to an SPE subject to consolidation as a variable interest entity.

[48] For purposes of determining whether an entity is the primary beneficiary, an entity with a variable interest (ownership or some other financial interests) shall treat variable interests held by its related parties as its own interest.

[49] Prior to this guidance, 3 percent was used as a criterion to determine whether to consolidate an SPE with another entity. This 3-percent test did not originate in a Financial Accounting Standards Board standard but rather was contained in a supplement to an EITF issue related to leasing transactions involving SPEs and subsequently appears to have become the de facto test for all SPEs.

activities (control), (2) the obligation to absorb expected losses of the SPE if they occur (risk), and (3) the right to receive residual returns of the SPE if they occur (reward). Many SPEs that were previously unconsolidated will be consolidated as a result of the interpretation, starting with their first fiscal year or interim period beginning after June 15, 2003.

Conflicts of Interest Reportedly Affected Research Analysts' Ratings of Enron and Global Crossing

According to some allegations, some research analysts at investment banks recommended Enron and Global Crossing securities to investors in order to get lucrative investment bank deals for their firms. Such analysts are better trained and positioned than the average retail investor to assess the value of a company's securities. The value and credibility of their recommendations depend on their maintaining unquestioned independence and objectivity in their research and resulting investment recommendations. The issues surrounding research analysts' actions in recommending Enron raise a number of serious questions, primarily concerning the effectiveness of barriers between the research and investment banking functions of investment banks. In response to this concern, regulators have introduced new rules designed to reduce such conflicts of interest, and a number of other actions have been initiated.

Research Analysts Allegedly Issued Misleading Stock Reports

Research analysts study publicly traded companies and make recommendations about the securities of those companies, often by issuing research reports. Investors often see research analysts at investment banks[50] as important sources of information about securities. However, many factors can adversely affect these analysts' independence and objectivity in their research reports, including investment banking relationships and compensation arrangements tied to investment banking revenues.

Conflicts of interest reportedly emerged at several investment banks that made stock recommendations about Enron and Global Crossing. For instance, research analysts with Merrill Lynch and Citigroup's Salomon Smith Barney Inc. (Salomon Smith Barney) who were covering Enron and Global Crossing allegedly were pressured to issue misleading research reports on these companies because the companies were current or prospective investment banking clients. Although PSI did not examine the research analyst issue, certain documents released at a PSI hearing

[50] These analysts are often referred to as sell-side analysts.

suggest that Merrill Lynch terminated a research analyst because he did not provide a sufficiently favorable rating on Enron that would have improved the investment bank's chances of being chosen by Enron to participate in lucrative investment banking work. Merrill Lynch officials contended that the analyst was terminated for other reasons and that he actually raised his rating on Enron while working at another firm, one month after he had left Merrill Lynch and before Merrill Lynch did so.

A number of class action securities lawsuits allege that a Salomon Smith Barney research analyst covering Global Crossing Ltd. was pressured to issue misleading research reports on this company because the company was a current investment-banking client. The analyst reportedly issued compromised or misleading research reports containing buy ratings for the company that had no basis in fact. The complaints also allege that the analyst provided strategic advice, essentially acting as an investment banker as well as a research analyst. This relationship between Salomon Smith Barney's analyst and its investment bankers was allegedly not disclosed. Citigroup officials told us that Salomon Smith Barney believed that the analyst did in fact have a reasonable basis for his analysis and that the company and the analyst are defending the lawsuits. The analyst in question resigned in 2002. In addition, Citigroup officials informed us that Salomon Smith Barney has created a new structure under new senior management and implemented a number of other steps to strengthen the independence of its analysts.

Regulators and Others Have Taken Some Actions to Address Research Analysts' Conflicts of Interest

The role of research analysts and the potential conflicts of interest involving them raise a number of issues. The primary one is the adequacy and effectiveness of barriers between the research and investment banking functions of investment banks. In June 2001, the New York Attorney General opened an investigation into the practices of Merrill Lynch concerning analyst ratings and in May 2002 reached a settlement with the firm. According to the terms of the settlement, Merrill agreed to fines of $100 million and significant reforms, including severing the link between analysts and investment banking.

In May 2002, both NYSE and NASD received SEC approval for rules addressing conflicts of interest involving analysts at companies that have an investment banking relationship with firms their analysts cover. The new rules are intended to reestablish the separation between the investment banking and research departments of large multiservice brokerage firms and prevent investment banking personnel from reviewing or approving research reports prior to publication. Similar restrictions apply to communications between the research department and the company being researched, with the additional restriction that the company being researched is not to be provided with a research summary, the research rating, or the price target. Further, the rules state that companies cannot be offered, directly or indirectly, favorable research, a specific rating, or a specific price target, nor can they be threatened with changes to research, a rating, or a price target as consideration or inducement for business or compensation. In addition, both NASD's and NYSE's rule changes require disclosure of financial interests held by the brokerage firm, analysts, and analysts' family members and of any other material conflict of interest associated with recommending a particular security. Analysts are also subject to trading restrictions with respect to securities in the subject company. In addition, the rules prohibit research analysts from receiving compensation in any form—bonus, salary, or otherwise—based on a specific investment banking services transaction. According to NASD officials, NASD and NYSE have incorporated the new rules into their examination programs and have already begun examining firms for compliance with them. Soon after these rules were adopted, NASD and NYSE began conducting joint examinations of multiservice brokerage firms for compliance with the new NYSE and NASD analyst rules on conflicts of interest.

NASD and NYSE proposed additional rules in December 2002 that are intended to further manage analyst conflicts. The rules would, among other things, further insolate analyst compensation from investment bank pressures, prevent the issuance of "booster shot" research reports,[51] and require disclosure of a final research report when an analyst terminates

[51] A "booster shot" report refers to a favorable research report issued around the time of the expiration, waiver, or termination of a "lock-up" agreement, which brokerage firms often enter into with their clients to restrict the sale of a client's securities for a defined period of time. This proposed provision would prohibit managers and comanagers of a securities offering from issuing research reports or making public appearances concerning a subject company for 15 days prior to or after the expiration, waiver, or termination of a lock-up agreement. This provision is intended to address situations in which research analysts may issue positive research reports or reiterate "buy" recommendations shortly before or just after the expiration of a lock-up agreement. Imposition of this 15-day blackout period is intended to mitigate and/or eliminate the incentive for a research analyst to issue positive research reports and to permit real market forces to determine the price at which such securities can be sold after the expiration of such agreements.

coverage of an issuer.[52] We could not evaluate the overall effectiveness of the rules because they are so new.

A number of other important steps have been taken to address research analysts' conflicts of interest. First, in the last year NASD has brought many enforcement actions against broker-dealers that have issued misleading analyst reports without having a reasonable basis for the statements made in the reports. NASD brought most of these actions under NASD Rule 2210, which requires broker-dealers to have a reasonable basis for assertions they make in their research reports. In April 2002, SEC announced that it had begun a formal inquiry into market practices concerning research analysts and the potential conflicts in the relationship between research and investment banking in brokerage firms. According to SEC officials, as part of this inquiry SEC, NYSE, and NASD conducted joint examinations of 12 multiservice brokerage firms. The purpose of the examinations was to ascertain facts, conditions, practices, and other matters relating to conflicts of interest associated with the work of research analysts. In October 2002, SEC, NYSE, and NASD announced that they would work jointly with the New York Attorney General's office and the North American Securities Administrators Association to bring to a speedy and coordinated conclusion the investigations concerning research analysts. NYSE and NASD conducted joint examinations of the same firms[53] separate from those examinations that they were conducting for compliance with the new NYSE and NASD analyst rules on conflicts of interest. SEC examination staff also participated in these examinations.

A settlement in principle to resolve issues of conflict of interest at multiservice brokerage firms was announced in December 2002, with 10 large investment banks agreeing to pay over $1.4 billion in sanctions and agreeing to certain reforms. Among the reforms were an agreement to sever links between research and investment banking, a ban on allocating

[52] Self-Regulatory Organizations: Notice of Filing of Proposed Rule Changes by the New York Stock Exchange, Inc. Relating to Exchange Rules 344 ("Supervisory Analysts"), 345A ("Continuing Education for Registered Persons"), 351 ("Reporting Requirements") and 472 ("Communications with the Public") and by the National Association of Securities Dealers, Inc. Relating to Research Analyst Conflicts of Interest, Release No. 34-47110, 68 Fed. Reg. 826 (January 7, 2003).

[53] The investment banks included Bear Stearns & Co. LLC;' Credit Suisse First Boston Corp.; Deutsche Bank; Goldman Sachs; J.P. Morgan Chase & Co.; Lehman Brothers, Inc.; Merrill Lynch & Co. Inc.; Morgan Stanley; Salomon Smith Barney, Inc.; and UBS Warburg LLC.

initial public offering shares to corporate executives and directors, an obligation to contract with at least three independent research firms to provide research to the brokerage firm's customers for 5 years, and the hiring of an independent consultant (chosen by regulators) for each firm with final authority to procure independent research from independent providers. Additionally, the settlement would require each firm to make its ratings and price target forecasts publicly available. The settlement in principle is subject to approval by the SEC Commissioners.

On February 6, 2003, SEC adopted Regulation AC (Analyst Certification), which requires that any research report disseminated by a broker, dealer, or certain associated persons of a broker-dealer include certifications by the research analyst that the views expressed in the research report accurately reflect the analyst's personal views and disclose whether the analyst received compensation or other payments in connection with his or her specific recommendations or views.[54] The regulation also requires analysts to provide certifications in connection with public appearances. By requiring these certifications and disclosures, according to SEC, the regulation should promote the integrity of research reports and investor confidence in the recommendations they contain.

According to SEC officials, SEC examination staff will continue to examine for issues related to conflicts of interest involving research analysts in future examinations. SEC, NASD, and NYSE will examine investment banks for compliance with Regulation AC and self-regulatory organization rules on such conflicts of interest.

Observations

Today structured finance transactions such as those Enron entered into with various investment banks are very complex arrangements designed to achieve a variety of economic and tax purposes. With such creative financing, two financial transactions can, for example, have identical financial or economic outcomes but substantially different tax and accounting implications. The appropriateness and presentation of such transactions can hinge, among other things, on the actual purpose and intent of the transactions involved. Designing, advising on, or participating in such transactions can be lucrative for investment banks, which compete vigorously for the business. In the case of Enron, the incentives to participate in transactions to accommodate the client were strong: the prospect of handsome revenues and the perceived risk-mitigating factor

[54] SEC proposed Regulation AC prior to the Sarbanes-Oxley Act being signed into law.

that Enron was a large, prominent, investment-grade company whose outside auditor had reportedly vetted the appropriateness of the transactions. Given these incentives, the investment banks may have reduced the weight attached to or overridden their risk-management systems. These events illustrate that lapses in market discipline can create significant reputation and legal risks and that adequate due diligence is always necessary, regardless of the sophistication or prominence of the counterparties.

Although investment banks have primary responsibility to practice prudent risk management procedures, prudent procedures do not guarantee prudent practices. The events surrounding Enron's collapse demonstrate the importance of regulatory oversight in identifying and promptly correcting weaknesses in risk management practices. Prior to Enron's collapse, federal financial regulators had not identified the lapses in investment banks' risk management practices and the threats reputation and legal risks posed to firms involved in complex structured transactions with Enron. Federal financial regulators placed significantly more emphasis on the regulated firms' risk of material loss from traditional risks, such as counterparty default, than they did on less quantifiable factors such as reputation or legal risk. We are encouraged that investment banks are beginning to strengthen their risk management practices by, among other things, gaining additional assurances of the underlying intent behind and the anticipated accounting treatment and presentation of complex structured finance transactions they facilitate for their clients. The purpose and intent behind these complex structured transactions must be properly understood and transparent. Now, federal financial regulators need to determine whether these safeguards will be sufficient and develop a means not only to ensure that the safeguards are implemented properly and swiftly but also to take steps to more regularly consider the reputation and legal risks associated with complex structured transactions in future examinations.

Accounting and auditing standards and securities laws recognize that an entity's management is responsible for the fair and accurate presentation of the entity's financial statements. Investment banks are not typically responsible for their client's accounting. However, it is a violation of the federal securities laws for investment banks to aid and abet complex structured financial transactions that will materially misstate a public company's financial statements, thereby deceiving investors and creditors. SEC would have the authority to bring a legal action for aiding and abetting a securities violation against an investment bank if the investment bank knowingly gave substantial assistance to its client in carrying out a violation of the securities laws.

However, we have observed that a conflict exists among the courts about the level of knowledge that SEC must prove to successfully bring an aiding and abetting case. As previously discussed, in some courts the level of knowledge must be actual knowledge, a difficult element to prove. In other jurisdictions, the proof of reckless disregard for the truth is sufficient. Depending on where the fraudulent conduct occurred or the location of potential parties to the suit, SEC may not be able to successfully pursue all cases that may involve potential aiding and abetting violations. Since investment banks might be tempted to participate in profitable but questionable transactions when successful SEC prosecution is in doubt, it is especially important that regulators be alert to this possibility and be ready to use the rest of their enforcement tools to deter such actions.

Another ongoing issue is the potential conflict of interest between investment bankers and research analysts. The value and credibility of research analysts' recommendations depend on the analysts' unquestioned independence and objectivity in their research and resulting recommendations. However, many factors can put pressure on an analyst's independence and objectivity, including investment banking relationships and compensation arrangements tied to investment banking revenues. SEC, NYSE, NASD, the New York Attorney General, and other states have taken actions to promote the integrity of research reports and investor confidence in the recommendations contained in those reports, but it is too soon to assess the overall effectiveness of these steps. In addition, SEC, NYSE, and NASD are required to take further actions to promote the integrity of research reports in compliance with the directives of The Sarbanes-Oxley Act. This issue will need to be monitored to ensure that regulatory actions achieve the desired results.

Agency Comments and Our Evaluation

We provided copies of a draft of this report to the Federal Reserve, OCC, SEC, and the Department of Justice for their comment. The Federal Reserve, OCC, and SEC provided technical comments, which we have incorporated where appropriate. The Department of Justice had no comment.

We are sending copies of this report to the Chairman and Ranking Minority Member of the Permanent Subcommittee on Investigations, Senate Committee on Governmental Affairs; the Chairman and Ranking Minority Member of the Senate Committee on Governmental Affairs; and the Chairman and Ranking Minority Member of the House Committee on Energy and Commerce. We are also sending copies of this report to the Chairman of the Federal Reserve, the Chairman of the SEC, the U.S. Attorney General, the Comptroller of the Currency, and other interested parties. This report will also be available at no cost on GAO's Internet homepage at http://www.gao.gov.

This report was prepared under the direction of Barbara I. Keller, Assistant Director. Please contact her or us at (202) 512-8678 if you or your staff have any questions concerning this work. Key contributors are acknowledged in appendix III.

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Appendix I: Scope and Methodology

To determine the role investment banks played with Enron Corporation (Enron) in designing and executing structured finance transactions, we reviewed public reports and congressional testimony, interviewed private and public sector officials, and searched the Internet for relevant information. We selected five transactions involving primarily three investment banks for our analysis. The transactions do not cover all of the transactions these investment banks participated in with Enron, nor do they represent transactions with all of the investment banks with which Enron had relationships. They do, however, exemplify a variety of relationships Enron had with a number of different investment banks. The five transactions were discussed at hearings held by the Senate Committee on Governmental Affairs, Permanent Subcommittee on Investigations (PSI),in July and December 2002. These transactions are among those involving allegations that investment bankers assisted Enron in manipulating its earnings but are not those included in Enron's restatement of its financials for the period 1997 through the second quarter of 2001. We did not have sufficient public information to determine the extent of investment bank involvement in the latter transactions. Given the short time frame and the ongoing agency investigations, we did not do an independent investigation into the involvement of these investment banks in possibly aiding and abetting Enron's alleged securities fraud arising from these latter transactions. Moreover, the investment banks described themselves as passive investors, and we did not confirm or refute their assertions. We interviewed investment bank and federal financial regulatory officials[1] to obtain their views on information (facts and issues) presented at congressional hearings regarding some of the above-mentioned transactions. We also spoke with PSI staff and compared PSI's disclosures, such as descriptions of transactions, with information presented in other publicly available documentation, including the Powers Report,[2] the bankruptcy court examiner reports,[3] Securities and Exchange Commission (SEC) complaints, and complaints in private lawsuits.

[1] For purposes of this report, we use the term "federal financial regulators" to refer to the Securities and Exchange Commission, (securities regulator) and the Board of Governors of the Federal Reserve System and the Office of the Comptroller of the Currency (both bank regulators).

[2] William C. Powers, Jr., Raymond S. Troubh, and Herbert S. Winokur, Jr., *Report of Investigation by the Special Committee of the Board of Directors of Enron Corporation*, February 1, 2002. This report was produced by the Special Committee appointed by Enron and chaired by William Powers, Jr., to investigate transactions between Enron and entities connected to related parties.

To determine regulatory oversight of structured financial products, we interviewed relevant officials at the federal financial regulatory agencies (SEC, Office of the Comptroller of the Currency [OCC], and the Federal Reserve) about their oversight and examination processes for structured finance transactions. We also reviewed examination guidance and relevant GAO reports.[4] To determine investment banks' risk management and internal controls processes, we interviewed members of the Securities Industry Association as well as representatives of the investment banks whose transactions we analyzed. We also reviewed companies' annual reports and literature on financial risk management.

To understand the role investment banks' research analysts played with Enron and Global Crossing Ltd. (Global Crossing), we focused on the alleged conflicts of interest that affected the objectivity and independence of Merrill Lynch & Co., Inc (Merrill Lynch) and Citigroup Inc.'s Salomon Smith Barney Inc. research analysts. We relied on congressional testimony, legal cases, law review articles, settlement agreements, press releases, and bankruptcy filings for most of our information. To determine the issues raised and responses taken, we reviewed SEC, New York Stock Exchange, and NASD rules, proposals, releases, and documents about their new policies and rules. To determine the standards for aiding and abetting liability, we relied on case law, statutes, and law review articles.

We found no publicly available documents or references to investment bank involvement with Global Crossing in its design or implementation of structured transactions. We discuss other client relationships, primarily those involving research analysts, that investment banks had with Global Crossing. For this discussion, we relied on public documents, including those obtained by the House Committee on Financial Services.

[3] Enron filed for bankruptcy on December 2, 2001. On April 8, 2002, the Enron Bankruptcy Court authorized the appointment of an examiner to inquire into certain transactions that were not reported in accordance with generally accepted accounting principles and requested that the examiner prepare reports regarding these transactions.

[4] *Risk-Focused Bank Examinations: Regulators of Large Banking Organizations Face Challenges*, (GAO/GGD-00-48, Jan. 24, 2000); *Long-Term Capital Management: Regulators Need to Focus Greater Attention on Systemic Risk*, (GAO-GGD-00-3, Oct. 29, 1999); *Risk-Based Capital: Regulatory and Industry Approaches to Capital and Risk*, (GAO/GGD-98-153, July 20, 1998); *Financial Statement Restatements: Trends, Market Impacts, Regulatory Responses, and Remaining Challenges*, (GAO-03-138, Oct. 4, 2002); and *Financial Derivatives: Actions Needed to Protect the Financial System*, (GAO/GGD-94-133, May 18, 1994).

Investigations and litigation are under way in connection with both Enron and Global Crossing, and it was not our objective to assess, nor should this report be construed as assessing, the potential culpability of the parties involved in the transactions discussed in the report. In instances such as these, if we have good cause to believe that any potential violations of applicable laws or regulations have occurred, we refer such matters to the appropriate governmental authorities for their consideration and possible action. As noted, there are currently ongoing and extensive litigation and investigations involving Enron and Global Crossing generally.

We conducted our work between September 2002 and March 2003 in Washington, D.C. and New York, N.Y. in accordance with generally accepted government auditing standards.

Appendix II: Investment Bank Involvement with Enron in Five Structured Finance Transactions

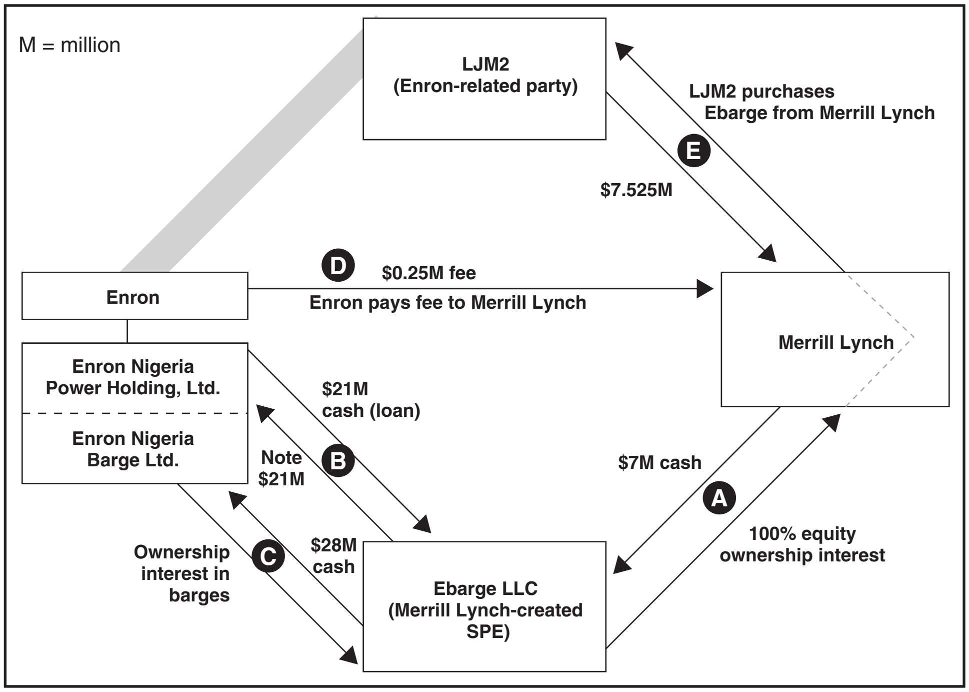
This appendix describes five transactions involving investment banks that assisted Enron Corporation (Enron) in its use of structured finance to generate recorded sales, decrease taxes, and facilitate prepay transactions that resulted in beneficial operating results. It has been alleged that Enron's accounting for these transactions was deceptive and that investment banks in various ways knowingly enabled Enron to manipulate and obscure its reported results or to evade taxes.

Enron's Nigerian Barge Transaction

Congressional hearing documents and an SEC complaint describe a transaction in which Enron reported a $12 million gain from selling interest in three power barges[1] located in Nigeria to Ebarge, LLC (Ebarge), a special purpose entity (SPE) created for this transaction by Merrill Lynch. This transaction occurred on December 29, 1999, 2 days before the year-end closing date of Enron's 1999 financial statements, reportedly to allow Enron's African Division to make its earnings target for the year. See figure 1 for a diagram of this transaction.

[1] In this transaction, Enron sold interest, or ownership, in Enron Nigeria Barge Limited, an entity whose sole assets were the three barges. Ownership interests are considered to be financial assets under FAS 140.

Figure 1: Simplified Nigerian Barge Transaction



Source: GAO.

Note: Analysis based on information from the Senate Committee on Governmental Affairs, Permanent Subcommittee on Investigations.

Merrill Lynch, through its SPE Ebarge, purchased an interest in the barges for $28 million from a Nigerian Enron subsidiary. Merrill Lynch provided $7 million in cash to Ebarge for equity ownership. The remaining $21 million was obtained as a loan from another Enron entity that received no interest payments from Ebarge. It has been asserted that Merrill Lynch, through its SPE, Ebarge, did not have equity from the purchase at risk because Enron officials made oral guarantees to arrange for the resale of Merrill Lynch's interest in the barges by June 30, 2000, with a specified return for Merrill Lynch for its involvement in the transaction. A publicly available Merrill Lynch document related to this transaction indicates that prior to entering into the transaction, Merrill Lynch received assurance from Enron that its investment would be liquidated within 6 months.[2] On

[2] Senate Committee on Governmental Affairs, Permanent Subcommittee on Investigations, *The Role of the Financial Institutions in Enron's Collapse*, Vol. 2, 107th Cong., 2nd sess., 2002, Exhibit 207.

June 29, 2000, after Enron's efforts failed to sell Merrill Lynch's interest to an independent third party, LJM2 Co-Investments, L.P., an Enron-related party, purchased Ebarge from Merrill Lynch, which ended Merrill Lynch's ownership interest in the barges. Merrill Lynch received fees and a return on its investment that totaled $775,000, equaling the allegedly promised return to Merrill Lynch for its involvement in the transaction.[3] If, as asserted, Merrill Lynch through its SPE, Ebarge, did not have an equity risk in the barges but instead had a credit exposure to Enron, then Enron should have reported this transaction as a secured borrowing instead of a $12 million gain on the $28 million sale of an asset. This accounting would have reduced Enron's net income and increased Enron's debt.

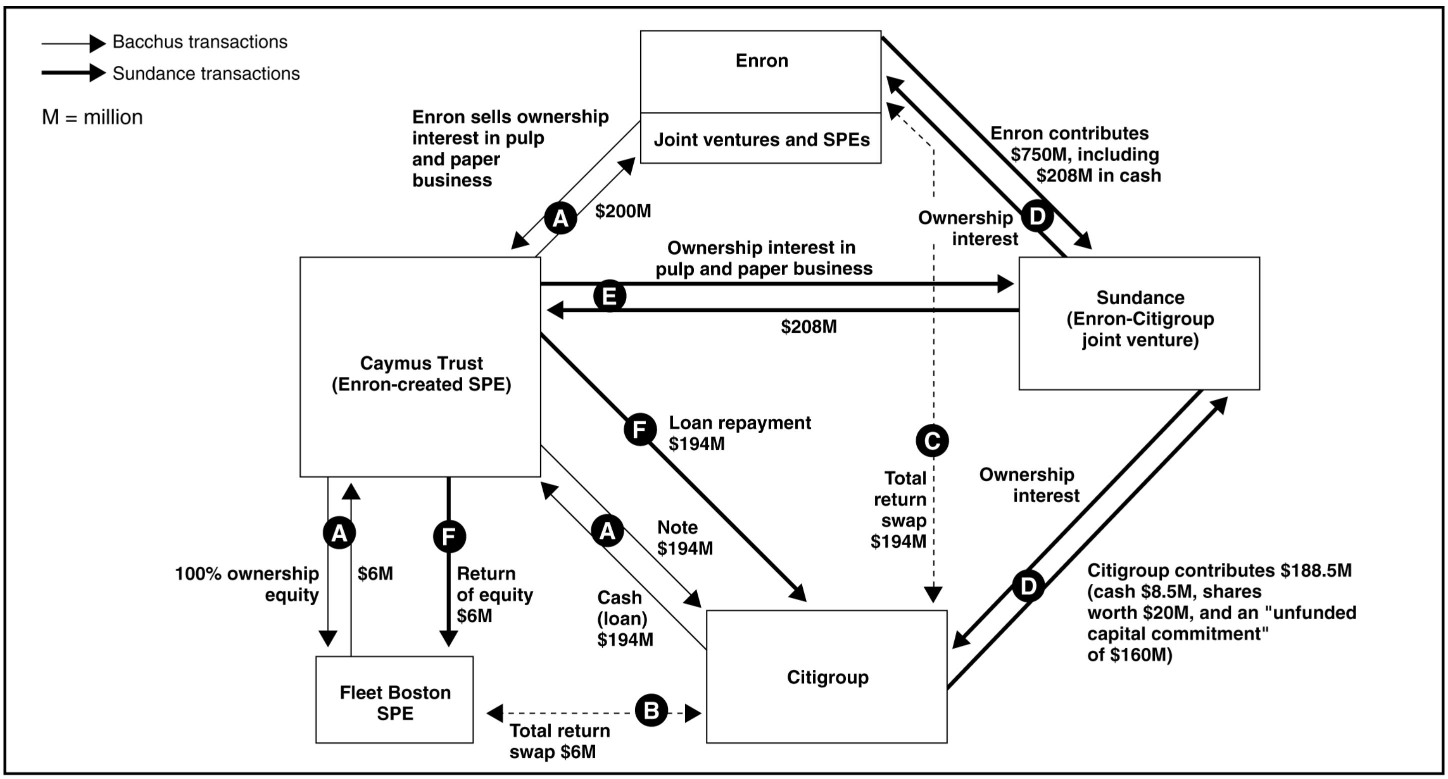
Merrill Lynch officials contended that Enron proposed and structured the transaction and also assured Merrill Lynch that its outside auditors had vetted and approved its accounting for the transaction. Merrill Lynch officials also contended that Merrill Lynch provided no accounting advice to Enron and that Merrill Lynch in fact was at risk in the transaction because, while Enron orally agreed to make a "best effort" to find another buyer for the asset, this promise was not a legally binding guarantee and there was no guarantee that Merrill Lynch would receive a certain rate of return. Merrill Lynch officials told us they undertook the transaction to accommodate Enron in the hope of receiving increased investment banking business from Enron at a later time. In February 2003, Merrill Lynch said that it had agreed in principle to pay a fine to resolve SEC civil charges that it aided Enron in fraudulently overstating Enron's earnings in 1999. The settlement in principle is subject to approval by the SEC. One of the transactions reported to be included in the settlement was this Nigerian barge transaction.

[3] It was reported that Merrill Lynch received fees of $250,000 from Enron and a $525,000 return on its 6-month investment.

Enron's Bacchus and Sundance Transactions

Publicly available documents describe another series of transactions, which Enron recorded as a sale, that involved Enron, Citigroup Inc. (Citigroup), and several SPEs. These transactions, referred to as Bacchus and Sundance, took place over a 6-month period beginning in December 2000.[4] PSI and the bankruptcy examiner concluded that the substance of the transactions was borrowing (i.e., a loan), which instead of being reported as debt was recorded as a sale with a gain that increased Enron's net income. See figure 2 for a diagram of these transactions.

Figure 2: Simplified Bacchus and Sundance Transactions



Source: GAO.

Note: Analysis based on information from the Senate Committee on Governmental Affairs, Permanent Subcommittee on Investigations.

[4] Senate Committee on Governmental Affairs, Permanent Subcommittee on Investigations, *Fishtail, Bacchus, Sundance, and Slapshot: Four Enron Transactions Funded and Facilitated by U.S. Financial Institutions*, 107th Cong., 2nd sess., 2002, S. Prt. 107-82.

The initial Bacchus transaction took place late in December 2000, just prior to the year's end. In this transaction, Enron sold ownership interest in a pulp and paper trading business to an Enron-created SPE, the Caymus Trust, for $200 million. The Caymus Trust purchase was funded by a $6 million cash equity investment by FleetBoston and a loan from Citigroup for $194 million. Enron recorded a $112 million gain from the $200 million sale of its ownership interest. It was reported that Citigroup assumed the risks of FleetBoston's ownership through a total return swap[5] and that Enron assumed Citigroup's risk associated with the $194 million loan, also through a total return swap. The effect of these agreements would indicate that Citigroup held equity risk of $6 million, or 3 percent, of the $200 million purchase and that Enron retained the remaining risk associated with the asset. However, it has been alleged that Citigroup, despite its swap contract with FleetBoston, did not have equity risk for the $6 million cash investment because Enron officials provided verbal guarantees to Citigroup to ensure the repayment related to the $6 million investment.

If Enron was in fact the only entity with equity risk, the prescribed accounting treatment would have been to consolidate the SPE into Enron's financial statements and to report the $200 million received as debt, not a sale. This accounting treatment would not have allowed the gain of $112 million that Enron recorded in its financial statements and would have increased Enron's reported debt by $200 million. The gain recorded as a result of this transaction represented about 11 percent of Enron's total net income in 2000. A publicly available Citigroup document indicates that "Bacchus is a part of a program designed to ensure that Enron will meet its year-end [targets]."[6] Another Citigroup document indicates that technical issues "may make Bacchus unworkable—Enron continues to try to resolve these unnamed issues." In this event, a Citigroup official noted that Enron would likely request a prepay transaction, which is discussed later in this appendix, for $200 million instead.[7] It was reported that Citigroup received $500,000 in fees for its participation in Bacchus, earned about $5 million in interest payments on the loan, and obtained a $450,000 yield related to the $6 million equity investment.

[5] A total return swap is a derivative transaction in which one party conveys to the other party all the risks and rewards of owning an asset without transferring actual legal ownership of the asset.

[6] Committee on Governmental Affairs, *Four Enron Transactions*, Exhibit 322d.

[7] Committee on Governmental Affairs, *Four Enron Transactions*, Exhibit 322e.

The Sundance transaction, which took place about 6 months after the Bacchus transaction, eliminated Citigroup's risk from the Bacchus transaction by redeeming Citigroup's investment. The Sundance transaction was initiated by the creation of an Enron and Citigroup joint venture, referred to as Sundance. Enron reportedly contributed approximately $750 million to Sundance in various financial assets,[8] future commitments, and $208 million in cash. Citigroup reportedly contributed $188.5 million to Sundance, comprising $8.5 million in cash, $20 million of shares in an Enron SPE, and $160 million in an "unfunded capital commitment." It was reported that Sundance immediately used the $208 million in cash to purchase the pulp and paper trading business interest from the Caymus Trust. The Caymus Trust then paid off the $194 million loan from Citigroup and returned the $6 million equity investment to FleetBoston. This activity reportedly eliminated any possible risk to Citigroup from the Bacchus transaction.

Citigroup agreed to participate in Sundance only after Enron had structured the joint venture to ensure that Citigroup's funds were virtually not at risk; moreover, Citigroup's returns would not depend on the operating results of the joint venture. In addition, Citigroup arranged to receive fees of $725,000 and a specified return of $1.1 million on its investment in Sundance; Citigroup reportedly did not share in any profits or increased value. A publicly available document prepared by Citigroup's Risk Management Group indicates that the group initially did not approve the Sundance transaction because, among other things, "the GAAP accounting is aggressive and a franchise risk to [Citigroup] if there is publicity (a la Xerox)."[9] This document also indicated the "mismanagement of the process raises real questions about the discipline and adherence to policies in the fixed income division [of Citigroup]."

At a congressional hearing that examined these transactions, Citigroup officials testified that Citigroup employees acted in good faith and understood these transactions to comply with existing law and the prevailing standards of the time. These officials also testified that their internal review committee at the time, the Capital Markets Approval Committee, had reviewed and approved the transactions and that the Risk

[8] The financial assets were Enron's ownership interests in various paper mills and real property.

[9] Committee on Governmental Affairs, *Four Enron Transactions*, Exhibit 333n. The memo refers to generally accepted accounting principles (GAAP).

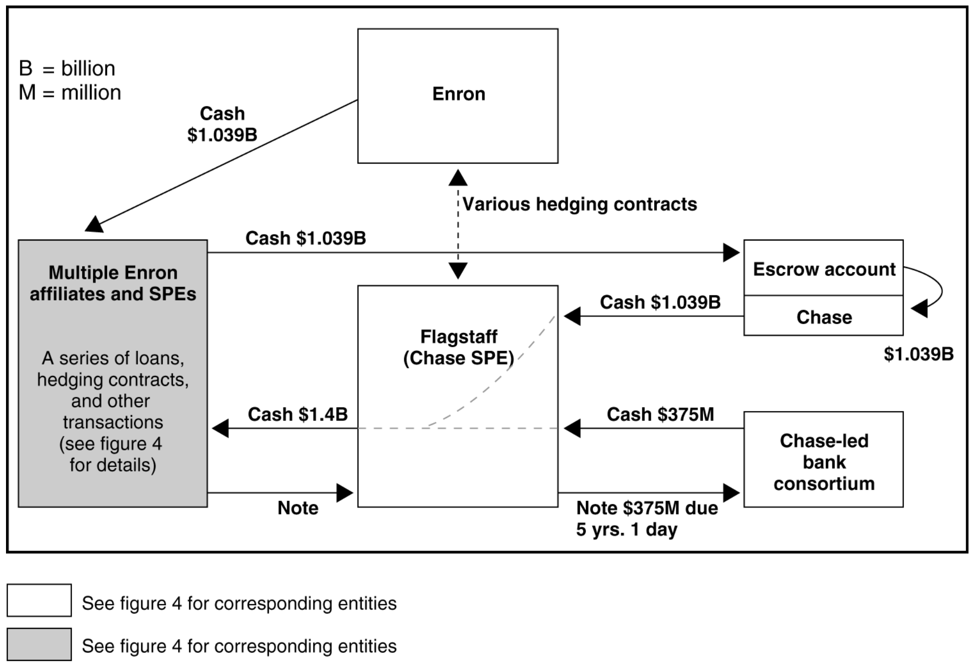
Management Group had ultimately approved it as well. Citigroup said it viewed the accounting decisions as decisions to be made by Enron and its accountants. Citigroup noted that Enron was a Fortune 10 company and that Enron's auditors from Arthur Andersen were presumed to know about the transactions and to have approved their accounting treatment.[10]

Enron's Slapshot Transaction

Publicly available reports describe a complex series of structured finance arrangements, referred to as the Slapshot transaction, which took place during the same day and included a $1.039 billion loan due later that day. These transactions involved Enron, J.P. Morgan Chase & Co. (Chase), a Chase SPE, and several Enron affiliates and SPEs and were designed to refinance an Enron paper mill and at the same time decrease Canadian taxes. Since these transactions were so complicated, we have provided a simplified diagram of the Slapshot transaction (fig. 3) and a more detailed diagram (fig. 4).

[10] The Fortune 500 list, compiled by Fortune magazine, ranks corporations by their revenue. Prior to its bankruptcy, Enron was in the first 10 and was audited by Arthur Anderson LLP, then a top five accounting firm.

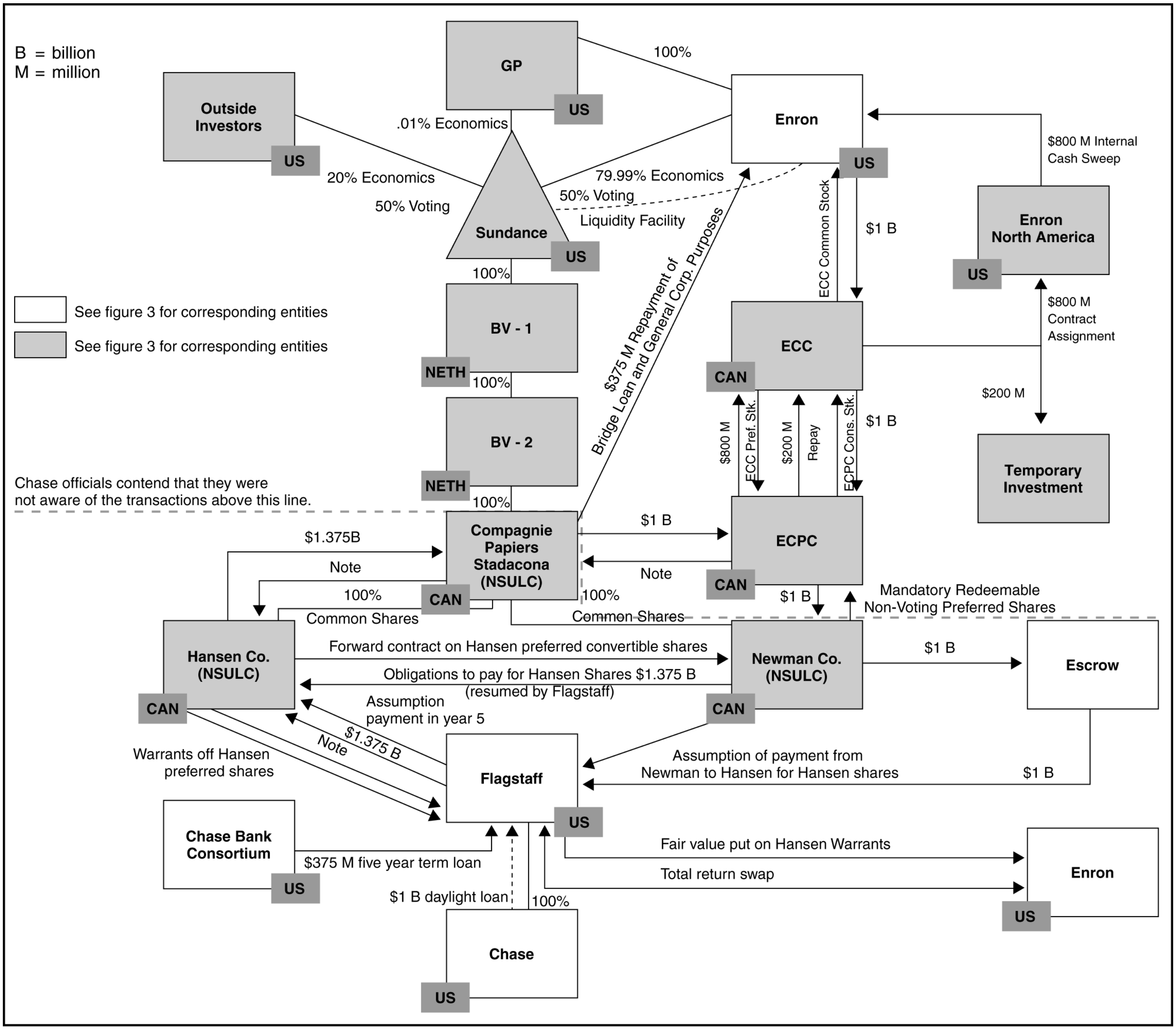
Figure 3: Simplified Slapshot Transaction



Source: GAO.

Note: Analysis based on information from the Senate Committee on Governmental Affairs, Permanent Subcommittee on Investigations.

Figure 4: Detailed Slapshot Transaction



Source: GAO.

Note: Chase officials and analysis based on information and original figure from the Senate Committee on Governmental Affairs, Permanent Subcommittee on Investigations.

Chase established a key entity in the transaction, Flagstaff Capital Corporation (Flagstaff), as a wholly owned SPE and organized a bank consortium that included three other large banks to issue a $375 million loan (due in 5 years and 1 day) that would refinance an Enron paper mill. The $375 million loan and a second loan for $1.039 billion from Chase were provided to Flagstaff. Prior to Chase's issuing the $1.039 billion loan to Flagstaff, it was reported that Chase required Enron to provide $1.039 billion in an escrow account in order to ensure the repayment of the $1.039 billion later the same day. After Flagstaff received the two loans totaling about $1.4 billion, it reportedly then loaned the same amount to an Enron affiliate. Subsequently, multiple loans and other contracts in the amounts of $375 million, $1.039 billion, and $1.4 billion reportedly were exchanged by various Enron-related entities. All of these transactions took place during the same day. A publicly available Chase document indicated that "only a $375 million net loan from Flagstaff was outstanding at the end of day one."[11]

The amounts involved in this transaction are key to understanding how Enron could reduce its Canadian taxes, which like U.S. taxes may be reduced by interest payments but not by loan principal repayments. It was reported that the parties involved in the transactions calculated that $1.039 billion was the net present value of the $1.4 billion due in 5 years and 1 day. The difference between these two amounts equaled approximately the $375 million loan. Thus, it was reported that Enron would treat the principal and interest payments on the 5-year and 1 day $375 million net economic obligation as interest payments on the $1.4 billion loan, reducing Canadian taxes by about $60 million and providing Enron with additional financial statement benefits totaling about $65 million over 5 years. In a publicly available Chase document related to the design of the Slapshot transaction, Chase indicated that an advantage of one aspect of the structure was that it provided "no road map for Revenue Canada."[12] It was reported that Chase was paid more than $5 million for designing and orchestrating the Slapshot transaction.

[11] Committee on Governmental Affairs, *Four Enron Transactions*, Exhibit 338.

[12] Committee on Governmental Affairs, *Four Enron Transactions*, Exhibit 344. On November 1, 1999, Revenue Canada became the Canada Customs and Revenue Agency whose mission is to promote compliance with, among other things, Canada's tax regulations.

At a congressional hearing that examined these transactions, a Chase official testified that Chase believed that its participation in the transactions was legal and followed established rules. He contended that Chase's Structured Finance Group had developed the generic form of this transaction and had received opinions from two leading Canadian law firms that the structure and the Canadian tax benefits the transaction provided were legal and valid. Copies of these opinions were provided to PSI. He went on to say that, with respect to the specific application of the transaction structure, each party involved in the transactions is responsible for ensuring that it correctly accounts for the transactions to which it is a party. At the time, Chase had no reason to believe that Enron and its external auditors were not doing so.

Enron's Prepay Transactions

Although prepay transactions are common in the energy industry in general, Enron's prepay transactions were allegedly unique in that they involved a circular cash flow arrangement among the three parties involved. Enron entered into prepay transactions with various investment banks, including Chase and Citigroup. Enron accounted for these prepay transactions as trading activities, which were reported as liabilities from price risk management on its balance sheet and as cash flows received from operating activities on the statement of cash flows. However, PSI and the bankruptcy examiner concluded that Enron's accounting for the transactions was inappropriate because the prepay transactions were in substance and intent loans, not trading activities, and Enron should have recorded them as debt and cash flows from financing activities. [13] Distinctions such as these are important to investors and creditors that rely on financial reporting in deciding whether to invest in or lend to an entity.

Mahonia Prepay Transaction

Publicly available reports describe prepay transactions among Enron, Chase, and an SPE, Mahonia, Ltd. (Mahonia), that was created to undertake transactions for Chase (fig. 5). In these transactions, Mahonia received cash from Chase in exchange for a commitment to deliver a fixed volume of gas at a specified future date. The purchase price was

[13] Emerging Issues Task Force (EITF) 98-10, *Accounting for Contracts Involved in Energy Trading and Risk Management Activities*, refers to energy trading activities as energy contracts entered into with the objective of generating profits on or from changes in market prices. Energy trading activities also include dealing, the activity of standing ready to trade—whether buying or selling—for the dealer's own account, thereby providing liquidity to the market.

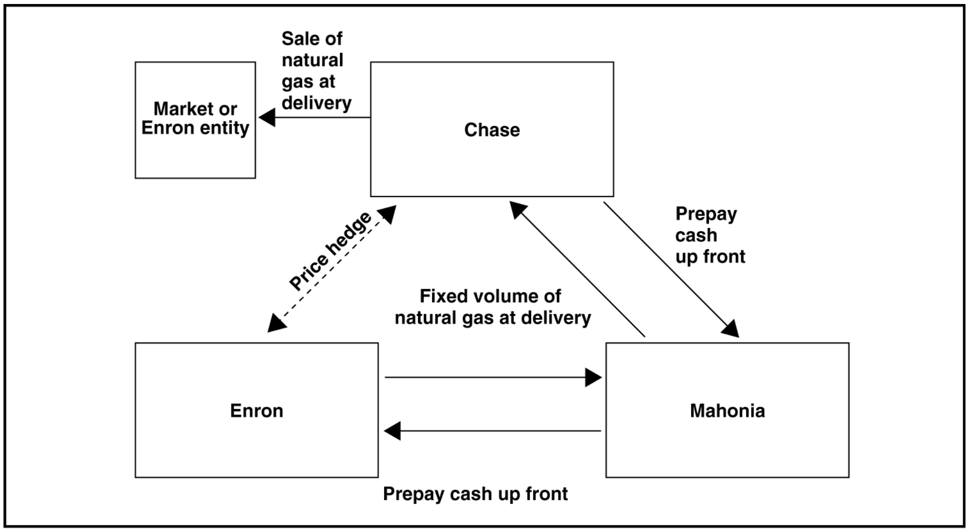
reportedly based on the estimated future market price of gas on the expected delivery date. At the same time, Mahonia and Enron entered into an identical contract, with Enron receiving from Mahonia funds that had originated with Chase. These two contracts resulted in cash for Enron and a commitment for Chase for the future delivery of a fixed volume of gas. Enron and Chase would both be at risk for changes in the price of gas. However, at the same time the two prepay contracts were executed, Enron and Chase entered into a commodity swap[14] that essentially eliminated the price risk from the transaction and ensured Chase a specified rate of return. When Chase received the delivery of gas from Mahonia (which Mahonia received from Enron) it sold the gas to the market, in some cases back to another Enron entity.[15] One publicly available Chase document indicated that "Enron loves these deals as they are able to hide funded debt from their equity analysts because they (at the very least) book it as deferred revenue or (better yet) bury it in their trading activities."[16] Between 1992 and 2001, Enron and Chase entered into 12 prepay transactions with a combined value of over $3.7 billion.

[14] Swaps can be used to reduce an entity's risk to changes in prices, currency rates, and other factors. The cash flows from swaps should be presented on the statement of cash flows in the same category as the cash flows from the items being hedged, provided that the accounting policy is disclosed.

[15] Not all of the Mahonia prepays ended with gas sales by Chase. On September 28, 2001, Chase participated in a $350 million prepay with Enron in which Enron's delivery at maturity was not going to be gas, but cash in an amount equal to the spot value of the specified quantity of gas. In this transaction, the money Chase received would come (via Mahonia) from Enron instead of from sales of gas to the market or back to an Enron entity.

[16] Committee on Governmental Affairs, *The Role of the Financial Institutions in Enron's Collapse*, Vol. 1, Exhibit 123.

Figure 5: Mahonia Prepay Transaction



Source: GAO.

Note: Analysis based on information and original figure from the Senate Committee on Governmental Affairs, Permanent Subcommittee on Investigations.

According to testimony given at a congressional hearing, an interview with us, and documents supplied to us, Chase officials said that they had understood that Enron, with its auditor's approval, had treated the prepay transactions as trading activities. After discussion with its auditor, Chase treated the prepays similarly and recorded them as trading assets on its balance sheet. Chase officials said that the firm entered into swaps to mitigate risk, as required by banking law, and that the risks of the different transactions and hedges involved in the prepays differed from those of a loan. In addition, the different components of the transaction received separate credit approvals, and each transaction stood on its own—there were no cross-default provisions and no netting of amounts, as alleged.[17] Chase officials also maintained that each of the entities involved in the transaction was legally independent of the others. Chase provided us with excerpts from other companies' financial statements describing those companies' prepays as a means of financing, recorded as liabilities for

[17] Cross-default provisions included in contracts between two parties would, on default by one of the parties, put that party in default in its other contract(s). Netting provisions in a contract provide that mutual obligations are settled at the net, as opposed to the gross, dollar value of the contracts.

price risk management.[18] Chase officials said that they believed Enron officials' assertion that Enron's prepay transactions were being properly accounted for as liabilities from price risk management in their financial statements.

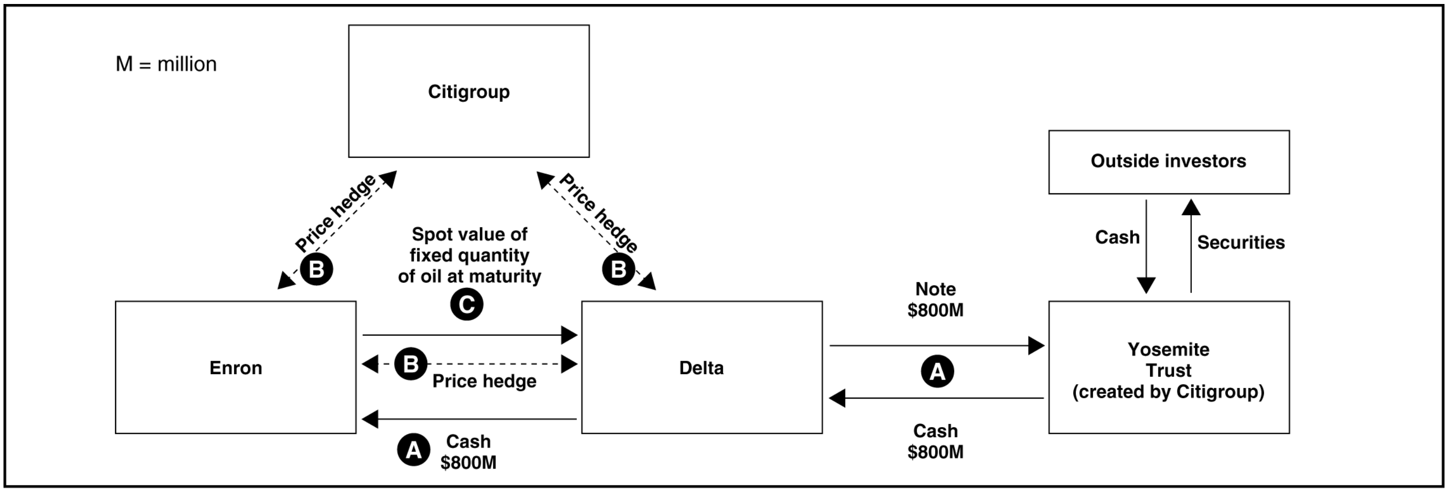
Delta-Yosemite Prepay Transaction

Another example of an Enron prepay transaction involved Enron, Citigroup, and a Citigroup-created SPE, Delta Energy (Delta), which served as a third party. It was reported that the earliest of these Citigroup prepay transactions, beginning in 1993, were similar in structure to the Chase prepay transactions. However, some of the later Citigroup prepay transactions involving Delta were funded by bond offerings to qualified institutional buyers instead of by Citigroup (fig. 6). By raising funds for the prepay transactions in this fashion, the institutional investors, rather than Citigroup, were at risk in case of Enron's bankruptcy or credit default. A total of six Enron bond offerings were issued through trusts, raising $2.4 billion for the prepay transactions. The first such trust, Yosemite, loaned the bond proceeds to Delta so Delta could initiate the prepay transactions involving Enron and Citigroup. The series of transactions that followed removed price risk, allegedly ensured a rate of return to Delta, and left Delta with the same risk it would have had if it had loaned money to Enron. One publicly available Citigroup document discussing the approval of an Enron prepay transaction indicated that Citigroup's "internal approval for the transaction will acknowledge that [Citigroup] was basically making a loan."[19] Between 1993 and 2001, Enron and Citigroup reportedly entered into 14 prepay transactions with a combined value of over $4.8 billion.

[18] We have not reviewed these transactions and cannot determine if they were similar to Enron's prepay transactions.

[19] Committee on Governmental Affairs, *Role of the Financial Institutions*, Vol. 1, Exhibit 188g.

Figure 6: Delta-Yosemite Prepay Transaction



Source: GAO.

Note: Analysis based on information and original figure from the Senate Committee on Governmental Affairs, Permanent Subcommittee on Investigations.

At a congressional hearing that examined these transactions and in an interview with us, Citigroup officials said that they had entered into the transactions in good faith and that their employees had understood that the transactions complied with existing law. The officials contended that Citigroup's internal review committee had reviewed and approved the prepaid swaps and the Yosemite transactions. The officials also said no inherent connection existed between the notes from the Yosemite transactions, in which the risk to investors was Enron credit risk, and the prepays. The proceeds of the notes were used for the prepays, the officials noted, but could have been used for other transactions, and investors were not misled about the nature of the transactions. The ultimate problem that affected the notes, in the officials' view, was that Enron had declared bankruptcy for reasons entirely unrelated to the prepaid transactions.

Appendix III: GAO Contacts and Staff Acknowledgements

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Staff Acknowledgements

In addition to those named above, Marcia Carlsen, Emily Chalmers, Orlando Copeland, Julia Duquette, Patrick Dynes, Joe Hunter, Barbara Keller, Christine Kuduk, Marc Molino, John Treanor, and Sindy Udell made key contributions to this report.

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