MINORITY STAFF
COMMITTEE ON GOVERNMENT REFORM
U.S. HOUSE OF REPRESENTATIVES
FEBRUARY 7, 2002 (REVISED JUNE 4, 2002)

FACT SHEET

How Lax Regulation and Inadequate Oversight Contributed to the Enron Collapse

As the facts about Enron's business practices continue to emerge, it is increasingly clear that Congress and federal agencies share blame for the Enron debacle. In various matters ranging from accounting practices to derivative trading, Enron and its accounting firm Arthur Andersen lobbied for and took advantage of inadequate regulation and oversight by Congress, the Commodity Futures Trading Commission (CFTC), the Securities and Exchange Commission (SEC), and the Federal Energy Regulatory Commission (FERC).

The following is a chronology of some of the congressional and regulatory actions described in this fact sheet:

1980s-90s	In a series of decisions in the late 1980s and early 1990s, FERC authorizes "power marketers" like Enron -- companies that buy and sell electricity -- to operate with little oversight of their energy-marketing activities.
1992-93	In response to a petition from Enron and an act of Congress, then-chairwoman Wendy Gramm begins process that culminates in CFTC exempting energy derivatives from regulation.
1994	The SEC exempts Enron's power marketing unit from regulation under the Public Utilities Holding Company Act (PUHCA). The decision protects Enron from a law that gives the SEC broad powers over public-utility holding companies, including the ability to check those companies' books and pre-approve securities offerings.
1994	In the face of congressional and industry pressure, the Financial Accounting Standards Board (FASB) abandons a proposal to require companies to deduct the cost of stock option grants from their reported profits.
1995	Congress passes the Private Securities Litigation Reform Act, part of the Contract with America, which makes it more difficult for shareholders to sue companies and their accountants. The Act effectively ensures that accountants can no longer

be held jointly and severally liable and it shields executives from liability for faulty financial projections.

1995 Treasury Department proposes legislation to crack down on security abuses pioneered by Enron that allowed companies to reduce tax obligations while hiding debt. The proposal is eventually dropped after strong opposition from Wall Street.

1997 The SEC exempts Enron's foreign operations from the Investment Company Act, which gives the SEC sweeping powers to regulate holding companies' activities, including their investment policies, affiliate transactions, capital structure, shareholder reports, and accounting.

2000 In the face of opposition from Congress, FASB waters down its proposal to eliminate an accounting method favored by the high-tech industry for reporting the costs of mergers.

2000 Then-SEC Chairman Arthur Levitt tries to eliminate auditor conflicts of interest by proposing a rule to prevent accountants from performing certain consulting services for companies they audit. After heavy pressure from members of Congress, the SEC adopts a watered-down version of the rule.

2000 After heavy lobbying by Enron, Congress passes the Commodities Futures Modernization Act as part of an omnibus spending bill. The Act codifies and expands CFTC's rule exempting energy derivative contracts from regulation. It also ensures that EnronOnline -- the company's online energy trading forum -- is not regulated.

I. CONGRESS, CFTC, AND ENERGY DERIVATIVE CONTRACTS

A. CFTC and Energy Derivative Contracts (1992-93)

Enron began as a traditional natural-gas pipeline business but it moved into the trading of derivatives -- complex financial instruments whose value is based on an underlying commodity or financial variable. By the time of its collapse, Enron was essentially a derivative-trading firm. Experts estimate that Enron was the fifth-largest commodity derivatives dealer in the United States.[1] It appears that Enron used derivative trades to inflate income, hide losses, and misrepresent the true nature of its business.

As a result of two actions in 1993 initiated by Wendy Gramm, then the chairwoman of

[1]*The Fall of Enron: Enron's Web of Complex Hedges, Bets,* Los Angeles Times (Jan. 31, 2002).

CFTC, Enron was effectively exempted from CFTC oversight of its derivative trading.

In October 1992, President Bush signed into law the Futures Trading Practices Act of 1992, which had passed both houses of Congress with overwhelming support. The Act included a provision authorizing CFTC to exempt classes of contracts from almost all provisions of the Commodity Exchange Act (CEA) if the Commission found, among other things, that such an exemption "would be consistent with the public interest."

On November 16, 1992 -- less than two weeks after Bill Clinton was elected President -- Enron and several other energy companies petitioned CFTC for an exemption from regulatory oversight for energy derivative contracts. Then-chairwoman Gramm -- who resigned from the Commission in January 1993 -- initiated a rapid process which culminated in CFTC issuing a final order in April approving the exemption. The order even exempted energy derivative contracts from CFTC's general authority under the CEA to protect against contracts designed to defraud or mislead.[2] In March 1993, five weeks after stepping down, Ms. Gramm was named to Enron's board of directors.

Rep. Glen English, who sponsored the Futures Trading Practices Act, criticized CFTC's decision to exempt energy derivatives from CFTC's anti-fraud authority. Rep. English said the decision "opened the door to serious fraud" and added that "[i]n the 18 years I've been in Congress, this is the most irresponsible decision I've come across."[3]

The second action by CFTC, in January 1993, exempted a form of derivative called a "swap" from regulation. A swap involves two parties agreeing to exchange cash flows with respect to some underlying economic variable. In a basic interest-rate swap, for example, a borrower with a variable-rate loan agrees to pay a dealer fixed sums in return for the dealer making the fluctuating payments on the loan. Effectively, the borrower is able to convert an unpredictable variable-rate loan into a predictable fixed-rate loan by passing risk onto the dealer. This allows the borrower to hedge against fluctuations in interest rates. Swaps and futures are functionally the same; they both allow parties to hedge against risk. However, at Congress' direction, CFTC exempted swaps from most market regulations. By the time Enron collapsed, it had apparently become a significant player in swaps markets.[4]

B. Congress and Energy Derivative Contracts (2000)

---

[2] 7 U.S.C. § 6b.

[3] *Federal Futures Agency Getting 'Hammered' in Congress,* Associated Press (May 9, 1993).

[4] *See, e.g, Collapse of Enron Triggers Confusion in Swaps Contracts,* Financial News (Dec. 10, 2001).

In December 2000, Congress passed an omnibus spending bill that included provisions sought by Enron further reducing CFTC's oversight of energy derivatives and allowing Enron to trade energy contracts electronically without oversight.

In the aftermath of the near-collapse of the hedge fund Long-Term Capital Management in 1998, many experts and policy makers -- including the head of CFTC -- tried to increase regulation or disclosure of derivatives trading. However, a broad industry coalition including Enron worked with sympathetic regulators and legislators to resist this pressure for more oversight and was even able to roll back regulation. According to the *Wall Street Journal*, Enron's "lobbying campaign was so aggressive that staff members of one congressional committee asked a lobbyist for an Enron-led industry group to negotiate major aspects of the bill directly with regulators."[5]

Enron's lobbying paid off when Congress passed the Commodity Futures Modernization Act in December 2000 as part of an omnibus spending bill. The bill expanded and codified the CFTC's decision exempting energy contracts from oversight. According to the *Wall Street Journal*, this "provision was sometimes referred to by Capitol Hill staff as the 'Enron Point.'"[6] The bill also exempted electronic energy trading -- such as that conducted by EnronOnline, Enron's internet trading system -- from CFTC oversight. And the bill effectively prevented CFTC from exercising any oversight over swaps.

II. CONGRESS, THE SEC, AND ACCOUNTING STANDARDS AND OVERSIGHT

The failure of Congress, the SEC, and private-sector accounting bodies to toughen accounting standards or enforce existing standards allowed Enron to hide debt and inflate revenues.

A. Private-Sector Oversight and Regulation

While the SEC has the statutory authority to set accounting principles, for over 60 years it has relied on the accounting industry to police and regulate itself.[7] Regulation is done primarily by the following private-sector bodies: the Financial Accounting Standards Board (FASB), the

---

[5]*Out of Reach: The Enron Debacle Spotlights Huge Void in Financial Regulation*, Wall Street Journal (Dec. 13, 2001).

[6]*Out of Reach: The Enron Debacle Spotlights Huge Void in Financial Regulation*, Wall Street Journal (Dec. 13, 2001).

[7]Testimony of Robert Herdman, chief accountant, Securities and Exchange Commission, before the Subcommittee on Capital Markets, Insurance, and Government Sponsored Enterprises and the Subcommittee on Oversight and Investigation, House Committee on Financial Services (Dec. 12, 2001).

primary accounting standard-setter for corporations, which is funded and overseen by accounting firms and their clients; the American Institute of Certified Public Accountants (AICPA), the industry's major trade association and lobbying group, which establishes auditing standards and takes disciplinary action against its members; and the Public Oversight Board (POB), which is partially funded by accounting firms and which monitors AICPA's oversight of accountants.

Critics have accused these private bodies of inadequately regulating and disciplining the accounting industry. They point to Andersen's roles in orchestrating and approving questionable accounting practices by Enron as evidence that the accounting industry needs stronger and more independent oversight.

On January 17, 2002, SEC Chairman Harvey Pitt -- who previously served as a lawyer for all Big Five major accounting firms and for AICPA -- outlined proposals to improve regulation of the accounting industry. Those proposals included a greater role for FASB and the SEC and the creation of a new regulatory body composed of members of the public that would focus on discipline and quality control. Mr. Pitt's proposals, which were negotiated with the accounting industry, have been criticized as inadequate.[8] According to Lynn Turner, former chief accountant at the SEC under Mr. Pitt's predecessor, Arthur Levitt, the proposal "falls way short."[9]

B. Accounting and Consulting Conflicts of Interest

Accounting firms have become increasingly reliant on revenue from consulting and other non-audit operations, which often exceed the revenue from comparatively stagnant auditing practices. For example, Enron reportedly paid Arthur Andersen $27 million for consulting and other services and $25 million for audit-related services in 2000.

As far back as the 1960s, the SEC expressed concerns about the independence of auditors being compromised when accounting firms served as consultants to the companies they audited. AICPA delayed taking action. As the *Washington Post* reported, AICPA:

> appointed a committee to study the issue -- and then, at the SEC's request, another committee to study the issue further. By the time the second committee completed its report, there had been considerable turnover at the SEC, "and the new group . . . did not pursue the issue," according to a history by [a former AICPA president].[10]

---

[8] *Dirty Books? Accounting Debacles Spark Calls for Change*, Wall Street Journal (Feb. 6, 2002).

[9] *Accounting for Enron: Pitt's SEC Plan for Self-Regulation of Accountants May Have Pitfalls*, Wall Street Journal (Jan. 18, 2002).

[10] *Doing a Number on Reforms*, Washington Post (Jan. 24, 2002).

In June 2000, then-SEC chairman Arthur Levitt tried to enact a rule that would have prevented accounting firms from providing certain consulting and other non-audit services to firms whose books they audit. The accounting industry strongly resisted these efforts and lawmakers in Congress threatened to cut the SEC's appropriations if the rule was not watered down.[11]

In November 2000, the SEC adopted a weaker version of the proposed rule which placed some limits on non-audit services. Several of these limits were not new but were rather codifications of existing rules by private accounting bodies. The watered-down rule was the product of negotiations with the Big Five accounting firms and AICPA and, according to Mr. Levitt, it "reflects, to a great extent, their concerns."[12]

C. Accounting for Special Purpose Entities (SPEs)

Special Purpose Entities or SPEs are created by a sponsor to carry out a specified purpose or activity and are common in modern financial markets. SPEs use partnerships and trusts to hold assets and finance debt. Companies generally are allowed to push debt off their balance sheets and into an SPE as long as (1) the company owns no more than 50% of the SPE, and (2) at least 3% percent of the SPE's capital is contributed by outside investors who both control the SPE and possess the risks and rewards of owning the SPE's assets. Enron violated or skirted these requirements by creating SPEs that it effectively controlled so as to hide debt and inflate the company's revenues. Furthermore, what little information Enron disclosed to its shareholders about its SPEs was buried in oblique footnotes to the company's financial statements.

Dating back to the 1980s, regulators have expressed concerns about such misuses of SPEs to FASB, but to little avail. The SEC first asked FASB to look at the accounting for SPEs in 1985. In the late 1980s, SEC staff repeatedly raised concerns about SPEs and asked a private-sector FASB task force to establish rules for SPEs. However, "[t]he end result was a set of weak rules that continue to mask from investors many off balance sheet transactions."[13]

The SEC has continued to push FASB to clarify what steps a company must take if it wishes to avoid consolidating SPEs onto the company's balance sheet. Such steps could include

---

[11]*Doing a Number on Reforms*, Washington Post (Jan. 24, 2002)*; TRB from Washington: Accounting*, New Republic (Feb. 11, 2002).

[12]Statement of SEC Chairman Arthur Levitt, SEC Open Meeting on Market Structure Initiatives in the Options and Equities Markets, and Rules Governing Auditor Independence (Nov. 15, 2000) (on line at www.sec.gov/news/extra/levonai.htm).

[13]Testimony of Lynn Turner, former chief accountant, Securities and Exchange Commission, before the Senate Governmental Affairs Committee (Jan. 24, 2002).

requiring the owner of the SPE to provide more equity and making sure that the SPE's owner actually bears the risks associated with the SPE. Further reform could also include requiring greater disclosure by companies about their transactions with SPEs. In its 2000 annual report to Congress, the SEC stated that "existing standards do not adequately address circumstances involving" SPEs and urged FASB "to continue its efforts to provide consolidated guidance concerning these entities."[14] FASB has reportedly been struggling to create a standard for SPEs since late 2000.[15]

D. Stock Options and Other FASB Initiatives

In the early 1990s, FASB sought to require companies to treat stock option grants to employees as a form of compensation which, like other compensation, would have to be deducted from the companies' profits. FASB argued that its proposal would give investors a more accurate assessment of company profits. For example, in 2001, Microsoft declared a profit of $7.3 billion; if the cost of the company's stock options that year had been included, Microsoft's profit would have been cut by a third.[16]

The FASB proposal was strongly opposed by the high-tech industry and its allies in Congress. In May 1994, the Senate overwhelmingly approved a resolution condemning the FASB rule. FASB persisted, however, and in October 1994, a number of Senators introduced a bill, S. 2525, that would have required a majority vote of the SEC before any FASB rule went into effect -- effectively ending FASB's independence. By the end of 1994, FASB had given in. Companies were allowed to avoid deducting the cost of most stock options from their earnings as long as they disclosed the impact of such options on net profits and earnings per share in footnotes to their financial statements.[17] Had FASB's proposed rule been implemented, the profits that Enron claimed from 1998 through 2000 would have been reduced by around $188 million.[18]

In 1999, FASB sought to eliminate an accounting method favored by the high-tech industry for reporting costs for mergers and acquisitions. Known as the "pooling of interests" or "pooling" method, this accounting technique did not require a merged company to show the premium it paid for the intangible "good will" assets of the acquired company, such as brand

---

[14]Annual Report for Fiscal Year 2000, Securities and Exchange Commission.

[15]*Enron Mess: What Is a Subsidiary, Anyway?* Daily Deal (Feb. 4, 2002).

[16]*Full Disclosure*, National Journal (Feb. 22, 2002).

[17]*Firms Campaign To Soften FASB Stock Option Rule*, Corporate Accounting International (May 1, 1995); *FASB Interpretation No. 44*, CPA Journal (July 1, 2000).

[18]*Full Disclosure*, National Journal (Feb. 22, 2002).

name, market prospects, and reputation.[19] FASB claimed its proposal would give investors more complete information about the true costs of a merger. In addition, FASB argued that the merged company should record depreciation in the value of the good will as a reduction in profits.[20] The proposal soon ran into opposition from members of Congress, who wrote letters, held hearings, and, in October 2000, introduced a bill, H.R. 5365, that would have imposed a temporary moratorium on FASB's proposal until further study was completed. In 2000, FASB backed down in part by agreeing that a decline in good will need be noted in profit-and-loss statements only when there is obvious damage to the value of the good will.[21]

E. Peer Oversight

Critics have alleged that Arthur Andersen's failure to adequately account for Enron's transactions is attributable in part to shortcomings in the peer-review process, under which accounting firms review each others' work every three years. Under the current system, peer reviews are given final approval by an AICPA committee, and only AICPA has the power to take any disciplinary action. No Big Five accounting firm has ever failed a peer review.[22]

On January 2, 2002 -- shortly before it disclosed that it shredded Enron-related documents -- Andersen announced the results of a newly completed peer review of its operations by Deloitte & Touche. According to Andersen, the review found "that its system of accounting and auditing quality has been deemed to provide reasonable assurance of compliance with professional standards, following the most extensive peer review in the firm's history."[23]

In 2000, in the wake of public hearings held by the SEC regarding an initiative to tighten auditor-independence rules, then-chairman Levitt commissioned an internal SEC report to look into the issue.[24] The draft report found that "accounting firms repeatedly unearthed what the SEC

---

[19]*Full Disclosure*, National Journal (Feb. 22, 2002).

[20]*Full Disclosure*, National Journal (Feb. 22, 2002).

[21]*Full Disclosure*, National Journal (Feb. 22, 2002). See also *Accounting Changes To Affect Network Mergers*, Network World (Jan. 29, 2001) (noting that FASB's revised approach to good will was "viewed as a possible compromise by many in the high-technology community, which is cautiously optimistic about the FASB's direction").

[22]*The Enron Scandal*, BusinessWeek (Jan. 28, 2002).

[23]Arthur Andersen, *Andersen Announces Results of Audit Quality Peer Review* (Jan. 2, 2002) (on line at http://www.andersen.com/website.nsf/content/MediaCenterNewsReleaseArchivePeerReview010202!OpenDocument).

[24]*Peer Pressure: SEC Saw Accounting Flaw*, Wall Street Journal (Jan. 29, 2002).

staff considered major flaws in the way audits were conducted -- but nevertheless gave each other clean bills of health in public reports of the reviews."[25] The draft report also included recommendations for strengthening oversight of the accounting industry.[26]

The draft report was apparently abandoned in August 2001 following the transition to the current SEC Chairman, Harvey Pitt.[27] The reform proposals recently put forward by Mr. Pitt include a proposal to replace the current peer-review process with a new process using permanent staff unaffiliated with an accounting firm.

III. CONGRESS AND THE PRIVATE SECURITIES LITIGATION REFORM ACT OF 1995

In the aftermath of the savings and loan scandal of the late 1980s and early 1990s, accounting lobbyists banded together to head off efforts to make it easier for investors to sue accounting firms.[28] Emboldened by their success, accounting firms then joined forces with business interests to lobby for protections for companies and their accountants from investor lawsuits. Those efforts paid off in December 1995, when Congress overrode a presidential veto to enact the Private Securities Litigation Reform Act as part of the Republican Contract with America. Current SEC Chairman Harvey Pitt, then a lawyer for the accounting industry, was a "central figure in getting the 1995 law adopted."[29]

The Act contained a number of measures designed to limit shareholder lawsuits. These included provisions shielding executives from liability for making dubious financial projections; eliminating coverage of securities fraud by the Racketeer Influenced and Corrupt Organizations Act; and delaying discovery proceedings in shareholder suits. The SEC ultimately backed the "safe harbor provision" regarding financial projections; some have suggested that this action was taken in response to threats of a congressional budget cut.[30]

---

[25]*Peer Pressure: SEC Saw Accounting Flaw*, Wall Street Journal (Jan. 29, 2002).

[26]*Peer Pressure: SEC Saw Accounting Flaw*, Wall Street Journal (Jan. 29, 2002).

[27]*Peer Pressure: SEC Saw Accounting Flaw*, Wall Street Journal (Jan. 29, 2002). An SEC spokeswoman denied that Mr. Pitt played any role in killing the report. *Id.*

[28]*Now Who, Exactly, Got Us into This?*, New York Times (Feb. 3, 2002).

[29]*Now Who, Exactly, Got Us into This?*, New York Times (Feb. 3, 2002).

[30]At the time of the SEC's endorsement, the Senate had passed a 10-percent cut in the SEC's budget. *SEC Backs Curbing of Lawsuits; Path Is Cleared To Pass Bill Limiting Frivolous Litigation*, Baltimore Sun (Nov. 18, 1995). A Public Citizen official charged that "[then SEC Chairman] Levitt has reversed his position and sold out small investors to buy some protection

Another provision of the Act significantly reduced the potential liability of defendants such as accounting firms in securities class actions by generally eliminating joint and several liability. Unless a plaintiff can show "knowing" securities fraud, a defendant can be found liable only to the extent that the defendant is at fault. Plaintiffs' lawyers and securities law experts say that this provision "laid the groundwork for accounting practices allegedly performed by Arthur Andersen that hid huge discrepancies between Enron's real and reported health. It was strongly supported by the Big Five accounting firms when it was enacted in 1995."[31]

At the time of the Act's passage, an official at the public interest group Public Citizen predicted the new law would lead to a "slow but mounting financial crime wave."[32] That prediction appears to have been borne out in recent years, as "a record number of corporations have restated their earnings, costing investors billions."[33]

IV. FERC AND POWER MARKETERS

Better oversight of Enron's energy-marketing transactions might have given regulators an early indication of the company's problems.[34] While FERC did not regulate the parent Enron corporation, it did regulate eleven of Enron's subsidiaries, including five electricity marketers.[35] FERC also regulated natural-gas pipelines in which Enron owned an interest.

Ken Lay was one of the leading advocates for deregulation of energy markets.[36] To a

---

for his agency's budget." *Another Hurdle Cleared*, International Accounting Bulletin (Nov. 27, 1995).

[31]*Securities Law and Bankruptcy at Issue*, National Law Journal (Jan. 28, 2002).

[32]*Auditors Shielded by Fraud Law Courts*, Los Angeles Times (Jan. 28, 2002).

[33]*Now Who, Exactly, Got Us into This?*, New York Times (Feb. 3, 2002).

[34]During a House hearing, Rep. Markey stated that "the Enron collapse raises a fundamental question about the nature and accuracy of oversight over traders who are marketing electricity." *FERC To Consider Disclosure Requirements for Financial Instruments*, Inside FERC (Dec. 17, 2001).

[35]Testimony of Patrick Wood, III, chairman, Federal Energy Regulatory Commission, before the Senate Energy and Natural Resource Committee (Jan. 29, 2002).

[36]Testifying before Congress in 1996, Mr. Lay estimated "that the potential consumer savings from a competitive restructuring of the electric industry could be between $60 and $80 billion per year. Other estimates have been as high as $100 billion a year. We think these savings can be achieved by reforming both the retail and the wholesale side of the business." Testimony of Ken Lay before the House Commerce Committee's Subcommittee on Energy and

large extent, Mr. Lay was successful in his lobbying efforts, as Congress and FERC moved towards a more market-based approach to regulating the energy industry throughout the 1990s. Those efforts -- which date back to passage of the Public Utility Regulatory Policies Act of 1978 -- received new impetus with passage of the Energy Policy Act of 1992 and with FERC's issuance in April 1996 of Orders 888 and 889. Those orders were intended to lay out a transition to competitive wholesale electricity markets.

As a result, a series of FERC decisions in the late 1980s and early 1990s, Enron and other "power marketers" were able to operate with little if any oversight. Many of the regulations which customarily apply to traditional public utilities have been waived or relaxed for power marketers. Power marketers are allowed to sell power at market-based rates.[37] They need not file their accounting records or their individual contracts with FERC and their requests for blanket approval for all future issuances of securities and assumptions of liability are routinely granted.[38] They do have to file quarterly reports on their energy transactions, but these have apparently been ignored by the Commission.

V. THE SEC AND PUHCA AND THE INVESTMENT COMPANY ACT

A. PUHCA (1994)

Enacted in 1935, the Public Utility Holding Company Act (PUHCA) was designed to eliminate unfair practices and other abuses by multistate electricity and natural-gas holding companies. The Act gives the SEC oversight over holding companies, which are defined as enterprises that directly or indirectly own 10% or more of stock in a public utility company. Under PUHCA, holding companies must maintain certain accounts and records, which are subject to SEC review, and must obtain the SEC's approval before purchasing or issuing securities. The SEC also regulates mergers and diversification proposals of holding companies.

In 1994, an SEC staff ruling exempted Enron Power Marketing, the company's wholesale

---

Power (May 15, 1996).

[37]*How to Get Market-Based Rate Approval*, Federal Energy Regulatory Commission (undated) (on line at http://www.ferc.gov/electric/pwrmkt/PMhow.htm).

[38]*How to Get Market-Based Rate Approval*, Federal Energy Regulatory Commission (undated) (on line at http://www.ferc.gov/electric/pwrmkt/PMhow.htm). "If a power marketer requests blanket approval, a notice will be published in the Federal Register establishing a period during which protests may be filed. Absent a request to be heard within the period set forth in the notice, the power marketer is authorized to issue securities." *Id.*

power-selling unit, from PUHCA.[39] Questions have recently been raised about the SEC's decision. According to one consumer group, making Enron subject to PUHCA:

> would have resulted in significant restrictions on Enron's broadband and foreign utility investments, as well as inter-affiliate transactions, and required SEC pre-approval of Enron securities issuances and direct oversight of books and records. Effective administration of PUHCA could have prevented, minimized or provided "early warning" of the events that precipitated Enron's collapse.[40]

While conceding that "Enron is a tragedy for our entire system of disclosure regulation," the SEC has argued that "the tragic collapse of Enron is not a result of its classification or lack of classification as a public utility holding company."[41] The SEC has, however, implicitly underscored the importance of PUHCA by arguing that any repeal of PUHCA should be accompanied by measures giving FERC and state regulators greater access to the books and records of holding companies and their affiliates.[42]

B. The Investment Company Act (1997)

Questions have also been raised about a 1997 SEC decision that gave Enron's foreign operations a broad exemption from the Investment Company Act of 1940. The Act requires investment companies to register with the SEC and subjects them to extensive regulation covering virtually all of their activities, including composition and election of boards of directors, investment policies and types of investments, transactions with affiliates, capital structure, reports to shareholders and the SEC, books and records, and accountants and auditors.

According to the *New York Times*, the Act "would have prevented [Enron's] foreign operations from shifting debt off their books and . . . barred executives from investing in

---

[39]*Accounting for Enron: SEC Feels Heat over Exemptions to Enron*, Wall Street Journal (Jan. 21, 2002).

[40]Letter from Marty Kanner, Consumers for Fair Competition, to Rep. Joe Barton (Jan. 25, 2002). Similarly, the Senate Energy Committee heard testimony that "[p]roper application of PUHCA would have identified and prevented Enron's ill-fated activities." Testimony of Scott Hempling before the Senate Energy and Natural Resources Committee (Feb. 6, 2002).

[41]*See* Testimony of Isaac Hunt, Jr., commissioner, Securities & Exchange Commission, before the Senate Energy and Natural Resources Committee (Feb. 6, 2002).

[42]Testimony of Isaac Hunt, Jr., commissioner, Securities & Exchange Commission, before the Senate Energy and Natural Resources Committee (Feb. 6, 2002).

partnerships affiliated with the company."[43] Enron was reportedly able to get the exemption by hiring the former boss of a leading SEC staffer; it was the staffer who later issued the exemption.[44]

VI. THE TREASURY DEPARTMENT AND MONTHLY INCOME PREFERRED SHARES (MIPS)

As reported by the *Wall Street Journal*, Enron was one of the pioneers in using so-called Monthly Income Preferred Shares (MIPS) to simultaneously hide debt and reduce its tax bill.[45] In 1993, in the first of several similar deals, Enron set up a Caribbean subsidiary, Enron Capital, L.L.C., which sold $214 million in preferred shares -- the MIPS -- to investors. The subsidiary then loaned the money to Enron, to be paid back over fifty years or more. Enron treated this transaction as a loan for tax purposes, deducting its interest payments to the subsidiary. Enron did not report the $214 million as debt on its balance sheet, however; instead the deal was described as "preferred stock of subsidiary companies" or equity.

Using MIPS, Enron and other companies accounted for their transactions in one way on their balance sheets and another way on their tax returns. The Treasury Department objected to this practice, considering MIPS to be a particularly aggressive and egregious tax abuse. However, investment banks, law firms, and corporations were able to defeat repeated efforts by the Treasury Department to crack down on the use of MIPS in the 1990s. In late 1995, for example, Treasury placed MIPS high on a list of corporate tax and accounting abuses to target and it put forward a legislative proposal to redress these abuses that would have increased government revenues by $800 million over five years.[46] In response, the backers of MIPS "assembled a flotilla of well-connected lobbyists."[47] With the assistance of sympathetic legislators, the lobbyists were able to beat back Treasury's efforts to prevent abuse of MIPS.

---

[43] *1997 Exemption Set Stage for Enron Woes*, New York Times (Jan. 23, 2002).

[44] *1997 Exemption Set Stage for Enron Woes*, New York Times (Jan. 23, 2002).

[45] *How Treasury Lost in Battle To Quash a Dubious Security*, Wall Street Journal (Feb. 4, 2002).

[46] *How Treasury Lost in Battle To Quash a Dubious Security*, Wall Street Journal (Feb. 4, 2002).

[47] *How Treasury Lost in Battle To Quash a Dubious Security*, Wall Street Journal (Feb. 4, 2002).