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.