Memo to: Oaktree Clients

From: Howard Marks

Re: Learning From Enron

> The investigation was not completed until June . . . The testimony had brought to light a shocking corruption, . . . a widespread repudiation of widespread standards of honesty and fair dealing . . . and a merciless exploitation of the vicious possibilities of intricate corporate chicanery. The public had been deeply aroused by the spectacle of cynical disregard of fiduciary duty . . .

Part of a draft post-mortem for Enron? Could be, but it's not. It's a passage from one of my favorite books, "Wall Street Under Oath." The book was written in 1939 by Ferdinand Pecora, who served as Counsel for the Senate Committee on Banking and Currency investigating the Crash of '29 and went on to become a Justice of the Supreme Court of New York. It recounts the outrageous 1920s conduct of commercial/investment bankers that inspired the creation of the Securities and Exchange Commission and the enactment of securities laws that govern our industry to this day. The bankers' conduct was rife with self-dealing, conflicts of interest and gross dishonesty.

In other words, reviewing the 1920s reminds us of history's tendency to repeat.

What Can We Learn From Enron?

An article about Enron in the December 5 Wall Street Journal made a big impression on me. Headlined "Behind Enron's Fall, a Culture of Operating Outside the Public's View," it read in part as follows:

> It was vintage Enron: minimal disclosure of financial information that, in retrospect, was central to understanding the complex company . . . . virtually unseen until the end was an Enron culture that contained the seeds of its collapse, a culture of highly questionable financial engineering, misstated earnings and persistent efforts to keep investors in the dark.
>
> Senior Enron executives flouted elementary conflict-of-interest standards. The company hired legions of lawyers and accountants to help it meet the letter of Federal securities laws while trampling on the intent of those laws. It became adept at giving technically correct answers rather than simply honest ones.

The article, and particularly the last sentence quoted above, prompted me to write a year-end memo to Oaktree' s staff stressing the importance of taking "the high road" and describing Enron as "a pretty good example of what Oaktree doesn't want to be."

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What we knew about Enron in December was a fraction of what we know today. It's now clear that there are many lessons to be learned from it.

Questionable Transactions – Form Over Substance

As little as six months ago, Enron was considered an exemplar of corporate growth and ingenuity. Little did we know, however, that its inventiveness had been directed not at developing highly profitable businesses, but rather transactions that could be used to paint an inaccurate picture of Enron and still squeak by under Generally Accepted Accounting Principles. Some of these transactions were breathtaking in their duplicity and chutzpah.

The most notorious examples relate to the creation of **off-balance sheet partnerships**. These "special-purpose entities" were used to hide debt and pump profits. As our analysts studied Enron, they couldn't believe the lengths to which its management had gone.

When Enron wanted to increase its debt to an extent that would have jeopardized the credit rating that was so essential to its business, it formed partnerships to do the borrowing away from Enron's balance sheet. Off-balance sheet partnerships are common, but for their debt not to be consolidated with that of the parent, outsiders must provide at least 3% of their equity capital. The self-interest of the providers of this risk capital, it is thought, will serve to keep the entities independent.

But Enron had a problem. It wanted to avoid consolidation with its own financial statements, but it feared that vigilance on the part of outside investors would prevent Enron from doing all it wanted in the partnerships. Investors with capital at risk would care about how much debt was taken on, what the partnerships bought with the borrowed money, and at what prices. They might even worry about having Enron executives running the partnerships, which did business with Enron. So outside equity capital had to be attracted to satisfy GAAP, but truly self-interested investors had to be avoided if Enron was to maintain its flexibility.

How could outsiders be enticed to invest capital without caring? Simple: guarantee the results. The key was for Enron, not the investors, to absorb the risk. This is accomplished by promising a full return of capital, and returns up to 30% a year in some cases, and backing the promise with Enron stock. Certainly the security provided by this investment-grade company's soaring stock would be solid. Enron also guaranteed some of the loans to these entities.

So with the "outside" investors' risk covered by Enron and the "independent" partnerships squarely under its control, they could be used any way Enron chose. When assets declined in value, the partnerships would buy them at Enron's cost, hiding the losses. When profits seemed likely to disappoint in a quarter, assets could be sold to the partnerships at inflated prices, covering the shortfall. And with investors insulated from the impact, there was no one to question the prices at which these trades took place and

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supply the "arms-length" aspect that would be present in dealings with a truly independent entity.

Less often discussed, but equally questionable, were the transactions that gave Enron **mark-to-market profits**. For example, Enron Energy Services was a highly-touted division that contracted to deliver electricity, gas and energy management services to commercial customers, sometimes for periods of up to a decade. Under mark-to-market accounting, anticipated profits from those contracts were reflected immediately.

Mark-to-market accounting is based on the view that because contracts signed today can greatly influence a company's value, the future profits or losses they imply should be recognized. Based on the terms of the contracts and the likely cost of fulfilling them, management projects the profit that will arise and runs it through the income statement. Obviously, the appropriateness of these profit projections depends on the reasonableness of the cost estimates. If I have agreed to supply gasoline six months from now at $2 per gallon, you can probably depend on the profits I say I'll make. But the accuracy of profit figures for supplying electricity in 2010 is another story.

> Although that technique is standard in commodities trading, problems emerge when there is no liquid market that can establish with a degree of certainty what future market values will be. (Los Angeles Times, February 12, 2002)

At Enron, we're told, the "reliable source" for documenting the future value of contracts – and thus their contribution to the current year's profits – was the company's own models. That's the equivalent of letting ballplayers call the game and keep their own scores.

The last type of transaction I'll discuss are **derivative trades** that made loans look like sales. Again, the amounts of money Enron needed to fund its perpetual motion machine exceeded the amounts that could be borrowed without causing its credit to be downgraded and bringing the motion to a halt. So Enron found a way to enter into "swap" transactions using derivative contracts that in effect were loans but could be accounted for in other ways.

In a normal swap transaction, party A pays party B a premium to exchange one flow of funds for another. For example, if party A holds a floating-rate loan but doesn't want to bear interest rate uncertainty, he might offer party B a fee plus the stream of payments on that loan in exchange for the payments on a hypothetical fixed-rate loan of the same amount and maturity.

In Enron's transactions, a financial institution agreed to accept one stream of payments in exchange for another <u>and then</u> paid Enron the estimated present value of the stream it had agreed to pay over time. Trades like these are called "prepaid swaps," because the financial institution agrees to pay immediately for the stream of future payments to which it becomes entitled. Thus Enron got a lump sum from the financial institution in exchange for the promise of payments in the future.

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That sounds like a loan to me. However, Enron's balance sheet told a different story. Because the derivatives related to commodities, the receipts usually were shown as "assets from price risk management" and the payments that it was obliged to make as "liabilities from price risk management." No loan transaction; just money in Enron's till and an obligation to make payments that amounted to interest and principal.

There's nothing wrong *per se* with off-balance sheet partnerships, mark-to-market accounting or swap transactions, or with the standard methods of accounting for them. They're engaged in many times a day, and almost always benignly. The problem arises when these transactions are entered into and accounted for so as to fool, misrepresent and obscure.

Among the common threads running through Enron's financial practices is the fact that (1) they had been designed for uses other than those to which Enron put them, and (2) Enron's accounting for them provided a distorted picture of what was actually going on.

What Was Wrong With Enron's Accounting?

The principal problem was that the transactions represented an effort to use accounting as a weapon against investors, rating agencies, counterparties and regulators.

Although the opponents of gun control like to say that "guns don't kill people; people kill people," I think it's people misusing guns who kill people. By the same token, it's not accounting that creates abuses, but people misusing accounting.

Like most things, transactions like those described above can be abused and misused. At their best they allow companies to accomplish legitimate goals and communicate them clearly. At their worst they can be used to circumvent their normal purposes and avoid apprehension (certainly as in "understanding," but perhaps as in "arrest" as well).

It seems clear that Enron's executives didn't say "What transaction is in the best interest of Enron and its shareholders, and what's the clearest way to account for it?" Rather, they tried to come up with a form of transaction that could be described so as to convey the desired impression – even if the transaction served no valid business purpose for Enron and the accounting for it was misleading.

While failings on the part of its executives, directors and outside auditors certainly contributed, Enron was able to do this in large part because the accounting profession had set out numerical rules that could serve as a roadmap for duplicity, rather than principles that would set standards for the intent and effect of financial reporting. The Wall Street Journal of February 12 explained the distinction:

> Auditors who issue clean bills of health are required to certify that a company's financial statements fairly represent the client company's financial performance.

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> But critics of the accounting profession today say that over the past three decades the standard setters have moved away from establishing broad accounting principles aimed at insuring that companies' financial statements are fairly presented.
>
> Instead, they have moved toward drafting voluminous rules that may shield auditors and companies from legal liability if technically followed in check-box fashion. That can result in companies creating complex structures that technically comply with GAAP but hide billions of dollars of debt or other corporate obligations.

As the Wall Street Journal wrote on February 1 and 8,

> . . . sometimes persnickety rules can become a license for larger dishonesty.
>
> This new environment's two highest values are tolerance and proceduralism. That doesn't encourage good judgment; it suppresses it.

So the lessons regarding accounting are simple:

- **We need accounting standards that are set and enforced in terms of principles, not just technical rules.**
- **Accounting is like any other tool; the results will depend on whose hands it's in.**

The Origins of Corporate Corruption

For those seeking an explanation for fortuitous outcomes, luck has been described as "what happens when preparation meets opportunity." I think Enron inspires a similar explanation for corruption: **it's what happens when exigency meets moral weakness**.

If Oaktree got into a bind, I hope we would admit that performance wasn't measuring up to expectations, that things weren't going our way, or that we simply had made mistakes. I hope we would accept the consequences and try to remedy the situation.

Unfortunately, however, not everyone works that way. Some people are less eager to face the music. If the high road doesn't work out and doing the right thing isn't of great concern, there are people who will cut a few corners or look for a "creative" way out.

I have no reason to believe Enron was formed in 1985 to be the Potemkin village it became, with the intention of misrepresenting results and profiting executives rather than shareholders. And I doubt if anyone said, "Who cares if we hire executives that are morally soft?" I think Ken Lay once had a dream that truly included new ways to profit in a changing energy industry. But when things didn't go according to plan and

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maintaining a lofty stock price became a challenging obsession, the people who mattered most either engaged in corrupt practices or failed to blow the whistle on them.

Corporate Rot Can Spread From the Executive Suite

In fact, Enron's culture in recent years seems to have encouraged doing the **wrong** thing. Certainly, the jury is still out regarding Ken Lay. Was he the oblivious dreamer who couldn't understand the details, trusted the wrong people and was duped? Or was he the manipulative master criminal we've heard vilified in Congress?

Whichever was the case, right now we only know the results. It certainly appears that Enron was a company where:

- hubris was encouraged,
- schemers rose to the top,
- people were rewarded for ends, not means, and
- **no one ever asked "but is it right?"**

Whistleblower Sherron Watkins has said that questioning CEO Jeff Skilling about the propriety of the partnerships would have been "job suicide." CFO Andrew Fastow is said to have cursed at the Enron representatives who negotiated against the partnerships he ran and to have tried to get one fired. Lawyers will argue the specifics, and judges and juries will decide, but it seems clear that there were bad guys at Enron, and that nothing in the climate there encouraged doing the right thing.

And encouraging moral behavior, perhaps above all else, is the responsibility of top management. One thing I'm convinced of is that you can't have a great organization without someone at the top setting the tone. The Chairman and CEO can't know everything that goes on in a company, can't be conversant with the details and merits of every transaction, and can't participate in any but the most senior hires. **But they can create a climate where expectations are high and the emphasis is on means, not just ends**.

When I get through telling prospective clients how well my partners manage Oaktree's portfolios, some ask, "Then what do you do?" In addition to communicating with clients and managing the business, I tell them, I try to provide leadership. You can't see it around the office or quantify its effect on the results, but it's what makes a company what it is.

That Depends on the Meaning of the Word "True"

I've seen organizations where, it seemed to me, the standard for truth was that "if something cannot definitively be proved to be a lie, we can say it's the truth." That standard, at best, appears to be what guided Enron.

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No one in control at Enron seems to ever to have said "Wait a minute! That's not what's really happening here" or "That description is too unclear to be useful." Enron appears to have used a very special dictionary. Its key verbs were "mislead," "obfuscate," "manipulate" and "disguise." Its adjectives were "opaque," "Byzantine" and "technically correct." And they had no need for "straightforward," "arms-length" or "candid." Much of the disclosure that did take place seems to have been arranged so that, if need be, Enron executives could say "if you looked in the right place and read it the way we intended, you couldn't say it's not there."

For example, if it was the number of words that counted, this paragraph from a much longer Enron footnote might pass for full disclosure.

> In 2000, Enron entered into transactions with the Related Party to hedge certain merchant investments and other assets. As part of the transactions, Enron (i) contributed to newly-formed entities (the Entities) assets valued at approximately $1.2 billion, including $150 million in Enron notes payable, 3.7 million restricted shares of outstanding Enron common stock and the right to receive up to 18.0 million shares of outstanding Enron common stock in March 2003 (subject to certain conditions) and (ii) transferred to the Entities assets valued at approximately $309 million, including a $50 million note payable and an investment in an entity that indirectly holds warrants convertible into common stock of an Enron equity method investee. In return, Enron received economic interests in the Entities, $309 million in notes receivable, of which $259 million is recorded at Enron's carryover basis of zero, and a special distribution from the Entities in the form of $1.2 billion in notes receivable, subject to changes in the principal for amounts payable by Enron in connection with the execution of additional derivative instruments. Cash in these Entities of $172.6 million is invested in Enron demand notes. In addition, Enron paid $123 million to purchase share-settled options from the Entities on 21.7 million shares of Enron common stock. The Entities paid Enron $10.7 million to terminate the share-settled options on 14.6 million shares of Enron common stock outstanding. In late 2000, Enron entered into share-settled collar arrangements with the Entities on 15.4 million shares of Enron common stock. Such arrangements will be accounted for as equity transactions when settled.

Could anyone tell what these 260 words meant? There's a lot of ink there, not much information. **Disclosure doesn't mean putting facts out there indecipherably, but rather in a way that lets people discern their significance**.

Obviously, Enron's communication was the opposite of truthful and complete. Equally obviously, Enron didn't want people to know what was going on. Truth was scarce at Enron, and something to be toyed with. The examples ranged from ridiculous to extremely serious. We can chuckle at the thought of Enron building a sham trading floor and coaching secretaries on how to sound like traders when analysts walked through. But there's nothing funny about the money people lost because, as the February 4 issue of Business Week reported,

> In September, Lay told employees: "Talk up the stock and talk positively about Enron to your family and friends." The company's upcoming financial report, he said, was "looking great."

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This was a few weeks after Jeffrey Skilling resigned and Lay was told by Sherron Watkins of her concerns, while he was actively selling his stock, and a few weeks before a $1.2 billion downward restatement of Enron' s net worth.

And it seems old habits die hard. Just a week or so ago, in defending the juxtaposition of negative developments at Enron and Ken Lay's stock sales, a spokesperson pointed out that Lay had bought stock last summer. True as far as it goes, it's my belief that he sold or otherwise disposed of more shares than he bought. It's funny how someone might take "he bought stock" to mean, "he bought stock on balance." To paraphrase a former world leader, it all depends on the meaning of the word "true."

The acid test for the truth is really quite simple: If everyone got a chance to knowledgeably compare reality against what we say about it, what would they think? Enron wouldn't have done very well under that standard.

Conflicts of Interest

It's an old-fashioned question, but one that seems to have been forgotten at Enron: **Whose interests come first?**

Each of us encounters this question daily, having to balance the interests of others against our own. Should I slow down for the driver signaling to change lanes? Can I take the last piece on the platter? The biggest one? If I'm late for a flight, is it okay to push through the security line? Is it fair to just pick out the cashews and almonds, or must I eat my share of filberts and peanuts too? Is it okay to break a date when a better offer comes along?

These decisions aren't easy. Rabbi Hillel described the dilemma two thousand years ago: "If I am not for myself, who will be? And if I am not for others, what am I?" Despite the difficulty, most of us were taught by our parents to do a decent job of balancing self-interest and the interests of others.

For people in positions as fiduciaries, the law makes it a lot simpler: the other guy comes first. It's obvious that an executor can't buy assets from the estate at bargain prices. Likewise, company managers and directors owe their first loyalty to shareholders, pension plan beneficiaries and, in insolvency, to creditors.

Like the test for truth, the test on handling conflicts seems pretty simple: **If everything we do ends up in the headlines, will anyone have grounds for complaint?** Well, no one seems to have applied that test at Enron. It all made it to the headlines, and Enron flopped.

The most egregious instance involves executives like Chief Financial Officer Andrew Fastow and Managing Director Michael Kopper who (1) set up off-balance sheet entities that did business with Enron, (2) assumed control of those entities, (3) negotiated on

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behalf of the entities with Enron subordinates whose compensation they determined, and (4) profited fabulously. Fastow is famous for having made $30 million from the entities, and Kopper made at least $10 million. Given that the partnerships are generally not believed to have served valid business purposes, those profits represent a direct transfer from Enron's coffers to those of the employees for which Enron received no legitimate *quid pro quo*.

By the way, Enron had an ethics policy, and it probably would have prohibited these things. So the directors voted to waive the policy. But that vote didn't make the actions right.

Neither was it a good idea for Ken Lay's sister to be Enron's travel agent, or for Enron to contract with and invest in companies owned by Lay and his son. Each of these might have had a valid business purpose. **But it's essential to avoid both conflicts and the appearance of conflicts**. We all might like to use employer dollars to benefit our relatives, our friends, and even ourselves, but the temptation must be resisted. If top executives engage in transactions that suggest self-dealing, even if they might be capable of tortuous rationalization, it makes a statement that fiduciary duty and moral behavior are dispensable. What could be worse?

In the business world, potential conflicts of interest arise all the time. We can't avoid them, but our goal must be to deal with them honorably. Clients, shareholders and others who depend on us must come first.

Whose Company Is It, Anyway?

When a public company is involved, an important question is whether management acts like the company belongs to them or to the shareholders.

As part of my business education I learned that America's commercial progress took a big step forward when management was separated from ownership. About a century ago, companies began to be turned over to hired managers. Because company owners aren't necessarily the best managers, it followed that the emergence of a professional manager class would, on balance, enhance the quality of management.

This made great sense to me. Certainly this separation is one of the things that made America the world leader in business. But now I think it has gone too far in some cases. Alan Greenspan said recently, "There has been a severance, in my judgment, of the interests of the chief executive officer in many corporations from those of the shareholders, and that should be pulled together." (Los Angeles Times, February 28, 2002)

Enron's managers didn't act like paid caretakers of other people's company, but rather as if they owned it. Of course, Ken Lay *et al.* would argue that everything they did was done to create value for the shareholders. But is there any reason to believe they acted the way the shareholders would have wanted them to act? Certainly they can't

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argue that they had the shareholders' blessing, given that they never let on what they were really doing.

Of course, executives defend their actions by invoking the cloak of shareholder governance: that shareholders elect the directors, and it's the directors who choose and direct the CEO. We've seen hundreds of times, however, how hard it is for the company-proposed slate of directors to lose an election or for a dissident proposal to be passed.

Acting in the interests of shareholders is just one option for management today, and clearly it wasn't the one chosen at Enron.

Aligning Interests

About a decade ago, Forbes published a special issue on executive compensation. In it, a sage, experienced director said of managers, "I've given up on getting them to do what I tell them to do; they do what I pay them to do." I've never forgotten that statement.

When individual compensation gets into the tens or even hundreds of millions of dollars per year (including stock and options), managers profit as if they owned the company and took the risk. They appropriate a major share of profits for themselves in the good years, even though they lose nothing (other than perhaps potential or previously-accrued profits) in the bad ones.

Set up this way, management has lots of incentive to take risk and cut corners. It sure worked that way at Enron. The executives can point out that the board approved the key elements in the compensation program. But once again, I say the board's control over management is limited.

Options have played a major part in the trend toward outsized compensation. Early on, when their use began, it was felt that options would align the interests of management with those of the shareholders by (1) interesting management in how the stock did, and (2) tying compensation to the company's long-term performance.

As with so many things, however, the negatives have been found out through experience:

- Options focus attention on short-term performance, not long-term.
- Options focus attention on the performance of the stock, not the company (and those are two very different things).
- Options give management a skewed interest in the company. It was thought that they would make managers into stockholders, but this is rarely the case. Employees usually sell very soon after exercising, often simultaneously. This is because they either don't have enough capital to hold or don't want to bear the downside risk. Thus executives profit from share appreciation but rarely hold shares. That's very different from the lot of the company's owners.

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- Because the cost of option programs never shows up in the income statement, their cost is considered in a distorted way. Option grants amount to giving a portion of the company to the employees, but no net income effect is ever seen under current GAAP.
- Stock price declines introduce the unattractive dilemma of option repricing. When a stock falls precipitously, management often proposes a commensurate reduction of the exercise price on options. With shareholders having taken a big loss, it seems unfair to exempt executives from the pain. But it is true that old options that are way out of the money won't serve to retain and motivate employees. And with option grants "free," repricing often is irresistible.

It seems obvious that the option culture, the stock market bubble and the advent of mega-compensation have combined in the worst of cases to encourage short-term fixes and artful – even fraudulent – accounting. I think it's no coincidence that our high yield bond portfolios encountered two examples of accounting fraud in February 2001 alone, more than in the previous twenty years put together.

Moving away from the subject of options, the New York Times of March 1 indicated another way in which compensation incentives can be counterproductive. Early in 2001, the Times reported, Enron executives and other employees received hundreds of millions of dollars in bonuses tied to earnings and stock price performance.

> . . . executives received large bonuses . . . with the amount based in large part on the earnings of the company – figures that investigators for a special committee of the Enron board have concluded were inappropriately inflated by company executives . . .
>
> Legal experts said that the payments could provide strong evidence of a motive for the financial machinations that investigators think distorted the company's reported performance and ultimately led to its demise. Without those efforts, the profits and stock price levels required to obtain the money certainly would not have been reached . . .
>
> Almost every decision that ultimately led to the company's collapse – including the establishment of a series of partnerships . . . which an investigating committee of the board concluded were used to bolster earnings improperly – was made during the time frame [when the earnings test for bonus purposes was underway] . . .
>
> [According to a former federal prosecutor,] **"The level of compensation that we are talking about here would certainly seem to be a powerful incentive for anyone to do anything."** [Emphasis mine]

Management should be incentivized, but constructively. Excessive, short-term focus on stock price performance is not in shareholders' long-term interest and, in egregious cases like Enron, obviously can bring disastrous results.

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I also want to touch on the issue of stock sales by executives. Perhaps because it's an issue with so much visceral appeal, the headlines are full of "Executives Sold While Company Crumbled; Employees and Small Investors Lost Everything."

But I don't think there's anything inherently wrong with executives selling stock. They buy it to profit, and they should be expected to reap that profit at some point in time. If the company and the stock do well, appreciation can create a position too large to hold prudently. So selling's okay; the issue is when.

Clearly, managers mustn't sell when they know things others don't. When that's true is a tough question and often a matter of degree; no shareholder can ever know as much as the CEO does. Selling while saying "the company's doing great" probably isn't a terrific idea – especially if it's not. And the number of shares it's proper to sell probably is a function of the absolute dollar amounts involved and the number of shares retained.

One last note: I have absolutely no sympathy for managers who are renegades, like Enron's seem to have been, but they're not the only ones at fault here. **Every investor who's complaining about the stock sales made by Enron executives could have learned about most of them from government filings and sold alongside. In fact, the onus is on investors who hold or buy while insiders are announcing massive sales.** Investors must accept responsibility for their actions; Enron's faulty transactions might have been covert, but most of the stock sales took place in plain sight.

<u>Where Does the Buck Stop?</u>

While we're on the subject of responsibility, who else should accept it in the case of Enron? (So far I haven't seen many hands going up.)

The little guys are employing **the Nuremberg defense**: "I only did what I was told." And they're right most of the time. It's true they could have objected to what they saw, but that would be asking a lot. The combination of certitude, principles, career alternatives and/or financial resources needed to create a whistleblower occurs only rarely.

Sherron Watkins might be the closest thing thus far, and she certainly did raise red flags in her memo of August. She was brave and stepped forward when few others did, but I'm not ready to canonize her yet. Before I do so, I'll have to get over the large number of references in her memo not to what was right or wrong, but to what might be found out. In August she wrote:

- Skilling's abrupt departure will raise suspicions,
- we will have to pony up Enron stock, and that won't go unnoticed,
- I am incredibly nervous that we will implode in a wave of accounting scandals,
- we are under too much scrutiny and there are probably one or two 'redeployed' employees who know enough about the 'funny' accounting to get us into trouble,
- too many people are looking for a smoking gun,

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- we do not have a fact pattern that would look good to the SEC or investors, and
- best case: clean up quietly if possible.

These quotations certainly suggest a preoccupation with perception. Did Watkins truly worry about right and wrong and choose her mode of expression to make an impact on Lay and company? Did she write to complain about wrongdoing or just to push for damage control? And are they two different things or the same?

Unlike the little guys, the top execs are employing what I call **the Geneva defense**: "I was in Switzerland during the war." Nobody ordered the misdeeds or even knew about them. Either they were out of the room or the lights went off. Control freaks with great memories left things to others or can't remember what happened. And, ultimately, they claim the directors and auditors approved everything.

The Role of the Auditors

Why do companies have auditors? So the owners can be sure that (1) they know what management is doing and (2) the financial statements accurately reflect what's going on. As such, auditors play an absolutely essential role in the corporate governance process.

In addition to checking the numbers and opining on the reasonableness of the financial statements, it's their job to tell directors, through the audit committee, when something's amiss. Every audit committee meeting should include some time when no management representatives are present. This is the auditors' chance to tell the directors about things they feel are wrong.

Did Arthur Andersen fulfill its responsibilities at Enron? They say yes and management says no. Surprise!! Certainly, at minimum, the picture is less than ideal.

- First, there's no getting around the fact that Andersen certified financial statements about which no one has a kind word to say. If they had misgivings, they weren't sufficient to make Andersen send up a red flag. We haven't seen any record of Andersen expressing misgiving to the audit committee.

- Andersen received $52 million in fees from Enron in 2000, less than half of which was for auditing. Auditors' compensation can be so great that keeping the job becomes too high a priority.

- Roughly $5 million of the total was for Andersen's help in structuring some of the complained-of transactions. When management says, "we'll pay you to think of a creative solution to our problem," there's a lot of incentive to come up with something that accomplishes the company's objectives in terms of effect and optics. And there's little likelihood that the same firm will disapprove it on audit. It's kind of like paying your IRS agent to design a tax shelter.

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- Finally, Andersen served Enron for nineteen years, and maybe things got too comfortable. While SEC rules require that the audit partner be rotated, they don't limit the tenure of the firm.

On the other hand, in Andersen's defense:

- It's hard for auditors to know more than management will tell them. (It is their job, however, to tell the audit committee when they don't feel they're getting complete information and to check matters independently where they can.) There's just too much evidence to the contrary for anyone to believe that honest auditors will always sniff out dishonest management.

- All of the details of the financial statements Andersen certified, and of their engagement at Enron, may have met the letter – if not the spirit – of the rules.

- As in any other field, the rotten apple - the dishonest auditor, or even the incompetent one – can do a lot of damage. We don't know yet what the real role of Andersen's David Duncan was in the Enron debacle, but we may find out if he receives immunity as seems to be under discussion.

Auditors are one of the shareholders' last bastions of protection. The Enron example shows us two things: their essential nature and their fallibility. We still need more help.

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So Who's Left?

The shareholders' ultimate protection comes from the board of directors. The directors are the representatives of the shareholders and the bosses of the CEO. They are in position to hire and fire, and to approve and disapprove. Sounds like there's no one for them to pass the buck to.

But the truth is, the directors don't work at the company, aren't involved in its day-to-day affairs, and know little that they don't learn from management. I'm a corporate director, and I get my information from management and the auditors (who get much of theirs from management). If they're criminal or uninformed, I'm powerless to protect the shareholders. Bottom line: we can't prevent all fraud and misrepresentation. At best we can discourage it, and at worst we can punish it. We usually assume people are telling the truth, and I would hate to work in a place where I can't.

The contribution of directors can be increased greatly if a few standards are adhered to. The failure to do so may have been one of the major problems at Enron:

First, **independent directors must be independent**. That means they should be aware that they work for the shareholders – not the company or the management – and act like

it. If directors derive unreasonable benefits from the company, they can lose their objectivity, become beholden or grow afraid of losing the job. For just one example in the case of Enron, the chairman of the board's investigating committee testified that all of the directors flew around on company jets. Would they have been willing to give that up to take a stand?

Second, **independent directors have to be hard-working people who will attend meetings diligently, ask tough questions and challenge management**. We're in the process of looking for directors for one of our companies. Someone I asked about a prospect said, "He'll be a pain in the ass to management." Within reason, that's what I want to hear. Relaxed attitudes negate the concept of independence. Directors who serve in perpetuity also should be looked at. After enough years, they can conclude their loyalty is to management.

Third, **at least some of the independent directors must be financially astute enough to fully understand what's going on**. There are valid reasons to include financial novices for knowledge they may have in areas like technology, law or the environment. But there should be enough financial experts to understand management's actions and question them when necessary.

Lastly, **having friends of management as directors can't help the board's independence**. (Although they are the CEO's bosses, directors often get their jobs through the CEO; how's that for a paradox?)

When, for example, you look down the list of the six directors on Enron's audit committee – probably the most important body in terms of protecting the shareholders – you see that at least five fail to satisfy all of these criteria:

- RJ chaired the audit committee for 15 years.
- RC missed more than 25% of the board and committee meetings.
- Enron has given $1.5 million to the cancer center JM headed.
- JW got an additional $72,000 a year as a consultant.
- WG's university program received $50,000 in Enron donations.

Getting highly competent and truly independent directors isn't easy. If the job pays too little, nobody qualified will take it. If it pays too much, independence can be compromised. And if Enron's board is stripped of indemnification and sued, it may become hard for companies to find independent directors at all.

Ultimately, it must be borne in mind that, under the current system, it's tough for shareholders to get boards other than those proposed by management. But as in many of the issues under discussion here, that doesn't mean they should stop pushing for boards that represent their interests.

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Don't Expect Much Help From the Analysts

On February 27, the Senate Governmental Affairs Committee held hearings regarding sell-side analysts who covered Enron. Its data showed that as late as November 8, weeks after the SEC had announced its probe of possible irregularities, 10 out of 15 analysts who covered Enron still rated it as a "buy" or "strong buy." (The stock, then around $9, is now worth roughly zero.) Enron's debt was selling at roughly 60 cents on the dollar at that time. The analysts may have thought the stock was a great buy, but debt investors apparently considered it unlikely that the creditors would be paid – in which case the stock would be worthless.

The analysts told the Senators their failure was attributable to the inaccuracy of the Enron financial statements on which they had relied. Certainly, analysts' starting point has to be the financial statements, and if they're fraudulent, accurate analysis is rendered very difficult. But still, an insightful analyst can call attention to poor earnings quality and inadequate or unclear reporting. In the case of Enron, none of the prominent sell-side analysts seems to have made a peep.

Thus Enron represents another instance, like the dot-coms, where **(a) most benignly, we'd have to say brokerage house analysts possess little insight and their opinions are of no value, and (b) most cynically, it seems they're not there to help investors as much as their companies' investment banking efforts**.

When I started off as an analyst in the 1960s, per-share commissions were high and it was the job of brokerage house analysts to generate them. They accomplished this by providing superior research. (Outright "sell" recommendations were rare nevertheless, perhaps because "buy" recommendations had a much bigger potential audience.) The process through which commissions were whittled down and analysts became driven by investment banking considerations instead built gradually since then.

The truth of the matter is that a hard-nosed analyst with a "sell" recommendation is likely to generate little in the way of commissions but certain to become *persona non grata* and assure that his employer won't get investment banking business from the subject company. Thus, as Sen. Joseph Lieberman said, "These influences compromise an analyst's objectivity and mean that the average investor should take their bottom-line recommendations with at least a grain of salt, if not a whole bucket."

Lack of objectivity isn't the only reason why analysts aren't much help. First, it's hard to develop superior information; in fact, SEC regulations require companies to give everyone the same data at the same time. Second, analysts often develop a closeness with companies and their executives that clouds their objectivity. And third, of course, any insight analysts may have is distributed widely so as to enter the public domain and quickly be reflected in market prices.

My bottom line on research (as you know): the average analyst isn't much help, and only a few are far above average – by definition. If you find an astute and independent

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analyst, stick with him (or her). Many sophisticated investors have learned to supplement brokerage house analysis with input from independent research organizations.

Where Does the Buck Stop?

Ours is a free market. **If undeserving (or crooked) companies get capital they shouldn't, the responsibility ultimately falls to the providers of equity capital**. I've read everything I could on Enron, and yet there's almost no mention that shareholders may have been remiss.

Sure, the shareholders were victims of what appears to have been organized and pervasive fraud. But no one can say there weren't warning signs. Shareholders held and bought Enron stock although they couldn't possibly have thought they understood the financial statements, or where the profits came from. They held while the top executives were selling. And they remained unperturbed when the CEO quit without explanation.

And I'm not just talking about individual investors. Al Harrison of Alliance, Enron's biggest holder, has been quoted as saying he bought on "faith." He even admits, "The company seemed to be on a deliberate path not to give full information. Shame on me for not doing something about it." (New York Times, March 3, 2002) Good marks for candor; not so good for due diligence.

I believe many investors underestimate the difficulty of investing, the importance of caution and risk aversion, and the need for their active, skeptical involvement in the process. *Caveat emptor*. Or as they say on TV, "don't try this at home."

Recap, Ramifications and Reform

As Enron's board committee concluded,

> The tragic consequences of the related-party transactions and accounting errors were the result of failures at many levels and by many people: a flawed idea, self-enrichment by employees, inadequately designed controls, poor implementation, inattentive oversight, simple (and not-so-simple) accounting mistakes, and overreaching in a culture that appears to have encouraged pushing the limits. (New York Times, February 3, 2002)

These transactions were just one element in the overall Enron picture, but they typify the malfeasance, laxness, and dereliction of duty that were widespread. I have listed some of the failings that have been laid to executives, accountants, auditors, directors and analysts. Fingers also are being pointed at commercial bankers, investment bankers, rating agencies, lawyers, politicians and regulators. Virtually no one has come away unscathed.

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Around the time the Enron disclosures reached their peak, contagion seemed ready to sweep the market. Tyco and other companies with "accounting issues" saw their stocks collapse. Whereas investors generally placed too much faith in companies in the late 1990s, now they have become highly skeptical, perhaps unduly so. As a friend described it, "A few years ago, if management said 'we'll make $5 billion,' investors swallowed it whole. Today if a CFO says 'we have $175 million in cash,' investors ask 'how do we know that's true?'"

We've read about the risk of a widespread loss of investor confidence. Allusions have been made to the corrupt practices of the 1920s and the fact that the resulting disillusionment had a lot to do with the stock market's doldrums in the following decade. Arthur Levitt, the last SEC Chairman, testified on Enron that, "What has failed is nothing less than the system for overseeing our capital markets." (Newsweek, February 4, 2002)

As The New York Times wrote on February 10, "The outcome will depend largely on how long the Enron collapse holds the attention of Washington and the public, and on whether once-elevated companies also come to be seen as houses of cards kept standing by financial sleight of hand." The good news is that no epidemic seems to have taken hold. People have been willing thus far to view Enron as an isolated example of management run wild.

That doesn't mean there won't be a spate of regulation and reform. That's what Pecora's disclosures produced, and there's no reason it won't happen again. The Enron story remains telegenic and political, and that makes it grist for Washington's mill. And I certainly don't mean to suggest that some reform isn't needed.

Here are just a few of the ideas that have surfaced (their presence here absolutely does not indicate my endorsement of them):

<u>On the accounting process</u>: regulate "special-purpose entities" and "off-balance sheet partnerships"; require that option grants be an expense against profits; specify broad principles for disclosure, not just technical rules; let the federal government set accounting standards.

<u>On auditors</u>: prohibit or limit non-audit work; make auditor hiring, firing and compensation the province of the board, not management; require increased commentary in auditors' opinion letters; enact term limits for auditing firms; restrict the movement of personnel from audit firm to client; end self-policing by the profession, substituting an outside body; increase "teeth" in disciplinary process regarding auditors; consider restoring civil liability for auditors (and lawyers) who "aided or abetted" a violation of securities law (eliminated by Supreme Court in 1994).

<u>On banks</u>: revive the Glass-Steagall Act separating commercial banking and investment banking (ironically, this law was one of the prime outgrowths of Pecora's investigations, and its key provisions were repealed just over two years ago); require disclosure of contingent liabilities and reserves against them (banks that had committed to lend to

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Enron while it was rated investment grade were taken up on their offer when the credit rating collapsed).

On brokerage house analysts: prohibit compensation tied to investment banking business; require disclosure of the derivation of analysts' pay, and of all fees received from the subject company; restrict analysts' trading in recommended stocks; require full disclosure of firms' and analysts' holdings and trading in those stocks; separate brokerage and research activities from investment banking.

On 401 (k) plans: limit investment in company stock; ease restrictions on sales of company stock; require notice before a moratorium on participants' changes goes into effect; improve reporting and participant counseling.

On companies, executives and directors: impose penalties for misleading financial statements; punish carelessness, not just fraud; require increased disclosure, especially regarding transactions with affiliates and insiders; put controls on the use of "creative" accounting concepts such as adjusted pro forma earnings; eliminate personal indemnification in cases of misleading financial statements.

On the SEC: review disclosure regulations; increase power to suspend or bar unethical executives or directors from working at public companies; require quicker, perhaps on-line reporting of insider trades (now not required until month-end), including sales back to the company (now not required until the next year); increase the SEC's budget so that it can hire and retain staff and increase enforcement activity.

On politicians: enact campaign finance reform (it might be on the way); require reporting of lobbyists' contacts; limit lobbyists' role in drafting legislation.

This vast laundry list of possible solutions suggests (a) the magnitude of the problem indicated by Enron and (b) the eagerness of government to ride to the rescue. Some changes will be made, but the belief that the problem isn't widespread should limit their scope.

What's the bottom line, then? The real lessons from Enron, in my opinion, are these:

- As long as there are disclosure rules – and that's forever – there'll be "technically correct" statements that leave investors in the dark. In order to get numbers with integrity, you need people with integrity.

- Rules are just the first building block in creating a safe market. We also need compliance and enforcement, neither of which will ever be 100%. Even though it’s the best in the world, our system for corporate oversight is far from perfect. The collective power of directors, auditors and regulators to protect shareholders withers in the face of serious corporate corruption. It's amazing what con men can get away with for a while.

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- As Enron's complex, questionable transactions indicate, the people looking for holes in the rules are often highly motivated, well financed and well advised. Those whose job it is to plug the loopholes are often over-matched, and their efforts to do so usually amount to a holding action. The furor over Enron's accounting shows that we need the ability to insist on adherence to general principles and punish those who violate them.

- Security analysis and knowledgeable investing aren't easy. Investors must be alert for fuzzy or incomplete information, and for companies that don't put their interests first. They must invest only when they know what they don't know, and they must insist on sufficient margin for error owing to any shortcomings.

- We all must watch out for unintended consequences, and that's especially true when promulgating regulations. Accounting rules and option programs were created with the best of intentions, but in the extreme they led to Enron's noxious transactions and counterproductive incentives. It'll be no less true the next time around.

I apologize for the length of this memo, but the Enron matter is so sweeping and multi-faceted that I found it inescapable. It is my aim here to shed light, not to recount events. I hope you'll find it interesting and of use.

March 14, 2002

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