INTERNATIONALLY AGREED PRINCIPLES FOR CORPORATE GOVERNANCE AND THE ENRON CASE

by

Andrew Cornford,
Senior Economic Adviser,
Division on Globalization and Development Strategies, UNCTAD

The views expressed are those of the author and do not necessarily reflect those of the UNCTAD secretariat.

Contents

Section		Page
A	**Introduction**	1
B.	**OECD Principles particularly pertinent to the Enron case**	4
C.	**Enron's record**	5
	1. A brief characterisation	5
	2. Some frequently used techniques	7
	3. Selected major transactions and other arrangements	8
	4. A look at some of Enron's financial reports	18
D.	**Key parties to the observance of OECD Principles by Enron**	23
	1. Board of directors	23
	2. Accountants/Auditors	27
E.	**Aftermath**	28
	1. The international response	28
	2. The response in the United States: accounting consolidation, Sarbanes-Oxley, and other effects	32
F.	**Wider policy implications**	37
	1. Some malfunctions of a model	37
	2. Complex corporate structures	41
	3. Corporate governance and key financial standards	44

A. Introduction

Recent corporate scandals in the United States are leading to a wide-ranging re-examination of frameworks for corporate governance in that country and elsewhere as well as of their underlying principles. Among the key standards for financial systems whose application is a major component of current initiatives to strengthen the so-called international financial architecture three are particularly pertinent to this re-examination: the OECD *Principles of Corporate Governance*[1], and the initiatives on International Accounting Standards and International Standards on Auditing[2]. The breakdown of corporate governance associated with the most prominent and the most baroque of recent scandals, that involving the collapse of Enron, was on a scale that involved extensive conflicts with the OECD Principles, thus pointing not only to problems regarding their implementation but also to various implications for their future interpretation and elaboration. A review of these conflicts follows to highlight some of their major features. This serves as a backdrop to a discussion of policy initiatives in the aftermath of Enron's collapse and of implications for the development and reform of corporate governance in emerging-market and other developing countries.

Corporate governance is concerned with the relationships between a business's management and its board of directors, its shareholders and lenders, and its other stakeholders such as employees, customers, suppliers, and the community of which it is a part[3.] The subject thus concerns the framework through which business objectives are set and the means of attaining them and otherwise monitoring performance are determined. The OECD Principles cover five basic subjects: (1) protection of the rights of shareholders; (2) equitable treatment of shareholders, including full

---

[1] OECD Ad Hoc Task Force on Corporate Governance, *OECD Principles of Corporate Governance* (Paris, 1999).

[2] The OECD Principles cover certain aspects of accounting and auditing in relation to corporate governance. In what follows these two subjects will be discussed only in this context, and there will be no review of the two international initiatives mentioned above which are more specifically directed at these subjects as such.

[3] The term "stakeholder", is unavoidably imprecise. It includes not only those most directly involved in a firm's process of wealth creation (actually specified in the OECD Principles) but also other parties so long as they are sufficiently strongly or directly affected by this process.

disclosure of material information and the prohibition of abusive self-dealing and insider trading; (3) recognition, and protection of the exercise, of the rights of stakeholders as established by law, and encouragement of co-operation between corporations and stakeholders in creating wealth, jobs and financially sound enterprises; (4) timely and accurate disclosure and transparency with respect to matters material to company performance, ownership and governance, which should include an annual audit conducted by an independent auditor; and (5) a framework of corporate governance ensuring strategic guidance of the company and effective monitoring of its management by the board of directors as well as the board's accountability to the company and its shareholders.

The models of corporate governance found in reality belong to a spectrum not everywhere characterised by clear-cut breaks. At the extremes of the spectrum there are none the less important differences in such characteristics as the regulatory framework for management and boards of directors, the priority attributed to the interests of different stakeholders in the firm, and the prevalent systems of business financing. Financial systems which have progressed beyond the rudimentary level mostly incorporate the same major features as building blocks but differ in the relative importance of these blocks and in the links between them. At one extreme is often placed the German model with its emphasis on multiple stakeholders and the influence exerted by banks through their shareholdings on firms' decision making; and at the other is the Anglo-Saxon model with its attribution of a major role in the efficient use of resources to open financial markets and its institutionalisation of priority for shareholder value. Between the two extremes are many other variants typically including features from one or the other extreme (and often from both). No further general discussion of the comparative strengths and weaknesses of different models of corporate governance is undertaken in this paper, though section F.1 does take up various ways in which recent scandals have highlighted shortcomings of the Anglo-Saxon one.

The preamble to the OECD Principles acknowledges that there is no single model of good corporate governance, and the Principles avoid prescriptive rules of a concrete character for many aspects of relations between firms, on the one hand, and lenders and investors, on the other. A prominent figure in recent initiatives for the

promotion of good corporate governance has described the role of codes or principles in this area as providing "a checklist against which to review … governance structures and processes" and disclaims for them responsibility for prescribing rules for application and compliance[4]. But the generality and flexibility of the Principles have the consequence that potential inconsistencies amongst them as well as other problems likely to arise in their application are glozed over. This is true, for example, of potential conflicts of interest between the different parties to corporate governance. Perhaps more fundamentally the practical implications of the different Principles can differ substantially according to the time horizon to which they are taken to refer, a subject which is an integral part of contemporary debates on corporate governance but on which the OECD Principles themselves are silent. Moreover, especially in the light of recent revelations, the Principles seem to pay too little attention to the issues of management incentives and remuneration. This matter is taken up primarily under various headings covering the role of the board of directors and transparency. Thus among the key functions of the board are selecting, compensating, monitoring and, when necessary, replacing key executives and reviewing key executives' remuneration. Under disclosure and transparency companies are enjoined to include in the former material information on the remuneration of key executives. Finally, under the role of stakeholders in corporate governance there is a reference to the need for scope to be given for performance-enhancing mechanisms for stakeholders' participation, which may include stock ownership plans or other profit-sharing mechanisms. But nowhere do the OECD Principles address the problem of too close a link between executive remuneration and reporting of financial results, especially short-term results.

In view of the way in which national frameworks of corporate governance typically reflect societal differences amongst countries, the avoidance in the OECD Principles of prescriptive rules concerning application and compliance and of any view as to the superiority of a particular financial system or framework of corporate governance seems appropriate as well as understandable. However, the "checklist"

---

[4] See A. Cadbury, *Corporate Governance and Chairmanship a Personal View*, (Oxford, etc., Oxford University Press, 2002), p.20. Adrian Cadbury was chairman of the United Kingdom Committee on the Financial Aspects of Corporate Governance (which reported in 1992) and a member of the OECD's Business Sector Advisory Group on Corporate Governance whose report led to the drafting of the OECD Principles.

approach implies that there are limits to what can reasonably be expected from such a statement of Principles. Nevertheless, as the sequel of this paper shows, the OECD Principles can serve to highlight particular abuses of corporate governance.

B. OECD Principles particularly pertinent to the Enron case

The flouting of OECD Principles in the Enron case was particularly evident in the four areas of shareholders rights, disclosure and transparency, the execution of its responsibilities by the board of directors, and the prohibition of abusive self-dealing. Failures under these different headings were linked in various ways, perhaps most importantly through inadequate disclosure and transparency.

Basic shareholder rights under section I of the OECD Principles include obtaining relevant information on the corporation on a timely and regular basis. Under section IV of the Principles the corporate governance framework is to ensure that timely and accurate disclosure is made on all material matters regarding a corporation, including its financial situation and performance, its ownership and its governance. In commentary on disclosure of the company's financial and operating results the Principles emphasise audited financial statements and discussion and analysis by management of its operations. Attention is drawn to the need for disclosure of transactions relating to the entire group of the company's entities since "arguably, failures of governance can often be linked to the failure to disclose 'the whole picture', particularly where off-balance sheet items are used to provide guarantees or similar commitments between related companies". Other items specifically mentioned under disclosure and transparency include the need for information about material foreseeable risk factors such as risks connected to particular industries or geographical areas or to commodity dependence, about financial-market risk, and about risk related to derivatives and off-balance sheet transactions. The information under disclosure and transparency is to be prepared, audited and disclosed in accordance with high quality standards of accounting, financial and non-financial disclosure, and audit. Mention is made here of this quality's dependence on the applicable standards, and endorsement is accorded to the development of high quality internationally recognised standards. An annual audit is to be conducted by an independent auditor in order to provide assurance regarding the

preparation and presentation of the financial statements. In the Principles' commentary on options for implementation here reference is made to limitations and rules in some OECD countries concerning auditors' receipt of non-audit income from clients, quality reviews of auditors by another auditor, and the mandatory rotation of auditors.

Under section V the responsibilities of the board of directors relate to strategic guidance of the company, effective monitoring of management, and accountability to the company and its shareholders. Board members are to act on a fully informed basis. The board's key functions regarding the selection, remuneration and replacement of executives have already been mentioned. The board is also to review and guide the firm's stratgegy and major plans of action, to monitor and manage potential conflicts of interest of management, the board itself and shareholders, and to ensure the integrity of the company's systems of accounting and financial reporting, including the independent audit and systems for monitoring risk and compliance with the law. If it is to achieve these aims, the board must be able to exercise objective judgement independent from management. For their purpose one possible approach is to assign sufficient non-executive board members to such responsibilities as financial reporting, nomination, and remuneration of executives and the board itself. A prerequisite for the satisfactory performance of the board's tasks is that its members have access to accurate, relevant and timely information.

The prohibition of abusive self-dealing is covered under section II of the OECD Principles. Abusive self-dealing refers to cases where persons having close relationships to the company exploit those relationships to its detriment.

C. Enron's record

1. A brief characterisation

Lack of transparency was at the heart of the breakdown of corporate governance in the case of Enron. Deficiencies here affected the firm's relations with investors and creditors, its own board of directors (and thus an important part of its internal control), and other stakeholders. Key features of Enron's inadequate

transparency were manipulation of both its earnings figures and its balance sheet. This manipulation involved extensive use of aggressive and creative accounting (some of which may be judged to have been fraudulent)[5]. The use of special purpose entities (SPEs) was part and parcel of these practices as was recourse to hedging and the use of derivatives in conflict with reporting rules or business logic (or both). Many of the transactions associated with this manipulation were also associated with self-dealing by Enron executives leading to substantial personal enrichment.

At the time of its filing for bankruptcy in December 2001 Enron had assets of over $60 billion, but a fuller picture of assets controlled by the firm would have had to take account of its extensive off-balance-sheet positions[6]. An idea of the firm's complexity can be obtained from such features as its 2,800 offshore units and the 54 pages required to list people and companies owed money by Enron[7]. This was a far cry from the firm which in the 1980s specialized in the provision of natural gas pipelines and related services. As one writer has put it, "The company deserved admiration for its early forays into trading gas and electricity, and for its plunge into the innovative financing of energy projects …This introduced new ways of managing risk, which lowered the costs of energy-related transactions for an array of businesses"[8]. But from these origins Enron expanded relentlessly into trading activities in 1,800 products or contracts and 13 currencies (which included bandwidth, pulp and paper, and contracts such as weather and credit derivatives[9]). It was in connection with this expansion that Enron began to engage in increasingly aggressive and creative accounting and to have extensive recourse to SPEs and other techniques

[5] According to one terminology aggressive accounting denotes forceful and intentional choice and application of accounting principles done in an effort to achieve desired results, typically higher current earnings, whether or not the practices followed are in accordance with GAAP; and creative accounting denotes steps used to manipulate the numbers in financial reports, including the aggressive choice and application of accounting principles, fraudulent financial reporting, and earnings management or income smoothing. Fraudulent financial reporting involves intentional misstatements or omissions of amounts or disclosures in financial statements done to deceive financial statement users, which are determined to be fraudulent by an administrative, civil, or criminal proceeding. See C.W. Mulford and E. E. Comiskey, *The Financial Numbers Game: Detecting Creative Accounting Practices* (New York, etc., John Wiley, 2002), p.3.

[6] In June 1999 of the total of more than $50 billion of assets owned or controlled by Enron one-third was estimated to consist of off-balance-sheet positions. See L. Fox, *Enron: the Rise and Fall* (Hoboken, New Jersey.: John Wiley), p.177. But by December 2001 many of these positions would presumably have lost part or all of their value.

[7] *ibid., p.286.*

[8] *ibid., p.307.*

[9] See P.G. Fusaro and R.M. Miller, *What Went Wrong at Enron: Everyone's Guide to the Largest Bankrupty in U.S. History* (Hoboken, N.J.: John Wiley, 2002), pp.76-78.

for keeping positions off its balance sheet. In many respects Enron's practices in these areas mirrored those of many other firms during the boom in stock prices of the 1990s. And part of the motivation of Enron's conduct was also similar to that of other firms, deriving from the links between stock prices and executives' remuneration and wealth. But in Enron's case the factor of its credit rating was also crucial. The firm's rapid expansion required access to large amounts of financing; and as its involvement in trading activities grew, so did the importance of its credit rating since this determined its financing costs and the willingness of its counterparties to trade with it[10]. A favourable earnings picture and the avoidance of excessive leverage on Enron's balance sheet were perceived by its management as essential to maintaining the firm's credit rating.

2. Some frequently used techniques

The techniques used by Enron to present its earnings and balance sheet in a favourable light and to conceal features of its real situation can be illustrated by means of a number of the more important cases. But first it may be helpful to describe some aspects of these techniques in more general terms.

One recurring feature of Enron's techniques in this context is the SPE. Such entities enable a company to borrow or engage on other more complex financial transactions against the assets held by the entity. Since the SPE contains some of the firm's assets (frequently accompanied by credit enhancements) but none of its outstanding obligations, it serves a vehicle for reducing risk and thus obtaining more favourable financing terms or persuading counterparties to engage in categories of financial transaction that they might not be willing to undertake with the firm itself. Historically SPEs have been used for various purposes: for example, for Hollywood companies they have made possible borrowing to finance the distribution of films against assets consisting of a number of films bundled together to meet the resulting

[10] In 1989 Enron became the first company to issue "credit sensitive notes", on which the rate of interest was tied to Enron's ratings from the major credit rating agencies. See Fox, *op. cit*. (at footnote 6), p.66.

obligations[11]; and in the OTC derivatives business they have enabled financial firms with less than the highest credit ratings to transact with those enjoying such ratings[12].

Hedges (which were important features of Enron's earnings management) are positions that produce gains or losses that partially or completely offset the losses or gains of another position. The acceptability of a hedge from the point of view of accounting rules or business logic turns on the correlation between the two mutually offsetting positions or on the existence of an outside party prepared to assume through a contract part or all of the economic risk of the position being hedged. These conditions are not fulfilled if the firm itself is the counterparty on both sides of the hedge contract or if the value of the two positions in the hedge both depend ultimately on that of the same underlying assets.

Mark-to-market accounting (which enabled Enron to place a value on its longer-term or more complex contracts) involves the revaluation of assets and liabilities on a regular basis and the incorporation of the results of this revaluation in a company's balance sheet and income statement. Such accounting can be relatively straightforward, for example, when unambiguous market prices are available for the assets and liabilities in question. But it is less so when applied to non-standardised OTC transactions between particular counterparties and to long-term complex contracts. In the latter case recourse is typically had to models for valuation purposes (a process known as mark-to-model), which thus depend on assumptions about an inherently uncertain future and provides considerable scope for judgement.

3. Selected major transactions and other arrangements

Early recourse by Enron to SPEs included arrangements (Volumetric Production Payments or VPPs) to finance the operations of small oil and gas companies. VPPs were used to lend to producers in exchange for agreed amounts of oil or gas, the financing being secured by the production fields and not by the producing company. The VPP itself was already a form of SPE but Enron then took

---

[11] See Fasaro and Miller, *op. cit*. (at footnote 9), p.x.

[12] On the pioneering use of a derivatives SPE (Salomon Swapco) by Salomon see N. Dunbar, *Inventing Money: the Story of Long-Term Capital Management and the Legends behind it* (Chichester, etc.: John Wiley, 2000), p. 118.

the process a step further by securitization, pooling securities backed by the VPPs in limited partnerships called Cactus Funds and using derivatives to smooth the earnings from sales of the oil and gas in the VPPs. Some of the securities so created were placed in SPEs which were used to meet the obligations due to bank loans incurred by Enron in connection with the VPPs, and others were sold directly to financial institutions. In either case the financial exposure of Enron resulting from the creation of the VPPs was removed from its balance sheet. Such SPEs were an extension of practices involving partnerships and other entities which had long been common in the energy business[13].

Another SPE, which was eventually to play an important role in difficulties regarding Enron's financial reporting in 2001, was the partnership with the name of Joint Energy Development Investors or JEDI, formed between Enron and the California Public Employees Retirement System (CALPERS) in the early 1990s. This committed Enron and CALPERS each to invest $250 million in natural gas projects during a three-year period. In late 1997 Enron sought a new partner for JEDI since it wished to engage in a new and larger partnership with CALPERS. For this purpose, in accord with a plan drawn up by its future chief financial officer, Andrew Fastow, Enron established a new partnership to buy CALPERS's stake in JEDI with an arrangement designed to ensure that JEDI remained an independent entity which would not have to be consolidated with Enron itself in its financial statements. If this condition was to be fulfilled, the new partnership, Chewco[14], had to meet a number of requirements: 3 per cent of its equity had to be invested by a third party unrelated to Enron; the investment had to be genuinely at risk; and, finally, the entity had to be controlled by a party other than Enron. The approach to solving the last problem chosen by Enron was to place some restrictions on the Enron employee, Michael Kopper, selected to manage Chewco and to establish a new outside limited partner for Chewco William Dodson (Michael Kopper's domestic partner), an arrangement eventually replaced by a set of entities controlled by Kopper and Dodson. The equity

[13] See Fox, *op. cit*. (at footnote 6), pp. 31-32 and 63-64.
[14] On the history of Chewco see W.C. Powers, R.S. Troubh and H.S. Winokur, *Report of Investigation by the Special Investigative Committee of the Board of Directors of Enron Corp.* (February, 2002) (which is better known simply as the Powers Report), chapter II, and Fox, *op. cit*., pp. 123-127, 232, and 275-276. The resemblance between the names of some Enron partnerships (such as JEDI and Chewco) and characters figuring in the film, *Star Wars*, is not coincidental. Chewco was named after the character, Chewbacca.

investment of Chewco's partners was financed with bank loans whose conditions included a requirement for the maintenance of cash collateral, which was met by a special distribution from JEDI to Chewco.

This arrangement was subsequently to be criticised on various grounds: for example, that the investment financed with a bank loan had only a doubtful status as equity; that part of the 3-per-cent equity consisted of an investment by Kopper, an Enron employee; and that the equity did not consist of an investment at risk since the loan backing it was secured by cash collateral provided by JEDI itself, to invest in which Chewco was established in the first place. Further questions over Chewco's independence were raised by fees it paid Enron for the provision of guarantees for its bank financing and for management[15].

In early 2001 Enron bought out Chewco in a transaction which generated handsome returns for Kopper and Dodson. However, this step did not end the story of Chewco's relations with Enron. In the autumn of 2001 Enron's accountants, Arthur Andersen, reviewed the accounting treatment of Chewco, concluding on the basis of information now available to them concerning the bank financing of the supposedly outside equity investment in Chewco and the associated cash collateral that the SPE had not been independent of Enron. As a consequence JEDI was consolidated into Enron's financial statements from 1997 onwards, contributing to sharp downward revisions of reported income in 1997-2000 and increases in the firm's debt during these years in the range of $561 million to $711 million. These restatements played a major role in the loss of creditworthiness which preceded Enron's filing for bankruptcy at the beginning of December.

SPEs were also employed by Enron as part of hedges of exposures linked to its assets. A major instance, which served as a model in certain respects for subsequent hedging operations, involved Enron's investment in the stock of Rhythms

[15] See Powers Report, pp. 49-58, which comments that its authors were unable to decide "whether Chewco's failure to qualify [as having sufficient outside equity] resulted from bad judgement or carelessness on the part of Enron employees or Andersen, or whether it was caused by Kopper and other Enron employees putting their own interests ahead of their obligations to Enron" (*ibid*., p. 54).

Netconnections ("Rhythms"), an internet service provider[16]. This investment, purchased in March 1998 for $10 million while Rhythms was still a privately held company, had appreciated in value to about $300 million after the public issuance of its stock in Spring 1999. The problem for Enron was that in consequence fluctuations in the value of the Rhythms investment were capable on imparting volatility to its reported income but that gains could not be quickly realized or easily hedged: short-term realization was impossible because investors in a privately held company are barred from selling shares for six months after the date of the initial public offering (IPO), and effective hedging was impeded by the absence of options on the stock (owing to its illiquidity and thus its potentially extreme volatility) and by the lack of comparable stock whose correlation with that of Rhythms would have made them suitable hedges.

Enron's response to this problem was a series of transactions carried out through two SPE's, LJMI and LJM Swap Sub L.P. (Swap Sub), created for the purpose of enabling the firm to hedge its exposure to fluctuations in its Rhythms investment. The hedge took the form of a put option sold to it by Swap Sub, whose assets consisted principally of Enron shares[17]. This hedge was potentially unstable since Swap Sub's ability to meet its obligations under the put option depended on the value of Enron's own stock and could be compromised if the Rhythms and Enron stock declined together. In the view of the Powers Committee the transaction did not meet the conditions of "a typical economic hedge, which is obtained by paying a market price to a creditworthy counterparty who will take on the economic risk of a loss[18]". The arrangement was also vulnerable to the charge of involving conflicts of interest since LJM was managed by Fastow, and since Fastow and other employees of Enron were investors in LJM through a partnership called Southampton Place L.P.

The restriction on Enron's ability to sell its Rhythms stock expired in October 1999 but only in early 2000, after limits to the hedge's affectiveness in reducing earnings volatility had become evident and when the price of the Rhythms stock

[16] On the hedging of Enron's exposure to Rhythms see Powers Report, chapter IV and Fox, *op. cit*. (at footnote 6), pp.148-54 and 159-162.
[17] To strengthen the hedge Enron subsequently entered into further derivative transactions (in the form of put and call options) with Swap Sub. See Powers Report, p. 85.
[18] *ibid*., pp. 82-83.

began to decline, thus meaning that its puts were in the money[19], did Enron decide to unwind the positions related to its Rhythms exposure. Several features of the unwinding were questioned by the Powers Committee, including the consideration received by Enron when it exercised the put on its Rhythms shares, a lucrative put option provided by Enron itself to Swap Sub during the negotiations on unwinding the Rhythms hedge in order to stabilize the latter's position as its obligations to Enron under the put began to mount, and large windfall gains to the investors in LJM[20]. Moreover, as in the case of Chewco, questions were raised concerning the level of Swap Sub's independent capitalization, and eventual consolidation into Enron's financial statements in November 2001 led to downward revisions of the firm's income in 1999 and 2000.

Another instance of Enron recourse to SPEs to hedge equity exposures, which incorporated mechanisms similar to those used for Rhythms and which led to eventual downward revisions in the firm's consolidated earnings, involved a set of entities called Raptors[21]. The financial capacity of each of the Raptors for meeting obligations under hedges consisted of Enron's own stock or stock owned by Enron, arrangements once again rendering the hedges questionable since Enron's stock and the SPEs' financial capacity would decline in step with the result that in the event of a sufficiently large decline in the price of Enron shares the latter would have to be replenished with additional Enron stock or by other means. Additional questions raised about the Raptors concerned the extent of their independence from Enron, conflicts of interest owing to Enron employees' involvement in their management and to their investments in the controlling partnership (LJM2)[22], the size of payments between Enron and the SPEs (which on occasion made possible increases in Enron's

---

[19] A put option is in the money when its exercise price exceeds that of the asset on which it is written (in this case the Rhythms stock).

[20] The Fastow Family Foundation received $4.5 million on an investment of $25,000 and two other Enron employees received approximately $1 million on investments of $5,800. See Powers Report, pp. 92-96.

[21] In this case the eponymous characters were the dynosaurs in the film, *Jurassic Park.* The story of the Raptors is covered in the Powers Report, chapter V, which notes that the transactions and structured finance vehicles involved were extremely complex so that "although we describe these transactions in some depth, even the detail here is only a summary"(*op. cit*., p.99).

[22] LJM2 was managed by Enron employees (Fastow, Kopper and Ben Glisan) and made an investment in each of the Raptors on which it was to receive an initial guaranteed return before any hedging or derivative transactions with Enron could take effect. The results were extremely favourable to LJM2: Fastow reported to investors in October 2000 that the internal rates of return on their investments in the four Raptors were 193 per cent, 278 per cent, 2500 per cent, and 125 per cent (in the last case a projection). See Powers Report, p. 128.

reported earnings) and the valuation of the services or asset transfers which were the reason for these payments, and other accounting issues.

Raptor I was established in the spring of 2000 with financial capacity of which by far the largest part consisted of Enron's own stock and stock contracts[23] and sold a put option (effective as of October) to Enron on 7.2 million Enron shares. This arrangement was replaced in the autumn by derivative transactions mostly taking the form of total return swaps on Enron investments, which served as a form of insurance to Enron since Raptor I compensated it for losses on these investments in return for receiving the gains on them[24].

The establishment of Raptor II and Raptor IV followed similar lines: put options on its stock were sold to Enron by entities, a large part of whose financial capacity consisted of contingent forwards contracts on Enron shares[25]. In the case of Raptor I the stock and stock contracts provided by Enron were subject to restrictions on selling or hedging for three years which led to their being valued for the purpose of the transaction at a substantial discount from their market prices, and similar restrictions applied to the stock contracts provided to Raptors II and IV. However, later in the year some of the Enron investments hedged through the Raptors began to decline in value, raising the question of whether the commitments under the hedges could be met. Enron's solution to this problem took the form of a costless collar, a structure based on options under which a floor was placed under the value of the Raptors' financial capacity: if the price of Enron's stock fell below a specified figure, Enron would pay the Raptor the difference in cash; and in exchange, if the price rose above a specified ceiling, the Raptor would pay Enron the difference. The costless collar was established in violation of the agreement originally transferring the Enron stock to the Raptors at a particular discount, since the discount reflected the restrictive effect of the provision that the stock would not be hedged for a three-year period. Thus Enron's hedging of the restricted stock transferred to the Raptors represented a

---

[23] The stock contracts were in the form of a contingent forward contract under which Raptor I had a contingent right to receive Enron stock at a future date so long as its price exceeded a certain level. (See Powers Report, p.100.) The contingent character of these contracts increased the risks to the financial capacity of the Raptor.

[24] The description of these contracts in the Powers Report (*op. cit*., pp. 107-108) is a little vague in that it fails to specify the way in which losses and gains would be calculated.

[25] Concerning such contracts see footnote 23.

transfer of value to them in return for which it should arguably have received additional consideration. It should also be noted that the costless collar did nothing to deal with the fundamental flaw of the hedging operations, that Enron was in effect engaging in a hedge with itself.

Raptor III was established to hedge a particular Enron investment in The New Power Company (TNPC). Wishing to realize a portion of the gains on its holding in TNPC Enron formed an SPE called Hawaii 125-0 (Hawaii) with an outside institutional investor to which it sold part of its interest in TNPC. Enron then entered into a total return swap with Hawaii under which it retained most of the risks as well as the rewards of this interest and would thus have to reflect in its earnings statements resulting gains and losses on a mark-to-market basis. Raptor III was set up to hedge this accounting exposure: once again there was an investment by LJM2 but the greater part of Raptor III's financial capacity was based on warrants on TNPC stock (which were the economic equivalent of TNPC stock) transferred to it a price approximately 50 per cent of that reached at the time shortly afterwards when the stock was publicly issued. The resulting capital gain to Raptor III provided it with the capacity to engage in hedging transactions with Enron in the form of a total return swap under which Raptor III received the gains on the TNPC stock in return for insuring Enron against losses on the same stock. Here too an SPE was being used to hedge an Enron investment with financial capacity which depended on the value of the asset being hedged.

Declines in stock prices putting the Raptor structures at risk soon followed, that of TNPC, for example, falling 50 per cent in comparison with its level at the time of its IPO by the late autumn of 2000. In consequence by the end of 2000 Enron had a gain on its hedges, which it estimated at more than $500 million, but one which it could only use to offset corresponding losses on the investments being hedged if the Raptors still had the capacity to meet their obligations[26]. Various approaches to solving the resulting problems were tried. For example, since the financial capacity problems were initially located in Raptors I and III, the capacity of Raptors II and IV

---

[26] The availability of Enron stock to the Raptors could be compromised by falls in its share price since under the stock contracts provided to them by Enron delivery was contingent on the condition that the share price exceed a certain level at a specified future date.

was deployed to shore up that of those under pressure through devices such as a temporary cross-guarantee agreement which effectively merged the credit capacity of all four Raptors, and through the infusion into them of additional Enron stock, subject to restrictions as to selling and hedging similar to those of the initial transfers but on which Enron itself none the less again provided hedges to the Raptors in the form of costless collars, thus increasing its own liability even as it attempted to prevent the collapse of the hedges of the value of its assets. However, such solutions were capable of providing only a temporary respite, and in September 2001 a decision was taken to terminate the Raptors, the accounting treatment for the transaction chosen for this purpose resulting in a charge of $544 million to Enron's after-tax earnings for the third quarter of 2001[27].

Many of Enron's other arrangements designed to keep debt off its balance sheet or adjust its reported earnings, which involved SPEs, were variants of more commonly used transactions. For example, sale and leaseback deals used to supply equipment for energy projects were placed in joint ventures with the equipment manufacturer, thus removing the associated debt from Enron's balance sheet. The LJM partnerships described above served as counterparties in a number of transactions involving sales of assets which enabled Enron to record gains in its financial statements or to avoid consolidation (or both). However, the Powers Committee questioned the legitimacy of the presentation of these asset sales as involving third parties independent of Enron as well as their accounting treatment. The Committee noted that Enron frequently bought back the assets in question after the close of the relevant financial reporting period; that the LJM partnerships always recorded profits on these transactions; but that the same transactions also generated earnings for Enron. This could be explained in some cases by undocumented side deals insuring the LJM partnerships against losses. The general conclusion of the

[27] As the Raptors came under pressure, a separate accounting problem due to the hedges but this time involving Enron's balance sheet emerged. When the Raptors were established, the promissory notes received from them in return for Enron shares and share contracts received accounting treatment leading to an increase in shareholders' equity. In September 2001 Andersen and Enron concluded that this had been incorrect,. and that there should have been no net effect on Enron's equity. The result of this correction was a downward revision of $1 billion in Enron's equity in its financial statement for the third quarter of the year. See Powers Report, pp. 125-126.

Powers Committee concerning such transactions was that "Enron sold assets to the LJM partnerships that it could not, or did not wish to, sell to other buyers[28]".

Another SPE, which facilitated manipulation of Enron's financial statements, was Whitewing Associates which was formed in December 1997 with funding of $579 million provided by Enron and $500 million by an outside investor. In March 1999 this arrangement was changed so that control was shared between Enron and the outside investor, thus allowing Whitewing to be deconsolidated from Enron. Whitewing was to be the purchaser of Enron assets, including stakes in power plants, pipelines, stocks and other investments[29].

Another technique used by Enron to keep debt off its balance sheet involved SPEs set up by its counterparties, and was designed to disguise the true character of financial transactions between Enron and certain major banks[30]. These transactions were prepaid swaps. Here one counterparty is paid a fixed sum up front in return for a stream of future payments to the other (the payments in Enron's case being linked to the price of oil). The cash flows associated with such swaps mimic those of a loan but, so long as the swap meets certain conditions, the transaction can be accounted for as a hedge. The nature of such transactions can be illustrated in detail for triangular deals involving JP Morgan Chase ("Chase"), an offshore SPE called Mahonia, and Enron. Under one leg of the deal Mahonia receives funds from Chase in return for a fixed amount of gas under a prepaid forward contract for which the price of gas is an estimated future price at the delivery date. Under another leg Mahonia and Enron execute a mirror transaction under which Enron receives the same sum of money from Mahonia that Mahonia receives from Chase, and in exchange commits itself to deliver to Mahonia the gas due to Chase under the prepaid forward contract. Simultaneously under the third leg (a financially settled commodity swap in which there is no transfer of title to gas) Enron and Chase enter into an agreement under which Enron is to pay a fixed sum (equal to principal – corresponding to the amount passing from Chase to Mahonia and from Mahonia to Enron – plus an implied interest rate), and Chase is to pay Enron the floating spot price on the amount of gas in the prepaid forward

[28] Powers Report, p. 135 (Chapter VI of the Report exemplified its conclusion with six transactions.)
[29] Fox*, op. cit*. (at footnote 6), p.157.
[30] The account which follows relies heavily on the report to the United States Senate Committee on Governmental Affairs, *The Role of Financial Institutions in Enron's Collapse*, July 2002.

contract. Under the fourth leg, Chase receives the title to gas from Mahonia, pays the floating price to Enron, and sells the gas at the spot price into the market or to Enron itself. Thus Enron has received a sum funded by Chase from Mahonia, and repays cash plus interest to Chase. The price risk for Chase on the gas transactions is eliminated since it sells gas in the spot market at the same time that it receives title to the gas from Mahonia and pays Enron the spot price.

Arthur Andersen, in a document obtained by a Committee of the United States Senate reviewing transactions of this kind, specified a number of conditions which must be met by a prepaid swap if it is to qualify as a trade or hedge rather than a loan, and which included the following: firstly, agreements under the swap should be stand-alone, i.e. not linked commercially; secondly, price risk should be transferred from the gas supplier to the purchaser; and, thirdly, the purchaser of the gas should have a business reason for the purchase, for example, not being an SPE designed to enable loan or debt transactions by parties such as the firm which established it in the first place. These conditions were not met in the Chase-Mahonia-Enron case for various reasons such as the status of Mahonia as an SPE established by Chase and the elimination of price risk to Mahonia and Chase owing to the back-to-back character of their receipt and delivery of gas and the associated receipt and payment of money.

Quite similar transactions were entered into by Enron with Citigroup and an offshore SPE called Delta which was established by Citigroup. One of the differences compared with the Chase/Mahonia/Enron deals concerned the original source of the money transferred from Delta to Enron. This was not always Citigroup itself but in some cases bond offerings through a trust whose notes were available for purchase by institutional investors (which thus assumed the credit risk associated with the financing). Other differences concerned the cash payments and derivative transactions which eliminated exposure to oil price risk for the three parties and ensured that the net payments mimicked a loan or debt transaction between Enron and its ultimate source of funds. If the prepaid swaps in deals such as those with Chase and Citigroup were accounted for as debt, total debt on Enron's balance sheet at the

end of 2000 would have been increased by about 40 per cent and its ratio of debt to equity by a similar percentage[31].

4. A look at some of Enron's financial reports

Coverage in Enron's financial returns to the Securities and Exchange Commission (SEC) and in its proxy statements to shareholders of operations such as those described in section C.2 was frequently skimpy. Commenting on coverage of Enron's related-party transactions, the Powers Committee concluded that "while it has been widely reported that the related-party transactions connected to Fastow involved 'secret' partnerships and other SPEs, we believe that is not generally the case" but also that "Enron could have, and we believe in some respects should have, been more expansive under the governing standards in its descriptions of these entities and Enron's transactions with them"[32]. Indeed, arguably only with the report of the Powers Committee itself (appointed to look into the firm's accounting in October 2001) and other investigations triggered by the firm's decline and bankruptcy in late 2001 did it become possible to develop a reasonably wide-ranging picture of the functioning of the complex network which by then constituted Enron and its closely related entities. In view of the central role of transparency – or rather its absence – in the Enron affair illustrations of the treatment accorded to the firm's hedging practices and SPEs in its annual reports of 1998, 1999 and 2000 are of some interest[33].

The 1998 report contains description of Enron's risk management but mostly at a general level. The note to its consolidated financial statement on accounting for price risk management gives an idea of the contents and the limits of this description:

> " Enron engages in price risk management activities for both trading and non-trading purposes. Financial instruments utilized in connection with trading activities are accounted for using the mark-to-market method.
>
> …

---

[31] These figures are based on the summary accounting data analysed in *ibid*., Appendix A, p.A-3.

[32] Powers Report, pp. 201-202.

[33] These reports were selected on the basis of easy availability. Chapter VIII of the Powers Report also contains a survey of Enron's disclosures in its proxy statements for shareholders. This survey does not suggest that there was any radical difference in the level of disclosure here in comparison with that in financial returns to the SEC, although Fastow was identified by name in the proxy statements.

> Financial instruments are also utilized for non-trading purposes to hedge the impact of market fluctuations on assets, liabilities, production and other contractual commitments. Hedge accounting is utilized in non-trading activities when there is a high degree of correlation between price movements in the derivative and the item designated as being hedged. In instances where the anticipated correlation of price movements does not occur, hedge accounting is terminated and future changes in the value of the financial instruments are recognized as gains or losses. If the hedged item is sold, the value of the financial instrument is recognized in income[34]."

A little later the Report goes into a bit more detail but still at a general level concerning the firm's exposures and instruments for hedging and risk management:

> "The investments made by Enron include public and private equity, debt, production payments and interests in limited partnerships. These investments are managed as a group, by disaggregating the market risks embedded in the individual investments and managing them on a portfolio basis, utilizing public equities, equity indices and commodities as hedges of specific industry groups and interest rate swaps as hedges of interest rate exposure, to reduce Enron's exposure to overall market volatility. The specific investment or idiosyncratic risks which remain are then managed and monitored within the Enron risk management policies".

In the section of the financial review dealing with financial risk management Enron does discuss its use of value-at-risk (VAR) analysis in the management of its exposure to market risks[35], and provides figures for the average, the highest level and lowest level of VAR corresponding to risks due to commodity prices, interest rates, exchange rates and equities. But there is no mention of the role of SPEs in its management of price risk. In the note to the consolidated financial statements on minority interests there is a reference to the formation of Whitewing Associates but its role in Enron's management of assets on and off the firm's balance sheet is not described[36].

In the 1999 annual report, in the note on minority interests, Enron does mention its recourse to limited partnerships as follows: "Enron has formed separate limited partnerships with third-party investors for various purposes"[37]. But these purposes are not described more specifically. In the note on unconsolidated equity affiliates there is a reference to the accounting deconsolidation of Whitewing Associates following a change allowing the equal sharing of control between Enron

---

[34] Enron, *Annual Report 1998*, p.50.

[35] VAR is the worst-case loss expected during a period at a specified level of probability. Larger losses are possible but only at lower levels of probability.

[36] See *ibid*., p.56.

[37] Enron, *Annual Report 1999,* p.52.

and the third-party investor[38], and in the note on related party transactions mention is made of the acquisition by Whitewing of $192 million of Enron's assets at prices leading Enron to recognize neither gains nor losses on the transactions[39]. The same note also includes a description of the establishment of the LJM partnerships which deserves to be quoted at some length in view of the role played by these partnerships in the account above:

> "In June 1999, Enron entered into a series of transactions involving a third party and LJM Cayman, L.P. (LJM). LJM is a private investment company which engages in acquiring or investing in primarily energy-related investments. A senior officer of Enron is the managing member of LJM's general partner. The effect of the transactions was (i) Enron and the third party amended certain forward contracts to purchase shares of Enron common stock, resulting in Enron having forward contracts to purchase Enron common shares at the market price on that day, (ii) LJM received 6.8 million shares of Enron common stock subject to certain restrictions and (iii) Enron received a note receivable and certain financial instruments hedging an investment held by Enron. Enron recorded the assets received and equity issued at estimated fair value. In connection with the transactions, LJM agreed that the Enron officer would have no pecuniary interest in such Enron common shares and would be restricted from voting on matters related to such shares.
>
> …
>
> LJM2 Co-Investment, L.P. (LJM2) was formed in December 1999 as a private investment company which engages in acquiring or investing in primarily energy-related or communications-related businesses. In the fourth quarter of 1999, LJM2, which has the same general partner as LJM, acquired, directly or indirectly, approximately $360 million of merchant assets and investments from Enron, on which Enron recognized pre-tax gains of approximately $16 million. In December 1999, LJM2 entered into an agreement to acquire Enron's interests in an unconsolidated equity affiliate for approximately $34 million. Additionally, LJM acquired other assets from Enron for $11 million."

The first paragraph describes the infusions of Enron stock into LJMI which provided the financial capacity which made possible the put option purchased on its Rhythms stock. But the hedging operation itself is not described. The second paragraph exemplifies the asset transactions in which Enron engaged with the LJM partnerships.

The 2000 annual report is a little more revealing but still falls far short of providing the information required for a reasonable picture of the risks associated with Enron's operations and structure. Under the note on minority interests the note again refers to the separate limited partnerships formed by Enron, this time also

---

[38] See *ibid.*, p.53.
[39] See *ibid.*, p.59.

mentioning a limited liability company formed for similar purposes. In the note on unconsolidated equity affiliates there is a reference to sales to Whitewing of Enron investments and assets amounting to $192 million in 1999 (already mentioned above) and $632 million in 2000 – sales on which Enron recognised neither gains nor losses. The same note also includes further description of the shifting of assets around the network of Enron and related parties which is worth quoting at length although the transactions in question were not among those described in section C.2:

> "Additionally, in 2000, ECT Merchant Investments Corp., a wholly-owned Enron subsidiary, contributed two pools of merchant investments to a limited partnership that is a subsidiary of Enron. Subsequent to the contributions, the partnership issued partnership interests representing 100 per cent of the beneficial, economic interests in the two asset pools, and such interests were sold for a total of $545 million to a limited liability company that is a subsidiary of Whitewing. These entities are separate legal entities from Enron and have separate assets and liabilities."

Note 16 on related party transactions is more forthcoming about Enron's use of SPEs for the purpose of hedging, and the information provided is such as should have raised questions in the mind of a financial analyst as to the source of these entities' financial capacity and its relation to the value of Enron's own assets – the very assets which (as was explained in section C.2) the arrangements were being used to hedge. Key parts of the note merit quotation at length and commentary which relates their contents to the account in section C.2.

> "In 2000 and 1999, Enron entered into transactions with limited partnerships (the Related Party) whose general partner's managing member is a senior officer of Enron. The limited partners of the Related Party are unrelated to Enron. Management believes that the terms of the transactions with the Related Party were reasonable compared to those which could have been negotiated with unrelated third parties."

This would appear to be a further description of Enron's relationship to the LJM partnerships ("the Related Party").

> "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 value 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."

Here Enron is describing its provision of financial capacity to the Raptors. Matching the figures in the note with those in the account of the Powers Committee is not always possible. However, according to the Powers Committee, the three identical put options on its own shares purchased from Raptors I, II and IV by Enron involved payments totalling $123 million on 21.7 million shares – the figures also specified in the note. There is also a reference here to the restrictions on the Enron shares (though the nature of the restrictions is not specified), and to the contingent right to receive up to 18 million additional shares in March 2003 subject to certain conditions (which, thanks to the Powers Report, are known to have referred to their price level). And there is a mention of the note worth $259 million received by Enron in connection with the establishment of Raptor III recorded by Enron at zero[40].

> "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."

This passage clearly refers to the costless collars into which Enron entered with the Raptors but without mentioning the inconsistency of this arrangement with the restrictions on selling, pledging or hedging these shares (to which attention was drawn by the Powers Committee).

> "In 2000, Enron entered into derivative transactions with the Entities with a combined notional amount of approximately $2.1 billion to hedge certain merchant investments and other assets. Enron's notes receivable balance was reduced by $36 million as a result of premiums owed on derivative transactions. Enron recognized revenues of approximately $500 million related to the subsequent change in the market value of these derivatives, which offset market value changes of certain merchant investments and price risk management activities."

---

[40] According to the Powers Report (*op. cit*., p.117) the note was recorded at zero "because it had essentially no basis in the TNPC stock" made available to provide the financial capacity of Raptor III.

This passage concerns the gains of Enron on it derivative transactions with Raptors I, II and III (mentioned in section C.2 above). However, realization of the gains depended on the financial capacity of the Raptors and, as would be indicated by a careful reading of the note on related party transactions, this capacity depended heavily on the value of the very stock being hedged.

The remainder of the note contains description of other transactions involving transfers of assets and liabilities between Enron and the LJM partnerships as well as of the termination of a put option on Enron shares sold by Enron to the partnerships.

D. Key parties to the observance of OECD Principles by Enron

1. Board of directors

A fundamental role in the achievement of good corporate governance under the OECD Principles is attributed to actors in the private sector. Amongst these actors are the board of directors and independent external auditors. To recapitulate, key functions of the former prescribed by the OECD Principles, which are part of the monitoring of management and were particularly relevant in the case of Enron, include selection and remuneration of executives, being alert to potential conflicts of interest adversely affecting the firm, and ensuring the integrity of the company's systems of accounting and financial reporting. Emphasis is placed in the OECD Principles on the need for objective judgement and independence from management. Prerequisites for satisfactory performance include access to accurate and timely information bearing on the fulfilment of these responsibilities. The role of the board in the area of conflicts of interest clearly includes the monitoring needed to avoid self-dealing by management.

The primary finding of a report to a committee of the United States Senate on the role of the Enron's board in its collapse is damning on several subjects covered by the OECD Principles, as is evident from the following:

> "The Enron Board of Directors failed to safeguard Enron shareholders and contributed to the collapse of the seventh largest public company in the United States, by allowing Enron to engage in high risk accounting, inappropriate conflict of interest transactions, extensive undisclosed off-the-books activities, and excessive executive compensation. The Board witnessed numerous indications of questionable practices by Enron management over several years, but chose to ignore them to the detriment of Enron shareholders, employees and business associates.[41]

In a review of this finding the experience and credentials of the Enron board should be borne in mind: in 2001 this consisted of 15 members, many of them with 15 or more years of experience on the Board of Enron and its predecessor companies, and many of them also members of the boards of other companies. Of the five committees of the Enron Board the key Audit and Compliance Committee (the primary liaison body with the external auditors) had six members, of whom two had formal accounting training and professional experience and only one limited familiarity with complex accounting principles; and the Compensation Committee had five members, three with at least 15 years of experience with Enron.[42] In such a review acknowledgement is also due that with regard to a number of key decisions the board of directors did not have access to the information required for them to perform their monitoring role in an informed way.

None the less the board approved or acquiesced in several other decisions with problematic features, and were aware of Enron's recourse to questionable accounting. For example, the board approved the Chewco transaction without posing questions bearing on the extent of the partnership's links to Enron, for example concerning the nature of its equity. However, there is no evidence that at the time of the decision any member of the board other than Jeffrey Skilling, then chief operating officer of Enron, was aware of the management role in Chewco of an Enron employee, Michael Kopper. The board approved the LJM partnerships, while aware of the conflicts of interest which their establishment entailed, Andrew Fastow (Enron's chief financial officer) being both manager of and major investor in the partnerships and thus, in the words of the Senate Committee Report, being permitted to "sit on both sides of the

---

[41] United States Senate, *The Role of the Board of Directors in Enron's Collapse*, Report prepared by the Permanent Subcommittee on Investigations of the Committee on Governmental Affairs, 8 July 2002, p.11.

[42] See *ibid*., pp. 1-2 and 9. Enron's Audit and Compliance Committee thus fulfilled the requirement of a recommendation of a United States Blue Ribbon Commission on Improving the Effectiveness of Corporate Audit Committees in 2000 that audit committees should consist of "financially literate" members, of whom at least one has accounting or financial management expertise (*ibid*., p.6).

table in negotiations between his business [the partnerships] and his employer"[43]. The approval given by the board was subject to certain controls such as reviews by Enron's external auditors and its chief accounting and chief risk officers of the transactions between the firm and the partnerships as well as an annual, overall review by the Board's Audit and Compliance Committee. However, the Board seems to have done little to ensure follow-up of these controls. Raptors I, II and IV were all approved by the Board which, owing to the transactions' complexity, relied here heavily on assurances from Arthur Andersen[44]. Nevertheless, since the Board seems to have been aware that the Raptors did not involve genuine hedges with risks transferred to third parties but were rather accounting devices to smooth Enron's earnings, as the Powers Committee puts it, "this was a proposal that deserved closer and more critical examination[45]." The Board's approval was also forthcoming for several other SPEs used by Enron to transfer large amounts of its activities off balance sheet, thus facilitating manipulation of its financial statements. For example, the Board was fully informed concerning the establishment of Whitewing Associates and was consulted as to its subsequent operation[46].

The record is replete with other developments (such as an increase in revenues from $40 billion in 1999 to $101 billion in 2000) which would appear to have deserved more questioning by the Board than they actually occasioned. Moreover Arthur Andersen provided regular briefings to the Board concerning Enron's accounting practices at which Andersen pointed to features that were novel and involved serious risk of non-compliance with generally accepted accounting principles. In the context of discussion below of policy towards complex corporate

---

[43] See *ibid*., p.29. The Rhythms transaction was approved at the same time as LJM1, this hedge being the first transaction in which the partnership engaged.

[44] See Powers Report, p. 107, and United States Senate, *op.cit*. (at footnote 40), p.43. The establishment of Raptor III was not submitted to the Board for approval because Enron's chief financial officer did not believe that such approval was necessary in the case of an entity whose financial capacity did not consist of Enron stock. However the Senate Subcommittee takes the view that this does not "excuse the Board's failure to find out about all four Raptors when a February 2001 list of LJM transactions, shown to both the Audit and Finance Committees, identified all four and stated they had a combined value of $127 million, far larger than any other LJM transaction on the list" (*ibid*., p.50).

[45] See Powers Report, p.158.

[46] To quote the Senate Subcommittee's summary. "the Enron Board allowed the establishment of Whitewing, supported it with Enron stock, restructured it as an off-the books entity, approved its use as an off-the-balance sheet vehicle to purchase Enron assets, monitored billions of dollars in Enron asset sales to Whitewing, and monitored Whitewing's impact on Enron's financial statements and its claims on Enron stock." See United States Senate, *op. cit*. (at footnote 41), p.41.

structures particular interest attaches to the fact that Enron's annual filings for 1999 and 2000, which were approved and signed by Board members without any indication of concern, listed almost 3000 related entities, with over 800 in offshore jurisdictions – 120 in the Turks and Caicos and 600 in the Cayman Islands[47].

The report to the Committee of the United States Senate criticised the Board's Compensation Committee for exercising inadequate oversight over compensation for Enron executives. For example, it drew special attention to the fact that in 2001 executives received almost $750 million in cash bonuses for performance in 2000, a year in which the company's entire net income amounted to $979 million[48]. While the OECD Principles include among board responsibilities the review of the remuneration of key executives and of the board itself, they provide no substantive guidance in this area. However, as noted in section B, the Principles attribute responsibilities to the board in the area of managing and monitoring potential conflicts of interest, while also stressing, though not under the responsibilities of the board as such, the need for the prohibition of abusive self-dealing. Here the account in section C of events such as the involvement of Enron employees in the management of, and investments in, the LJM partnerships point to serious weaknesses in the performance of Enron's Board.

Section V of the OECD Principles includes the requirement that the board be independent of management. In this context they acknowledge the variety of practices in different countries, but also specify that "board independence usually requires that a sufficient number of board members not be employed by the company and not be closely related to the company … through significant economic…ties". The finding of the report to the Senate Committee concerning the effect on Enron's Board of financial ties between the company and certain Board members suggests that this requirement was not met in the case of Enron. These ties took such forms as retainers or payments for consultancy services (or both) to two Board members, another Board member's service on the board of directors of a company making substantial sales of oilfield equipment and services to Enron subsidiaries, donations by Enron to medical and educational institutions with which Board members were associated, hedging transactions between Enron and an oil company of which a Board

[47] See *ibid*., p.23.
[48] See *ibid*., p.54.

member was a former chairman and chief executive officer, and payments for services and other contributions to organisations engaged in governmental relations, tax consulting and lobbying where a former Board member had ownership interests or otherwise played a prominent role[49]. It should perhaps also be mentioned here that of the compensation paid to the Board a substantial proportion was in the form of stock options, a practice capable of exerting on the Board pressures to approve decisions likely to have a favourable influence on the firm's stock price similar to those also exerted on management (pressures which, as discussed above, contributed to the establishment of SPEs and recourse to other techniques for the purpose of manipulating the firm's financial reports).

2. Accountants/Auditors

As mentioned in section B, the prescriptions of the OECD principles regarding auditing comprise the preparation, auditing and disclosure in accordance with high-quality standards and a requirement of independence for the external auditors. Enron's external auditor was Arthur Andersen, which also provided the firm with extensive internal auditing and consulting services. Some idea of its relative importance in these different roles during the period leading up to Enron's insolvency is indicated by the fact that in 2000 consultancy fees (at $27 million) accounted for more than 50 per cent of the approximately $52 million earned by Andersen for work on Enron. Andersen was paid substantial sums in connection with transactions mentioned in section C. For example, it charged over $1 million for services related to the structuring and accounting treatment of the Raptor transactions, and $5.7 million for work during 1997-2001 on the Chewco and LJM transactions[50].

Some (though not all) members of the Audit Committee of the Enron Board apparently found it reassuring that Andersen's work for the firm went beyond external auditing, leading Enron itself to characterise the combined roles as "an integrated audit"[51]. The history of relations between Enron and Arthur Andersen suggests that they were frequently characterised by tensions due to the latter's misgivings

[49] See *ibid*., pp. 54-56.
[50] See Powers Report, pp. 24-25.
[51] United States Senate, *op. cit*. (at footnote 41), p.57.

concerning several features of Enron's accounting[52]. However, overall Andersen's performance, revelations concerning which were to lead to the break-up of the firm, led to the following assessment by the Powers Committee: "The evidence available to us suggests that Andersen did not fulfil its professional responsibilities in connection with its audits of Enron's financial statements, or its obligation to bring to the attention of Enron's Board (or the Audit and Compliance Committee) concerns about Enron's internal contracts over the related-party transactions[53]". Andersen clearly did not meet the requirement of the OECD Principles that the external auditors be independent of the firm it audits, and both the Powers Committee and bodies of the United States Senate which have investigated Enron's collapse have taken the view that lack of independence linked to its multiple consultancy roles was a crucial factor in its failure to fulfil its obligations as Enron's external auditor[54].

E. Aftermath

Recent scandals, especially those involving Enron and some other prominent United States corporations, have unsurprisingly led to widespread calls for changes in accounting standards and strengthening of other features of regimes of corporate governance. In the United States these calls have already led to action on the legislative and other fronts but at the international level concrete measures are understandably taking longer to develop.

1. The international response

The OECD has committed itself to a drive to strengthen corporate governance wordwide. The focus of a meeting in Paris in November 2002 to discuss national and

---

[52] For example, in March 2001 a senior Andersen partner, Carl Bass, was removed from functions involving oversight of Enron. See *ibid.*, p.58. Bass was the primary contact between Enron and Andersen's Professional Standards Group, accounting experts whose task was to make sure that Andersen's accountants observed accounting rules in their work for clients. Bass had expressed reservations concerning Enron's methods for bolstering the Raptors when they ran into difficulties, hedging connected to investments of the LJM partnerships, and other Enron transactions with the effect of boosting the firm's reported income for 2000. See Fox, *op. cit.* (at footnote 6), pp. 211-212 and 228-230.

[53] Powers Report, p. 24.

[54] United States Senate, *op. cit.* (at footnote 41), pp. 57-58 and Staff, *Financial Oversight of Enron: the SEC and Private-Sector Watchdogs*, Report to the United States Senate Committee on Governmental Affairs, 8 October 2002, p.28.

international initiatives addressing weaknesses in market foundations and improving market integrity included not only the OECD Principles but also other relevant OECD instruments such as the OECD Guidelines for Multinational Enterprises and the Anti-Bribery Convention[55]. In his statement to the International Monetary and Financial Committee Meeting of September 2002 the Chairman of the Financial Stability Forum, the body established to strengthen the overall surveillance of the international financial system and entrusted with a special role in promoting the implementation of key financial standards, drew attention to the role of poor corporate governance generally in recent failures and singled out particular areas where ongoing initiatives had a role to play. These areas included the accounting treatment of consolidated entities, revenue recognition and equity-based remuneration; auditing standards and practices, where the Chairman gave special emphasis to the issues of auditor independence and oversight of the profession; financial reporting where recent scandals had underlined the importance of comprehensive, truthful, timely and clear disclosure; and the role of credit rating agencies which exert an increasingly pervasive influence on financial markets. The chairman also welcomed the decision of OECD ministers to bring forward to 2004 their comprehensive review of the OECD Principles and expressed the hope that the revision would embody more specific guidance than the existing Principles[56].

A successful outcome of efforts to accelerate international initiatives on corporate governance must still confront difficulties which are intrinsic to the process. Some of these are due to the interrelated character of these initiatives, which means that impediments to speedy progress in one area can also slow movement overall. Others are due to the problem of reconciling with national legal regimes any increasingly detailed rules which may be enunciated as part of the initiatives.

The effects of the interrelated nature of ongoing initiatives bearing on corporate governance is particularly evident in the case of accounting standards. While additional impetus has been given to the negotiation of international accounting standards by recent corporate scandals, many of the outstanding issues remain

[55] "OECD launches drive to strengthen corporate governance", 15 November 2002, http://www.oecd.org.

[56] Statement by Andrew Crackett, chairman of the Financial Stability Forum to the International Monetary and Financial Committee Meeting, 28 September 2002, http://www.fsforum.org.

extremely contentious among the different parties involved[57]. One of the issues concerns a question which was especially important in the case of Enron, namely international standards for the SPEs which can be used to manipulate financial reports. Likewise whether to charge remuneration in the form of stock options against profits and if so, how to measure them remain a subject on which there is not yet a decisive consensus. Such was the scale of recourse to such options among major United States corporations in the 1990s that treating them as an expense would have significantly affected reported profits in many cases (including that of Enron). Other difficult issues include the way in which gains on the investments in companies' pension funds should be included in earnings, the extent to which assets and liabilities should be valued on the basis of mark-to-market, and the appropriate balance in accounting standards between dependence on highly prescriptive, detailed and voluminous rules (the approach traditionally favoured by the United States), on the one hand, or on more general, principles-based regulations (the approach more favoured by European countries), on the other[58].

Movement from the enumeration of general principles, of which the largely checklist approach of the OECD Principles is an example, to more detailed core rules for financial markets and corporate governance is likely to be gradual as well as constrained by considerations of national sovereignty, and perhaps more so for issues related to corporate governance than for most other subjects under these headings. Even with regard to banking regulation, a field where technical considerations predominate to a greater extent than for those covered by most other key financial standards, evolution in the direction of more detailed rules has been spread over a considerable period of time. The first initiatives of the Basel Committee on Banking Supervision after its establishment in 1974 concerned mainly supervisory co-

---

[57] Promulgation of international accounting standards is a task assumed by the International Accounting Standards Committee (IASC), an independent private-sector body formed in 1973 with the objective of achieving uniformity in accounting principles and in 2000 including 153 professional accounting bodies (representing over two million accountants) from 112 countries. The key responsibility in setting international accounting standards (IAS) is entrusted to a Board (IASB) with 14 members of whom at least five have a background as practising auditors, at least three a background in the preparation of financial statements, at least three a background as users of financial statements, and at least one an academic background. See IASC, *International Accounting Standards Explained* (New York, etc.: John Wiley & Sons, 2000), Part I.

[58] The consequences of the differences between these two approaches can be illustrated for leases where the IAS treatment is less than one-tenth as long as that of the United States Financial Accounting Standards Board (FASB). See J. Dini, "Can one honest man save accounting?", *Institutional Investor*, July 2002, p.42.

operation and the allocation of supervisory roles for cross-boarder banking. The first major initiative setting out common rules in a core regulatory area was the Basel Capital Accord of 1988, which has been followed by other work of this kind as well as papers enunciating minimum standards[59].

Corporate governance is linked to several parts of countries' private, company, and insolvency law, regimes for which – where they are relatively developed – typically have much more pervasive links with different aspects of commercial and social life than bank regulation and supervision. Thus acceptance of increasingly detailed globally applicable rules in this area will have to overcome sensitivities and other difficulties, several of which are more complex than those with which the Basel Committee on Banking Supervision has had to grapple.

The extent of the links between corporate governance, on the one hand, and national commercial laws and practices, on the other, may also lead to the eventual raising in a more urgent way than hitherto of the issue of representativeness in connection with the process of enunciating progressively more detailed, globally applicable rules for corporate governance. So far this process has been carried out within the OECD, an organisation which has extended its membership beyond its founding and mainly industrialised original member countries but which still falls well short of being universal or even of including all countries with developed or rapidly developing systems of company law[60]. Resolving the issue of

---

[59] The subject of what he calls progress towards "a single global rule book" figures prominently in the book by G. A. Walker, *International Banking Regulation, Law, Policy And Practice* (New York, etc.: Kluwer Law International, 2001), especially chapters 5.7 and 6.2. Though the point of view expressed here differs somewhat from that of this author, the discussion above was none the less much influenced by his analysis.

[60].The Basel Committee on Banking Supervision, whose original membership consisted of 12 industrialised countries, has also had to confront the problem of representativeness as it increasingly assumed the role of global standards setter. Its response to this problem initially involved mainly the development of contacts with supervisory authorities elsewhere whose responsibilities included significant coverage of international banking. Vehicles for such contacts included regional groupings of supervisors, in the formation of which the Basel Committee often played a part, and International Conferences of Bank Supervisors, which have taken place every two years since 1984. In the preparation of its key 1997 document on standards for banking supervision, *Core Principles for Effective Banking Supervision*, the Basel Committee collaborated with supervisors of economies outside its membership, and a role in the adoption and application of these *Core Principles* at the national level has been attributed to a Core Principles Liaison Group of 22 members including several developing countries. But this outreach (which has not succeeded in altogether quelling criticism of the representativeness of the Basel Committee's processes) would be difficult to replicate in the case of

representativeness is capable of further slowing international agreement on detailed rules for corporate governance.

Within these constraints incremental progress can be envisaged – but progress not likely to entail agreement on a comprehensive set of rules. The OECD Principles come in three parts: a preamble, the checklist proper, and annotations (which provide some elaboration of the principles in the checklist). Whilst one can envisage some strengthening of the language of the checklist as a response to recent scandals (for example, by incorporating explicit references to disclosure concerning SPEs and off-balance-sheet instruments such as derivatives under section IV, "Disclosure and transparency"), the annotations could provide an appropriate place for piecemeal elaboration and interpretation of the Principles. When such elaboration and interpretation constitute a response to actual experience of egregious failures of corporate governance, they should be able to command broad consensus. In the aftermath of Enron this approach might cover not only SPEs and off-balance-sheet instruments but also the remuneration of management and of the board of directors. Such an approach could be supported by the issuance of background papers on suitably chosen topics relevant to corporate governance in the interest of reviewing the state of the art in different countries and of supplementing the annotations to the Principles, while avoiding the danger of rendering the basic document unwieldy[61].

2. The response in the United States: accounting consolidation, Sarbanes-Oxley, and other effects

The reverberations of recent corporate scandals for regimes of corporate governance and financial regulation can be expected to be far-reaching. This is particularly true of the United States where new measures and rules have already been introduced.

For example, FASB has issued new rules governing accounting for "variable interest entities" in order to tighten conditions under which avoidance of accounting consolidation is permitted (a key feature of the Enron case). Such entities, which are henceforth to be consolidated and which will include categories of SPE currently not

---

corporate governance owing to the greater heterogeneity of the corps of officials with supervisory and enforcement responsibilities in this area at the national level.

[61] The Working Papers of the Basel Committee on Banking Supervision furnish a model for such background papers.

subject to consolidation, have one or both of the following characteristics: (1) the equity investment in the entity is not sufficient to permit it to finance its activities without additional subordinated financial support from other parties; and (2) the equity investors lack one or more of the essential characteristics of a controlling financial interest, namely the ability to make decisions about the entity's activities through voting or similar rights, the obligation to absorb its expected losses, and the right to receive its expected residual returns as compensation for the risk of absorbing these losses[62]. Hitherto two enterprises were generally subject to consolidation if one controlled the other through voting interests, but FASB believes that recourse to a broader criterion emphasising the risk dispersion among the parties involved will lead to more consistent application of consolidation and thus to improved comparability between enterprises engaged in similar activities, including cases where some of these activities are conducted through variable interest entities. The new rules are also designed to improve disclosure for enterprises with significant interests in variable interest entities but not meeting the criterion of being the primary beneficiaries with which the entities are to be consolidated.

A more direct influence on the cross-border financial relations of the United States will be exerted by the Sarbanes-Oxley Act, whose passage in 2002 constituted the first major legislative response to recent corporate malfeasance[63]. This Act is directed at a wide range of the abuses revealed in recent scandals and prescribes stringent penalties under several of its headings. Provisions affecting directors and senior executives include a requirement for certification of reports filed with the SEC, prohibition of insider lending to a firm's executives and directors, penalties for accounting restatements reflecting misconduct, bans on trading by executives and directors in the firm's stock during certain "blackout periods" for retirement plans[64],

---

[62] FASB, "Consolidation of Variable Interest Entities: an Interpretation of ARB No. 51", *FASB Interpretation No. 46 (Financial Accounting Series)* (Norwalk, Conn.: FASB, January 2003).

[63] The discussion which follows makes extensive use of the review of Simpson Thacher and Bartlett, *Sarbanes-Oxley Act of 2002: CEO/CFO Certifications, Corporate Responsibility and Accounting Reform*, 31 July 2002.

[64] A "blackout period" denotes a period of more than three business days during which there is a suspension of the right to sell the firm's equity for 50 per cent or more of the participants in, and beneficiaries of, individual-account retirement plans. Many of Enron's employees experienced large losses on Enron stock in such plans. Sales of this stock were subject to certain restrictions, and were actually impossible during the period from 17 October until 19 November 2001 owing to a change in the plans' administrators. Employees' bitterness at their losses was exacerbated by the knowledge that the firm's chairman and other senior officers of the firm were selling substantial parts of their holdings

and a requirement for independence for members of audit committees. Enhanced disclosure is to be achieved by various provisions including the following: the requirement that the SEC review a firm's periodic financial reports at least once every three years; the obligation on directors, officers and others owning 10 per cent or more of the firm's securities to report changes in their ownership within a specified, short period; new requirements for disclosure concerning subjects such as off-balance-sheet transactions, internal controls, and the existence or absence of a code of ethics for a firm's senior financial officers[65]; and timely disclosure of material changes in firms' financial condition (so-called real time disclosure). Auditor independence is to be strengthened by limiting the scope of non-audit and consulting services for audit clients, and by requiring that a firm's audit committee pre-approve non-audit services provided by the firm's auditor. Under the same heading an audit firm will not be permitted to provide audit services to a client if the lead or co-ordinating partner with primary responsibility for the audit or the partner responsible for reviewing the audit has performed audit services for that client in the previous five fiscal years. Standards for accounting firms and professionals are also to be strengthened by the establishment of a Public Company Accounting Oversight Board, which will have the authority to conduct investigations and disciplinary proceedings in connection with compliance with the Act annually and will carry out periodic inspections of such firms, annually for those auditing more than 100 issuers and every three years otherwise.

Other provisions of Sarbanes-Oxley include rules to strengthen the independence of research analysts, lengthening the statute of limitations for litigation involving the violation of certain securities laws, the establishment of new securities-related offences and increases in certain criminal penalties, and new protections for employee "whistleblowers". Interestingly the Act calls for studies and reports to be prepared for the United State Congress in the various areas – reports which can be presumed to serve as a possible basis for further legislative or regulatory measures. The studies will cover the adoption of principles-based accounting, mandatory

---

during a period when the former frequently touted Enron stock in intra-firm communications. See Fox, *op. cit* (at footnote 6), pp. 252-253 and 289-290.

[65] The code of ethics is to cover standards necessary to promote honest and ethical conduct (including the ethical handling of conflicts of interest), adequate disclosure in periodic financial reports, and compliance with official rules and regulations. If such a code of ethics does not exist, the firm is to disclose the reason.

rotation of accounting firms, funds for restitution for injured investors, SPEs, the consolidation (and thus concentration) of the accounting industry, credit rating agencies, the extent of violations of securities laws by securities professionals, SEC enforcement actions (the aim being to identify areas of financial reporting most susceptible to fraud), and the role of investment banks in assisting issuers to manipulate their financial reports. Sarbanes-Oxley is self-evidently intended to prevent malpractices important in the Enron case with respect to financial reporting, self-dealing, and the independence and integrity of auditors. But the Act will also affect the country's regime of corporate governance much more generally, and thus the form and extent of its compliance with the OECD Principles.

Sarbanes-Oxley does not generally distinguish between United States and non-United-States firms, covering as it does all those to which the Securities Exchange Act of 1934 applies. This Act, whose primary objective is to assure the public availability of company information, applies not only to firms with publicly traded stocks but also to those with more than a threshold number of shareholders and value of assets. As far as firms from developing countries are concerned, its major direct impact will be non-United-States issuers of securities in United States financial markets, and consequent difficulties are likely to involve features of legal regimes in other jurisdictions not conforming with Sarbanes-Oxley. Such features may include insider loans (since many legal regimes permit loans to executives and directors), the rules to be followed by audit committees, the code of ethics for senior financial officers, and the oversight of and some of the more detailed rules for auditors. It should also be noted that the Act may also have implications for the competitiveness of United States firms abroad. Section 302 of Sarbanes-Oxley prohibits entities incorporated in the United States from reincorporating abroad to avoid or lessen the legal force of the Act's provisions regarding financial reporting. As a result minimising possible adverse effects on their international competitiveness is likely to be an important objective of United States firms in negotiations with the SEC over the detailed rules through which different parts of Sarbanes-Oxley will be implemented.

Mention has already been made of possible further legislation in the United States concerning subjects covered by studies mandated by Sarbanes-Oxley. Another area where revelations concerning Enron may lead to such action is taxation. The

revelations in a recent lengthy report to Finance Committee of the United States Senate by Congressional tax experts, which has not been reviewed for this paper, document complex transactions structured for the purpose of tax avoidance and use for the same purpose of offshore subsidiaries which were part of the extensive network of such entities described in section C.1[66]. Here too Enron was provided with assistance by accountancy firms and investment banks. Tax matters are not ignored in Sarbanes-Oxley: under title X, section 1001, it is stated that "ït is the sense of the Senate that the Federal income tax return of a corporation should be signed by the chief executive officer of such corporation". But substantial tightening of the tax code now also seems eventually likely.

Owing to the size of the United States economy and the importance of its firms and financial markets to the world economy major changes in its regime of corporate governance will significantly affect negotiation and implementation of new international initiatives in this field (whose early manifestations were described in section E.1). This will not be the first time that reforms in United States corporate governance driven by scandals have had substantial international ramifications. The Foreign Corrupt Payments Act (FCPA) of 1977, which was a response primarily to questionable payments in the Watergate case and to bribery overseas by Lockhead Aircraft Corporation, was directed at two different but related areas of corporate governance: the first was the prohibition of bribes to foreign officials made directly or through third parties; and the second was reform of firms' accounting and internal controls with the objective preventing the inaccurate recording of large sums in books and records to facilitate bribes and questionable payments[67]. The direct impact of FCPA in terms of keeping foreign issuers out of United States financial markets is impossible to estimate but has probably been significant[68]. The indirect impact, in particular the influence on the nature of United States participation in negotiations on

---

[66] See D.C. Johnston, "U.S. tax report is 'eye-popping' ", *International Herald Tribune*, 14 February 2003, and J. Chaffee, "Enron tax shelters bring calls for reform", *Financial Times*, 14 February 2003. The report to the Senate Finance Committee is 2,700 pages in length.

[67] See, for example, E.H. Flegm, *Accounting: How to Meet the Challenges of Relevance and Regulation* (New York, etc.: Ronald Press/John Wiley, 1984), pp. 152-155.

[68] One prominent recent case involved Marconi, the electrical-equipment and telecommunications company which, under pressure to reduce the share of debt in its balance sheet, none the less forbore to issue new equity in the United States market owing to its non-compliance with FCPA. See J. Plender, *Going off the Rails: Global Capital and the Crisis of Legitimacy* (Chichester: John Wiley, 2003), p.135.

international initiatives concerning corporate governance in such fora as the United Nations and OECD, has been important in that the United States has pushed strongly for multilateral commitments for the elimination of bribes and illicit payments, partly out of an understandable concern as to the adverse competitive effects of FCPA on its own firms in international trade and investment. At this stage the nature of any adverse effects of Sarbanes-Oxley on the position of United States firms is still difficult to identify, so that pressures on the country's negotiators from this source are hard to forecast. But so far-reaching a reform will inevitably contribute substantially to future international standard setting on corporate governance, accounting and auditing.

F. Wider policy implications

1. Some malfunctions of a model

Recent corporate scandals have set back the cause of promoting corporate governance modelled on that of the United States. Such promotion accompanied the increased international attention accorded in recent years to principles of good practice in this area, even as the OECD Principles carefully avoided expressing a preference for any particular model. What these scandals achieved was to highlight the gulf between the idealised version of what is more often referred to as the Anglo-Saxon model of corporate governance, on the one hand, and its largest real-life counterpart, on the other.

To simplify a little, in the Anglo-Saxon model disclosure plays a key role in enabling holders of the firms' liabilities (debt and equity) to ensure good corporate governance and, beyond such governance, efficient use of the economy's financial resources. Under company law shareholders have the responsibility for appointing a firm's directors and the chief executive officer. The non-executive directors monitor both the performance of the executive directors and that of the business as a whole. The shareholders are also responsible for the appointment of the auditors, who have the key role of ensuring adequate disclosure. In the event of a failure of these elements of corporate governance to ensure satisfactory performance by the firm, then the model still has an alternative way of achieving this goal in the form of a hostile

bidder for the firm's assets who, so this version of the story goes, will use them more efficiently[69].

As is evident from the account in section C, the Enron case provides a dramatic demonstration of how assumptions about the efficiency of disclosure and of disciplines imposed by financial markets may not hold. Along with other recent scandals it points to the need to analyse the economic sectors responsible for generating and using financial information in terms of their structure, conduct, and performance along lines familiar from industrial economies[70]. The findings of a

---

[69] This characterisation of the Anglo-Saxon model follows that of Plender, *ibid*., p.137, who prefers the epithet, "Anglo-American". A recent World Bank paper on corporate governance (M.R. Iskander and N.Chamlou, *Corporate Governance: a Framework for Implementation* (Washington, D.C.: The World Bank Group, May 2000), pp. 22-23) furnishes a more fulsome account of the links between efficiency and financial markets in the Anglo-Saxon model of corporate governance, and one of which parts are worth quoting at length:

> "THE DISCIPLINE OF COMPETITIVE FINANCIAL MARKETS. Both equity and debt markets impose substantial discipline on management. Equity markets continuously monitor and place an objective value on corporations and, by extension, on their management. The day-to-day performance of a company's shares on a stock exchange is a transparent reminder to managers and owners of the company's perceived viability and value. This assessment permits shareholders to assess management performance and gives managers an incentive to minimize the costs of equity, since failure to do so will make them vulnerable to takeover. An active market for corporate control, fluctuations in stock prices, and the influence of shareholders keep managers focused on efficiency and commercial success.
>
> …
>
> Debt markets impose additional and often more stringent and direct discipline through threats of bankruptcy or an end to a poorly performing firm's access to capital. Transparent and properly regulated markets for debt finance prod corporations to employ debt profitably by servicing it or by covering creditor losses if the debt cannot be repaid."

The same study acknowledges that "share prices can be an effective measure of performance only if equity markets are deep and well regulated to ensure fairness, efficiency, liquidity and transparency", and that other factors also play a role in "external discipline for good corporate governance". These include "reputational agents" such as lawyers, investment bankers, investment analysts, credit rating agencies, consumer activists, environmentalists, and accounting and auditing professionals, who "exert enormous pressure on companies to disclose accurate information to the market, to improve human capital, and to align the interests of managers, shareholders, and other stakeholders." In principle forces mentioned in this passage could lead to the favourable outcome described, but the authors leave little doubt that in their view a reasonable approximation of this model is also readily achievable in practice. In this respect they are less sceptical than Plender (though they were writing before the unfurling of recent corporate scandals).

[70] The major features of such analysis are described in standard textbooks of the subject. See, for example, W.G. Shepherd, *The Economics of Industrial Organization*, 2nd edition (Englewood Cliffs, N.J.: Prentice-Hall, 1985), pp.5-7. As traditionally applied, such analysis focuses mainly on the ways in which variations in market structure are associated with variations in the degree to which the behaviour of economic agents approximates that of the competitive model. Extension of the analysis to the production and use of financial and other information about firms would require a different concept of structure which encompassed, *inter alia*, relations between institutional arrangements and incentives

recent report for the United States Senate, while not consciously the product of this analytical framework, none the less contain important conclusions about the interaction of the pressures under which regulators and the "private sector's watchdogs" operate, on the one hand, and both their conduct and their performance, on the other, for this purpose digesting not only the reports cited in section D but also much other relevant material[71].

In the case of the SEC, the regulatory body responsible for reviewing firms' financial statements, the Senate report focuses on the agency's passivity, which led it to miss warning signs concerning Enron's misconduct[72]. This failure reflected partly resource constraints. The SEC's stated goal had been to review every company's annual report at least once every three years. However, in practice the annual returns of less than 50 per cent of public companies had been reviewed in the previous three years, and no review of Enron's returns had taken place after that of 1997 (despite warning signs such as those discussed in section C.3.)[73]. The failings of Enron's board of directors and of its auditors were taken up above in section D, and the Senate report summarises the material and conclusions discussed there[74].

Other sets of "private-sector watchdogs" covered in the Senate report but not mentioned above in section D are financial analysts and credit rating agencies. Concerning the first group, while citing some honourable exceptions, the report notes that most financial analysts covering Enron stock continued to recommend it to investors well into the autumn of 2001, even as revelations concerning Enron's

---

to conflicts of interest, on the one hand, and a concept of performance in terms of adequately servicing the information needs of investors, lenders and other stakeholders, on the other.

[71] Staff, *op. cit*. (at footnote 54).

[72] *ibid*., pp. 11 and 31-40.

[73] Enron was also subject to the oversight of the Federal Energy Regulatory Commission (FERC), the body responsible for regulation of the interstate transmission and wholesale of electricity and natural gas, licensing of hydroelectric projects, and oil transmission by interstate pipelines. Under these headings the FERC is concerned with rate levels, the maintenance of competition, and construction of pipelines. FERC's oversight did not concern Enron as a corporation *per se* but various particular activities. A report to the United States Senate on FERC's oversight focussed, *inter alia*, on areas where Enron is now known to have engaged in questionable transactions (such as the California energy crisis), and on financial risks to which it was exposed by its trading activities (a subject taken up further in section F.2). The overall verdict of the report for the Senate is that FERC "was no match for a determined Enron" and "has yet to prove that it is up to the challenge of proactively overseeing changing markets." See Majority Staff (United States Senate Committee on Governmental Affairs), "Committee Staff Investigation of the Federal Energy Regulatory Commission's Oversight of Enron Corp.", *Staff Memorandum*, 12 November 2002, p.2.

[74] *ibid*., pp.27-29.

accounting and management failings began to proliferate. Many of the analysts made this recommendation even though they admitted that they did not fully understand the firm's operations and structure. The overall verdict of the report is that "Wall Street analysts [were] far less focussed on accurately assessing a company's performance than on other factors related to their own employers' businesses", citing here the employment of many of them by banks that derived large investment-banking fees from Enron transactions, that were investors in Enron's off-balance-sheet partnerships, and that had credit exposure to Enron[75]. The report draws attention not only to the links between analysts' bonuses and the profitability of the firms employing them but also to more general pressures for favourable recommendations on a stock such as complaints and even legal threats from firms evaluated negatively and restrictions on the access of analysts responsible for such evaluations to the information required for their work[76].

The major credit rating agencies enjoy great power by virtue of the influence of their ratings over firms' access to capital markets and over the cost of their financing. Their influence is associated with the granting to them since 1975 by the SEC of the status of nationally recognised statistical ratings organisation (NRSRO). Their reliability has been called into question by a number of events in recent years such a tardy identification of problems in countries affected by the Asian financial crisis[77], and more recently by the failure of three major agencies to lower Enron's rating to below investment grade until a few days before the firm's bankruptcy in the face of a series of unfavourable disclosures. Here the report does not suggest a role for conflicts of interest and attributes the agencies' shortcomings to lack of inquisitiveness (despite the indications in Enron's financial reports of a propensity to engage in manipulation) and excessive attention to the firm's cash flow, the confidence of its counterparties, and the announcement shortly before its bankruptcy of a possible merger with Dynegy, another large trader of gas and electricity[78].

---

[75] *ibid.,* p.70.
[76] *ibid.*, pp.81-90.
[77] See Basel Committee on Banking Supervision, "Supervisory lessons to be drawn from the Asian crisis", *Basel Committee on Banking Supervision Working Papers No. 2* (June 1999), section 2 (c), and A. Fight, *The Ratings Game* (Chichester, etc.: John Wiley, 2001), chapter 4.
[78] See Staff, *op. cit.* (at footnote 54), Part Two, section II.D.

Some of the more general lessons of the Enron case for corporate governance have already been taken up in this paper as part of the discussion of the policy response in section E. But the questions posed by the shortcomings of the SEC and the "private-sector watchdogs" also bear on the credibility of the so-called Anglo-Saxon model of corporate governance, which rode so high in the 1990s and was touted in some quarters as an appropriate eventual goal or benchmark for reform globally. At bottom the major lesson of the Enron case and other recent corporate scandals with respect to such goals and benchmarks is that, like other social constructs, corporate governance and financial systems are susceptible to the effects of flaws and fault lines which are the product of financial innovation, human ingenuity (not all of it necessarily legal), and other changes in mores and in the social and economic context. Outcomes will continue to reflect the never-ending efforts of rule-setters and regulators to accommodate, and to handle the problems posed by, the evolution of accounting and other financial practices. Fashions in models of corporate governance will reflect not only their intrinsic strengths and weaknesses but also the challenges posed by particular historical circumstances and stages of development. Many (but not all) of the problems revealed by recent corporate scandals are more pertinent to the corporate governance of developed than of emerging-market or other developing countries. What should be reassuring to the architects of corporate governance in the latter two groups is the confirmation by recent revelations that there is no nirvana for such governance, and no blueprint providing an alternative to step-by-step improvement, which may draw lessons from the experience of countries with more developed regimes but attributes national conditions and history an integral role in the framework for system design.

2. Complex corporate structures

As explained in section C.1, by the time of its bankruptcy Enron had become a highly complex network of entities with a substantial part of its revenues earned from trading contracts in markets unregulated by the SEC or the Commodity Futures Trading Commission (CFTC)[79]. Large conglomerate forms supplying goods and

[79] Most of Enron's initial participation in the derivatives business involved energy contracts (exempted from CFTC regulation in the early 1990s), but from 1997 it also became a pioneering player in the market for weather derivatives, and in 2000 started an entity called EnronCredit.com which dealt in

services subject to different regulatory or legal regimes are frequently hard to control, and the difficulties are likely to be greater when a significant part of their activities is cross-border.

The regulation of financial conglomerates supplying traditional banking, securities and insurance services through the same corporate structure has become a subject for international initiatives in its own right, the body established for this purpose being the Joint Forum on Financial Conglomerates[80]. The Joint Forum has the task of facilitating the exchange of information between supervisors within and between sectors, and to study legal and other impediments to such exchange. Beyond this the Forum is also to examine possible assignments of roles to different supervisors as part of improving their co-ordination and to develop principles for more effective supervision of financial conglomerates. The issues covered under these headings include not only supervisory methods and capital levels for such firms but also intra-group exposures, management structures, the suitability of managers, shareholder ownership, and intra-group conflicts of interest[81].

The latter group of subjects seems pertinent to the case of Enron, and many of the principles enunciated by the Joint Forum actually cover failings in the firm's functioning identified since its bankruptcy. Even for the entities covered by the Joint Forum's work, namely financial conglomerates, application of these principles in

---

credit derivatives. Weather derivatives enable firms (for example, in heating oil) to hedge their exposure to weather through contracts where payments are made or received on the basis of the recorded temperature in relation to a predetermined level. Credit derivatives refer to a class of contracts whose value is linked to some indicator of the credit risk of private or governmental entities. The market in credit derivatives is largely dominated by banks which are of course subject to regulation as such. See Fox, *op. cit*. (at footnote 6), pp.48, 133-135, and 187-188. The FERC (which, as mentioned in section F.1 was responsible for regulation of interstate transmission and wholesale of electricity and natural gas and thus for oversight of many of Enron's activities) conducted in May 2001 an investigation into Enron Online, the firm's electronic platform for transactions in electricity and natural gas, with the objective of discovering whether it was associated with abusive market practices. In the view of a report for the United States Senate, the FERC failed to follow through on various concerns raised during this investigation, including some with a bearing on the firm's eventual bankruptcy such as a trading model exposing it to large financial risks and the dependence of its trading capability on its creditworthiness. For example, the FERC did not respond to its own findings by establishing a formal process for monitoring Enron's financial status despite the firm's position as North America's largest energy trader. See Majority Staff, *op. cit*. (at footnote 72), pp.3 and 19-23.

[80] The Joint Forum was established in 1996 under the aegis of the Basel Committee, IOSCO and the IAIS to take forward the work of an earlier entity, the Tripartite Group, established in 1993 to address issues related to the supervision of financial conglomerates. See Basel Committee on Banking Supervision, *Compendium of Documents produced by the Joint Forum* (Basel: BIS, July 2001), p.5.

[81] For an extensive review of the work of the Joint Forum and before it of the Tripartite Group see Walker, *op. cit*. (at footnote 59), Part II, chapter 3.

practice is still at a preliminary stage, depending as it does on their incorporation in rules and standards set by other regulatory fora such as the Basel Committee, IOSCO, and IAIS, their eventual embodiment in national laws and regulations, and further development of co-operation between supervisors in different sectors and countries. But, as things stand, these initiatives do not cover firms like Enron with its concentration on activities outside specialised regulation[82]. In the United States Enron was of course subject to the country's regime of corporate law and to supervision by the SEC as a listed company. And many of its energy activities came within the ambit of oversight by the Federal Energy Regulatory Commission (FERC). But findings discussed above suggest that the governmental bodies responsible for Enron's supervision proved unequal to the task. Enron's determination to minimise regulatory interference in its activities played a role here. But it is difficult to avoid the conclusion that much of the problem lay in the very complexity of Enron – a type of corporate structure for the regulation and supervision of which rules are still underdeveloped and relatively untried.

These remarks should not be taken as implying the view that complex corporate structures are necessarily inappropriate for developing countries. Corporations with highly complex organisational structures have played important roles in the development process of several countries, perhaps most importantly in Asia[83]. But caution is justified, especially given the scope for lesser accounting transparency and for regulatory evasion and arbitrage now provided by recourse to SPEs and to certain types of hedging transactions, and by the exploitation of the opportunities provided by the possibility of locating in several jurisdictions (including those with only limited disclosure requirements). Such caution can be exercised at the stage of the original licensing or (in the case of foreign firms) the according of market access, of the application of company law and the associated supervision or oversight,

---

[82] Problems arising in the supervision of mixed conglomerates, i.e. firms including substantial non-financial activities, have been addressed by the Basel-based bodies, the Tripartite Group in a 1995 report recommending some form of supervisory ring-fencing of such activities. But the principal focus of the bodies' work were the conglomerates' financial activities. See, for example, *ibid*., pp. 190 and 203.

[83] For example, large diversified industrial groups have played central roles in the rapid industrialisation of Japan and Republic of Korea – trading companies in the former and the chaebol in the latter. The considerable achievements of these groups are not in doubt, although different authorities vary in their assessment of the precise balance of benefits and costs associated with their activities.

and of the granting of permission to extend the scope of a firm's activities into major new sectors. Perhaps one further proviso is in order here. Complex corporate structures and complex financial transactions (such as those exemplified in the case of Enron) demand high levels of skill on the part of those responsible for supervision and oversight. Shortages of people possessing such skills are a commonplace feature of developing countries (and to some extent of developed ones as well). The availability of the required levels of capacity for oversight and supervision should be given appropriate weight in development or reform of a country's regime for conglomerate firms.

3. Corporate governance and key financial standards

The OECD Principles are one of the 12 financial standards which have been identified as essential to the soundness and stability of financial systems and as having a key role in measures to strengthen the so-called international financial architecture[84]. Observance of these standards is now a subject covered by IMF Article IV surveillance, and a positive assessment under this heading is one of the conditions for a country's eligibility for financing under the IMF's Contingency Credit Line (CCL)[85]. Other roles for the key financial standards are also envisaged. One unsurprisingly is their incorporation in the decision making of international lenders and investors[86]. Another, which has been proposed in the new round of multilateral trade negotiations, would link countries' discretion with regard to prudential measures under certain provisions of the WTO General Agreement on Trade in Services (GATS) in ways not yet defined to progress under the heading of key financial standards[87].

---

[84] For the role envisaged for these key financial standards and for some commentary see UNCTAD, *Trade and Development Report, 2001,* Part Two, chapter IV (reprinted as A. Cornford, "Standards and regulation," chapter 2 of Y. Akyüz (ed.), *Reforming the Global Financial Architecture: Issues and Proposals* (London: Zed Books for UNCTAD and Third World Network, 2002.)).

[85] *ibid*, Part Two, chapter IV, section D and chapter VI, Box 6.3.

[86] *ibid*, Part Two, chapter IV, section D.

[87] According to paragraph 2(a) of the GATS a country "shall not be prevented from taking measures for prudential reasons, including for the protection of investors, depositors, policy holders or persons to whom a fiduciary duty is owed by a financial service supplier, or to ensure the integrity and stability of the financial system." However, this freedom is qualified by the provision that "where such measures do not conform with the provisions of the Agreement, they shall not be used as a means of avoiding the Members commitments or obligations under the Agreement." For a more extensive commentary see A. J. Cornford, "Some implications for banking of the draft General Agreement on Trade in Services of December 1991", *UNCTAD Review*, No. 4, 1993, section VIII.

Recent financial scandals will inevitably affect the political climate within which work on the implementation and further development of the standards will take place. As described in section E.1, the scandals have already provided the impetus for further efforts to strengthen corporate governance within the framework of the OECD. But more broadly they raise questions about a basic assumption of international initiatives on the subject, that although regimes in industrial countries could be improved by further work on particular subjects of corporate governance, many of them covered by ongoing work under different key financial standards, these regimes have none the less reached a level of development satisfactory enough for the major target of future reform to be emerging-market and other developing countries. While the relatively underdeveloped condition of regimes in most countries belonging to the latter group of economies is not disputed, a lesson which many will draw from recent events is that corporate governance in industrial countries is being importantly weakened by firms' capacity to get round major features of legal regimes and regulation through opportunities furnished by innovations involving financial transactions and institutional structures as well as by the access to multiple jurisdictions which has accompanied the internationalisation of business.

From the first there were queries as to the suitability of corporate governance as a subject for application of the incentives and sanctions envisaged as part of the global promotion of key financial standards. The grounds for such queries included the summary nature of the OECD Principles, the complexity of the subject and the potential intrusiveness of international initiatives, and the non-representativeness of the body (the OECD) which had enunciated the Principles[88]. To these queries there will now be added others reflecting acknowledgement that in important respects the state of the art in regimes considered the most developed has recently demonstrated shortcomings hitherto unrecognised or only partially recognised. Corporate

[88] Promulgation as opposed to enunciation of the OECD Principles is also to involve other organisations, a key role here being attributed to the World Bank. The World Bank and the OECD have established a Global Corporate Governance Forum whose agenda includes consensus building, technical assistance, the design and implementation of projects, and the promotion of policy dialogue. For this purpose the Forum will include, in addition to its two sponsors, regional development banks, other international organisations, bodies working on the key financial standards such as IOSCO and IASC, and a Private Sector Advisory Group. The Memorandum of Understanding on the Establishment of the Global Corporate Governance Forum between the OECD and the World Bank is reprinted as Appendix 3.3 of Iskander and Chamlou, *op.cit*. (at footnote 68).

governance has in fact so far been one of the less scrutinised subjects in the reports (ROSCs) of the IMF and World Bank assessing countries' progress regarding key financial standards[89]. This seems understandable in the light of the subject's difficulties. Much good can eventually result from a patient process of development and reform in this area, in which international co-operation through exchange of experience and technical assistance can play a significant part. But this process should also incorporate acknowledgement of the proven limitations as well as the strengths of all known models of corporate governance. Progress regarding such governance requires practical experimentation, and this experimentation in turn can only take place if national policy makers are left considerable discretion as to choices regarding their route to development and reform.

[89] The Reports on Standards and Codes (ROSCs) are the result of a joint programme of the IMF and the World Bank to assess progress in the implementation of key financial standards. Each assessment of a standard results in a ROSC module, only those standards believed by a country to be most relevant to its circumstances being covered. Although the exercise is a voluntary one, the subjects of the financial standards will still be included in IMF Article IV surveillance for countries not volunteering but on the basis of other sources of information.