Enron and the SEC

The following essay will help answer the question of how Enron got started in energy trading and what securities laws affected Enron. Most of the information about Enron deals with their accounting practices and the partnerships they formed. Because of this most of the information included in this essay is an analysis of the securities laws and how they would pertain to a trading company. This essay starts out with a brief history of Enron and how it came into being. Followed by a discussion of securities laws as they pertain to Enron and other trading companies along with how the laws affecting Enron would have been different if they were a public utility company.

Enron is the brainchild of Kenneth Lay and was formed through a merger between two gas pipeline companies in 1985. In 1985, Kenneth Lay used money from the sale of junk bonds to finance the merger of Houston Natural Gas and Internorth. The result of this merger was Enron. Enron was formed from the beginning to be more than a utility company. Enron wished to be a major player in the energy market. Enron hoped to achieve this by buying and selling energy futures. Enron saw an opportunity to take advantage of the newly deregulated energy market. Enron started its new venture buying and selling gas and electricity futures.

In the 1980s oil prices fell causing people to switch from natural gas to fuel oil. This created a problem for natural gas companies such as Enron. This did not last long. Gas prices began to fluctuate and buyers became worried about the future. Enron saw this as its chance to start the trading side of their business. Enron started to lobby the government for more deregulation. Once the government deregulated the natural gas market it allowed Enron to start
trading natural gas contracts. Enron continued to lobby the government until it deregulated the electricity market allowing Enron to trade electricity futures.

In 1990, Kenneth Lay hired Jeffrey Skilling to head a new division. The purpose of this new division was to be the finance side of Enron. With this power, Jeffrey Skilling opened up new markets for Enron and even created markets for products never before traded by anyone. Some of these include advertising time, and Internet bandwidth. By 1997, Jeffrey Skilling was made chief operating officer. Even with all of this, the company was not making enough money causing it to go bankrupt in 2001.

Since Enron started as a utility, it seems fitting at this point to talk about SEC rules and regulations regarding a utility company. The SEC defines an electric utility as a “…company (,) which owns or operates facilities used for the generation, transmission, or distribution of electric energy for sale, other than sale to tenants or employees of the company operating such facilities for their own use and not for resale." It also defines a gas utility as a “…company which owns or operates facilities used for the distribution at retail (other than distribution only in enclosed portable containers, or distribution to tenants or employees of the company operating such facilities for their own use and not for resale) of natural or manufactured gas for heat, light, or power." Enron fits both definitions. The gas utility is especially well suited to Enron since it owned largest natural gas pipeline in the US after the merger. Enron also fits the definition of a public utility defined as “…an electric utility company or a gas utility company."

Since Enron fits these definitions there are certain requirements Enron must fulfill in order to satisfy the needs of the SEC. One of the requirements is that they must register with the SEC. This process includes filling the necessary paper work which can include the following: organization financial structure, “the terms, position, rights, and privileges of the different

1 "Public Utility Holding Company Act of 1935" 79ba3
classes of their securities outstanding, the terms and underwriting arrangements under which their securities, during not more than the five preceding years, have been offered to the public or otherwise disposed of and the relations of underwriters to, and their interest in, such companies, the directors and officers of such companies, their remuneration, their interest in the securities of, their material contracts with, and their borrowings, bonus and profit-sharing arrangements, options in respect of securities, balance sheets for not more than the five preceding fiscal years, certified, if required by the rules and regulations of the Commission, by an independent public accountant, and finally profit and loss statements for not more than the five preceding fiscal years, certified, if required by the rules and regulations of the Commission, by an independent public accountant.

The process would be similar if Enron was classified as an investment company. This reclassification would have happened as soon as Enron engaged or proposes to engage in the business of investing, reinvesting, owning, holding, or trading in securities, and owns or proposes to acquire investment securities having a value exceeding 40 percentum of the value of such issuer's total assets. A "Security" means any note, stock, treasury stock, security future, bond, debenture, evidence of indebtedness, certificate of interest or participation in any profit-sharing agreement, collateral-trust certificate, preorganization certificate or subscription, transferable share, investment contract, voting-trust certificate, certificate of deposit for a security, fractional undivided interest in oil, gas, or other mineral rights, any put, call, straddle, option, or privilege on any security (including a certificate of deposit) or on any group or index.

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2 "Public Utility Holding Company Act of 1935" 79ba4
3 "Public Utility Holding Company Act of 1935" 79ba5
4 "Public Utility Holding Company Act of 1935" 79eb2B
5 "Public Utility Holding Company Act of 1935" 79eb2C
6 "Public Utility Holding Company Act of 1935" 79eb2d
7 "Public Utility Holding Company Act of 1935" 79eb2e
8 "Public Utility Holding Company Act of 1935" 79eb2g
9 "Public Utility Holding Company Act of 1935" 79eb2h
10 "Public Utility Holding Company Act of 1935" 79eb2i
of securities (including any interest therein or based on the value thereof), or any put, call, straddle, option, or privilege entered into on a national securities exchange relating to foreign currency, or, in general, any interest or instrument commonly known as a "security", or any certificate of interest or participation in, temporary or interim certificate for, receipt for, guarantee of, or warrant or right to subscribe to or purchase, any of the foregoing.\textsuperscript{12}\textsuperscript{\textdagger}

Included in the preceding definition was an interest in oil and gas rights. This was exactly what Enron was doing. They started to trade in gas and electricity futures. This means they sold contracts for gas and electricity for a future date at an agreed upon price. Once these contracts equaled more than 40 percent of their assets they would have needed to reclassify as an investment company. Specifically they would have to classify as a management company. The definition of a management company is an "…investment company other than a face-amount certificate company or a unit investment trust.\textsuperscript{13}\textdagger\textdagger

The registration requirement for an investment company includes:

\begin{quote}
\textquote{a recital of the policy of the registrant in respect of each of the following types of activities, such recital consisting in each case of a statement whether the registrant reserves freedom of action to engage in activities of such type, and if such freedom of action is reserved, a statement briefly indicating, insofar as is practicable, the extent to which the registrant intends to engage therein: (A) the classification and subclassifications, as defined in sections 4 and 5 [15 USCS § § 80a-4 and 80a-5], within which the registrant proposes to operate; (B) borrowing money; (C) the issuance of senior securities; (D) engaging in the business of underwriting securities issued by other persons; (E) concentrating investments in a particular industry or group of industries; (F) the purchase and}
\end{quote}

\textsuperscript{11} “Investment Company Act of 1940” 3a1C

\textsuperscript{12}\textdagger

\textsuperscript{13}\textdagger\textdagger
sale of real estate and commodities, or either of them; (G) making loans to other persons; and (H) portfolio turn-over (including a statement showing the aggregate dollar amount of purchases and sales of portfolio securities, other than Government securities, in each of the last three full fiscal years preceding the filing of such registration statement)\(^{14}\)

\[\text{?} \quad \text{“a recital of all investment policies of registrant, not enumerated in paragraph (1), which are changeable only if authorized by shareholder vote}^{15}\text{”}\]

\[\text{?} \quad \text{“a recital of all policies of the registrant, not enumerated in paragraphs (1) and (2), in respect of matters which the registrant deems matters of fundamental policy}^{16}\text{”}\]

\[\text{?} \quad \text{“the name and address of each affiliated person of the registrant; the name and principal address of every company, other than the registrant, of which each such person is an officer, director, or partner; a brief statement of the business experience for the preceding five years of each officer and director of the registrant; and}^{17}\text{”}\]

\[\text{?} \quad \text{“the information and documents which would be required to be filed in order to register under the Securities Act of 1933 and the Securities Exchange Act of 1934 all securities (other than short-term paper) which the registrant has outstanding or proposes to issue.}^{18}\text{”}\]

These requirements are very different from those of a utility company. These requirements focus mainly on the securities and investment side of the business. It deals with the

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12 “Investment Company Act of 1940”2a36
13 “Investment Company Act of 1940”section 4 paragraph 3
14 “Investment Company Act of 1940”8b1
15 “Investment Company Act of 1940”8b2
16 “Investment Company Act of 1940”8b3
17 “Investment Company Act of 1940”8b4
specifics of how to inform the public of the securities they are holding and the policies surrounding the investments. It also has a provision for full discloser of the companies the: officers, partners and directors work for. This is to inform the public of any conflict-of-interest that may result from security trading. The similarities are in the final submission which includes documents that would be required by the SEC under the “Securities Act of 1933” and the “Securities Exchange Act of 1934.”

Since Enron went bankrupt it is only fitting that this essay include information about what the responsibilities are now under the “Securities Exchange Act of 1934. “Companies in bankruptcy are not relieved of their reporting obligations. Neither the United States Bankruptcy Code /7 nor the federal securities laws provide an exemption from Exchange Act periodic reporting for issuers that have filed for bankruptcy. In the release, however, the Commission expressed the general position that, with respect to issuers subject to the jurisdiction of the Bankruptcy Court, it generally would accept reports which "differ in form or content from reports required to be filed under the Exchange Act.". 19 However, upon further review the requirements do change. “Instead of Form 10-K and 10-Q filings19 a company must submit a “form 8-K within 15 calendar days after the monthly report is due to the Bankruptcy Court.19 Also, “(t)he issuer still must satisfy all other provisions of the Exchange Act….19”

Furthermore, if “(i)suers reorganizing under the jurisdiction of the Bankruptcy Court (it) must file a Form 8-K to disclose any material events relating to the reorganization. Issuers liquidating under the jurisdiction of the Bankruptcy Court must file a Form 8-K to disclose whether any liquidation payments will be made to security holders, the amount of any liquidation

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18 “Investment Company Act of 1940”8b5
payments, the amount of any expenses incurred, and any other material events relating to the liquidation."\textsuperscript{49}

If Enron ever emerges from its bankruptcy, it will need to “…file an appropriate Form 8-K. That Form 8-K should include the issuer's audited balance sheet. From then on, the issuer must file Exchange Act periodic reports for all periods that begin after the plan becomes effective.”\textsuperscript{49} This means that when it is all said and done Enron is going to have to disclose a lot more information on a much timelier basis than it did in the past. If Enron decides to liquidate then it will need to file a final Form 8k “…to report that (e)vent.”\textsuperscript{49}

In looking at the preceding laws regarding bankruptcy it is evident the Enron still has a long road ahead of it and even though the company went bankrupt it will not excuse them from needing to file reports with the SEC. The Securities act includes a lot of information and even has rules regarding bankruptcy if Enron succeeds they will be held lot more accountable then they ever have been in the past.

By forming the investment company, it created a need for Enron to reclassify its business. It also forced it to need to disclose more information. As a result, Enron tried to hide its losses to look better for the public. The result of this information hiding and “creative accounting” they created a problem that soon grew too big to be stopped. If Enron were to follow the rules of registration of an investment company, the public would have known of Enron’s problems long before they filled for bankruptcy. In the future, if Enron survives this will not be a problem. They will be under so much scrutiny by the SEC that it will be almost impossible to breath without reporting.
Summation of Footnotes

1 "Public Utility Holding Company Act of 1935" 79ba3
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4 "Public Utility Holding Company Act of 1935" 79eb2B
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9 "Public Utility Holding Company Act of 1935" 79eb2h
10 "Public Utility Holding Company Act of 1935" 79eb2i
11 “Investment Company Act of 1940” 3a1C
12 “Investment Company Act of 1940” 2a36
13 “Investment Company Act of 1940” section 4 paragraph 3
14 “Investment Company Act of 1940” 8b1
15 “Investment Company Act of 1940” 8b2
16 “Investment Company Act of 1940” 8b3
17 “Investment Company Act of 1940” 8b4
18 “Investment Company Act of 1940” 8b5
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