

Market Economy and Self-correcting Institutions

An efficient market economy needs effective and independent regulators, speedy justice and mechanisms to enact laws to protect the investors and citizens. These are the lessons we in India need to learn from the US response to the collapse of Enron. It soon became the world's largest electricity and natural gas trading company.

In a series of breathtaking developments, Enron collapsed by December 2001 and filed for Chapter 11 bankruptcy protection. The growth and collapse of Enron make a fascinating study. But what is more important is the lightning speed with which the US government, legislature, regulatory agencies and justice system responded to the crisis. This quick response limited the damage to the US economy, and is now instituting new safeguards against future failures and crises.

The crisis for Enron started on October 16, 2001 when Enron reported a \$618 million third-quarter loss and disclosed a \$1.2 billion reduction in shareholder equity. The regulatory agencies responded swiftly. Within a day, the Security Exchange Commission (SEC) acted and sent a letter to Enron asking for detailed information. By October 20, the Internal Revenue Service (IRS) sought and obtained information from the Republican House Majority Issues Committee to show how it raises and spends its money, and it revealed large donations from Enron. By October 22, the informal SEC enquiry was publicly acknowledged by Enron; this news caused a 20% dip in Enron share value.

On Oct 28 and 29, US Treasury Secretary O' Neill and Commerce Secretary Evans were approached by Enron for help, but both refused to intervene. By Oct 31, SEC enquiry was upgraded to a formal investigation. By Nov 8, Arthur Anderson, the accounting firm that destroyed key documents, received a federal subpoena for documents related to Enron, and Enron filed documents with the SEC revising its financial statements for the past five years to account for \$586 million in losses. On Nov 29, SEC investigation was expanded to

include Arthur Anderson. On Dec 2, Enron filed for chapter 11 bankruptcy protection, marking the swift collapse of the once trading giant.

Legislature immediately began hearings on the subject. By Dec 12, Joseph Berandin, the Chief Executive of Arthur Anderson appeared before Congress. On Jan 3, 2002, Senator Joseph Lieberman chaired the full Governmental Affairs Committee heading the investigation of the White House's involvement in the collapse. Top executives and directors of Enron were subpoenaed by the Senate Committee. By Jan 10, the Justice Department began criminal investigation of Enron's collapse. On Jan 24, Congressional hearings on the subject began. On Feb 24, the Justice Department instructed the White House to preserve any documents related to its dealings with Enron, and the White House agreed to comply.

Institutional improvements followed equally rapidly. On Feb 14, SEC revealed its plans to alter its policies on corporations' disclosure of financial information. Within days, Judiciary stepped in as class action lawsuits were filed against Arthur Anderson and Enron by shareholders. The Congress filed an unprecedented lawsuit against Vice President Cheney as he refused to disclose details of interaction between Enron executives and Bush administration's energy task force which he headed. On March 7, President Bush himself revealed to public a detailed proposal to require corporate chief executives to vouch personally for their companies' financial statements. On March 20, the House and Senate proposed pension reform plans to offer more legal protection to workers in the wake of the Enron controversy. On April 2, the Senate called for new laws and dramatic changes in American business executive behaviour.

Results of investigations and policy changes started flowing by April 2002. On April 9, David Duncan, Arthur Anderson's lead Enron auditor pleaded guilty to obstruction of justice in destroying Enron-related documents. On April 11, the House of Representatives passed Bush's new Pension Reform Bill in the wake of Enron scandal. On April 17, a House committee approved legislation passing a new auditor oversight board. On April 24, the House passed accounting reform package, calling for stricter oversight and disclosure

policies. Wonder of all wonders, prosecution already began against Arthur Anderson in a Houston court, and the trial is in final stages by June first week!

This breathtaking speed is not peculiar to Enron or the US. The junk bond scam occurred in the US in 1980s. The chief accused, Michael Milken was tried swiftly and sentenced to jail term and completed his sentence years ago. Nick Leeson, the accused in Barings Bank scandal in Singapore was apprehended, tried, and sentenced, and has already completed his sentence.

Now witness the securities scam of Harshad Mehta and the stock market scam of Ketan Parikh. Years after the scam, Mehta died of natural causes, and as of now nothing of consequence happened. Ketan Parikh case is still under investigation. The less said the better about Bofors, HDW and other scandals. No wonder, our people exhibit little faith in capital markets, governments, regulators and courts. We need to get our act together if we want rapid economic growth. Rule of law and trust in institutions are the paramount requirements for a well-functioning market. Mistakes and accidents are bound to happen in any system. The test of the system's resilience is how it responds to events, internalizes lessons of past experience, and institutes safeguards to protect its citizens.

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