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VOLUME 7
ISSUE 19
OCTOBER 21, 2005

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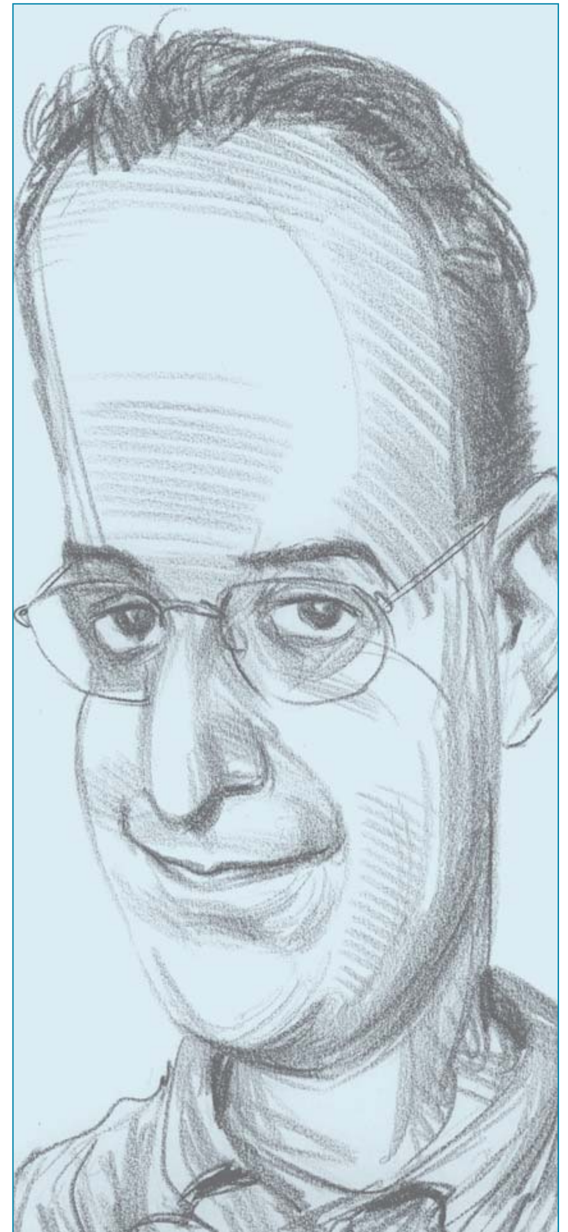
listeningin

Partnoy's Solutions

To Control Systemic Risk, Would Shine Light On Economics of Derivatives

*Wall Street, we have a problem." That, in a nutshell (with apologies to **Apollo 13**), is **Frank Partnoy**'s message, grounded in the three years he spent on over-the-counter derivatives desks at Morgan Stanley and First Boston in the early 1990s, and refined during the subsequent decade as he turned to the practice of law, first in Washington, then as a professor at the University of San Diego School of Law. Over that span, Frank has cranked out not only the boatload of scholarly articles expected of a young prof, but also two books, the best-selling **F.I.A.S.C.O.: Blood in the Water on Wall Street**, a semi-autobiographical account, **Liars' Poker**-style, of his wastrel youth on the derivatives desk and the more recent **Infectious Greed**, an ambitious, heavily footnoted tome in which he traces the roots of many of the Street's most sordid post-bubble scandals to, in a word, derivatives.*

Don't, however, jump to the conclusion that that singular description is simplistic or somehow represents a (considerably delayed) parting shot from a disgruntled former derivatives salesman. Frank uses the term "derivatives" to encompass all the myriad innovative and highly complex unregulated trading vehicles the Street has dreamed up over the last decade and half, most to enable transactions to go forward while avoiding legal impediments. In their impenetrable density and perverse incentives coupled with a social acceptability, Frank finds metaphors for much that now ails corporate and public life, not to mention an explanation for why the financial markets often seem to be spinning out of control. Listen to him. The NY Fed has lately called the Street's biggest banks on the carpet for leaving mountains of back office paperwork undone on trillions in derivatives. Frank also has some ideas to limit the potential damage.
KMW



Another financial fraud is unraveling before our eyes. I assume you're not especially surprised—
No, I am not surprised. I don't know that anyone expected that this would happen at **Refco**, but I am

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Published exclusively for clients of Weeden & Co. LP

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welling@weeden, an exclusive service for clients and prospective clients of Weeden & Co. LP, is published biweekly on Friday mornings, by welling@weeden, a research division of Weeden & Co. LP. Editorial and partnership offices are located at 145 Mason Street Greenwich, CT 06830. Telephone: (203) 861-9814 Fax: (203) 618-1752 Email: welling@weedenco.com jean_galvin@weedenco.com.

First-class postage is paid at Stamford, CT

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Victor Juhasz
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not surprised by revelations that there are transactions that are not reported in financial services companies.

There's nothing new about cooking the books.
Nothing at all. Though a loan this size to a CEO is a bit unusual, I am not surprised by anything anymore. You are probably not, either.

I wish I could say I am shocked, but I've seen this movie before. Too often. The only surprise is usually the identity of the latest perpetrator. Who would have expected the Orange County Treasurer, for instance?
Exactly, exactly. We are surprised by who turns up as the most recent perpetrator but we are not surprised that there is one.

And once again, the web of interlocking transactions and self-dealings will probably prove too convoluted to unravel for quite some time.
That was certainly one of the problems with Long Term Capital and it was one of the problems with Enron and I am sure it will be a problem with Refco. Another will be that the way most people will come to understand what happened will be through a handful of journalists who have to work quickly and often don't have either the facts or the training to get the facts or understand all the details. So there will be a sort of myth that will arise from people's partial understanding of the truth. It might, in the end, accurately point to the sources of the problem—but I doubt it. As you know, I don't think the popular understanding of what happened in those two big prior scandals, Long-Term Capital and Enron, is terribly accurate.

I am not sure there is any such thing as a popular *understanding* of those two events.
What I mean is that Enron, for instance, certainly is thought of simplistically as being a deliberate fraud; the whole thing was a house of cards run by evil perpetrators at the top who were stealing from employees and shareholders. I am sure you and I don't think that is anything close to what actually happen at Enron. And the Refco story may be even more complicated.

Or less. Refco's woes seem to stem from old-fashioned securities fraud, while it may be, as you contend in your book, that everything, or at least most, of what was done at Enron met the letter of the law. But my take on it is that virtually everything Enron did pushed the envelope—in an era in which the envelope had degraded to whatever somebody could get away with. The net effect was to disguise a massive and continuous transfer of wealth from Enron's investors, employees, customers and business partners to its insiders and a coterie of institutions that were its enablers. All of whom were only too happy to rationalize their "good fortune" to ask any probing questions. So this went on until it got too big for anyone to control, a little too much light got shed on a few of its self-dealings, a few sheep declined to be shorn and the whole thing unraveled. Unbridled greed is the basic motivation, whether the actor is Willy Sutton, Phillip Bennett, Ken Lay, Jeff Skilling or Andy Fastow. Only their levels of sophistication—and willingness to brazenly thumb their noses at social conventions or "the law"—differ.
Essentially, I think that business as a whole is not particularly well understood and that in these situations the truth only emerges, eventually, out of litigation. The people who have been involved in litigation related to Enron or even LTCM, now know those basic stories. But I am not sure the public ever really does hear them.

"All the Wall Street and corporate scandals were not caused, simply, by a bunch of individuals acting like bad apples. There is a way to understand how the last 15 years happened through the lens of financial innovation, the increase in the complexity of financial instruments and the institutions that trade them, at the same time that markets were being excessively deregulated."

I'm more cynical. What often emerges from litigation isn't necessarily the truth, only the version of history promulgated by the parties with the deepest pockets, I am afraid. And even so, that process all too often takes years, so that verdicts are rendered long after public attention has moved on to more current issues. Then too, our legal process wasn't real-

ly built to deal with the complexities of modern business transactions, so that any successful litigation almost by definition bites off just a tiny fragment of any story. Otherwise no lawyer can build a case that's digestible by judge or jury.
I think that is a fair characterization, in the sense that litigation takes a long time and litigants are constrained. But they also have incentives to develop the facts.

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Besides, one reason that it takes a long time is that the parties to litigation have to considerable time and resources to develop the facts of a case. You and I haven't spoken before, but I have talked to a lot of journalist who are smart people who write about the markets. And they are all constrained, too. Journalists have deadlines. They often don't have the time or resources to do the kind of digging that lawyers are going to be paid tens of millions of dollars to do.

No argument, counselor. Journalists lack subpoena power and don't even have the rules of the civil discovery process working in their favor. And most have to work very quickly. But it's often amazing what you can discover merely by asking questions, actually reading documents, looking at available evidence.
Exactly. Journalists try to get as much of the story and as much of an understanding as they can, but inevitably have to do so against a deadline. And without subpoena and without the discovery process. So there are handicaps.

On the other hand, a journalist has a chance of exposing something approaching the truth within a time frame that might match the public's attenuated attention span.
That is right. One of the problems with exposing these stories far down the line–and you certainly saw that with books about Enron–is that people just don't care anymore. They have moved on. I certainly face those types of time constraints in writing ***Infectious Greed***. A lot of the stories I recount in the book were historical but because it also encompassed the most recent developments, the publisher wanted to get it out as quickly as possible.

Of course, quickly, in book publishing is still more akin to geologic time than to net speed.
I wrote it pretty quickly. In some sense, I had been doing a lot of the background research for that book for years. It was in the back of my mind for a decade. But the actual writing took place over less than a year.

That is pretty close to warp speed, for a book.
Especially since I do have other responsibilities I had to fit it around. I am a law professor.

You mean you are actually expected to teach?
Exactly. I teach law students. But part of my day job is also to do legal research and writing. And writing ***Infectious Greed*** was consistent with some of the other projects that I had going. Still, it take a while to write 150,000 words.

No kidding. Particularly, if you insist on writing cogent ones.
Not to mention that there are a lot of details enumerated in this book. There are something like 1,000 footnotes. All of that, obviously, took a fair amount of time to put together.

The price you paid for becoming an academic?
Well, my first book [***F.I.A.S.C.O.: Blood in the Water on Wall Street***], did not have any footnotes in it. It was more autobiographical and wasn't as rigorous. But I thought that footnoting this book was important. Some of the claims I was making I assumed might be controversial. I wanted anyone who disagreed with me to be able to see all of the source material I used to explain what I think happened at Enron or what I think happened at Long-Term Capital or what I think the weaknesses of Arthur Levitt's reign as SEC chair were. Anyone who flips to the back of the book can see that it's not just my opinion, it's backed by studies of various kinds, research. It's a much more serious book than ***F.I.A.S.C.O.,*** which was more of a fun book, including some of the laughs, bawdy locker room antics and color of the trading floor; some racy descriptions of investment bank culture and all of that sort of thing. And yes, I wrote it before I became an academic. ***Infectious Greed*** is more of a dark story about the major changes in financial markets over the last 10-15 years and some of what I think are the

most serious problems that have resulted. So my two books are really different animals. I really thought it necessary for ***Infectious Greed*** to be footnoted, because I want it to withstand the test of time. If someone picks it up in 10 or 20 years, I want them to be able to see how my assertions were supported.

Footnotes or no, Wall Street hasn't exactly embraced your books.

I guess that is right. I think that the public reaction from Wall Street has been critical–certainly of the first book. Morgan Stanley made public statements disparaging the book. But in private conversations with me, I have to tell you, a lot of Wall Street people I know told me, "You've got this thing right." Some of them may have complained to me that maybe my rhetoric in certain places seemed unfair, but I also got a fair amount of private support. I have to tell you that I still get a lot of emails and phone calls from people who say things like, "Oh, by the way, on this scandal you missed the following three egregious things that I know about because of personal experience." I get a lot more of those than I do the ones that say, "You are really out of line here." Maybe that's because the people who disagree with me filter themselves out of the pool that bothers to correspond. I don't know. On the other hand, there are people like George Needham, of Needham & Co., who is a very well-known and well-respected person in Wall Street–he threw a book party for me and invited a lot of his friends from the Street. I will tell you that the Wall Streeters who have talked to me after looking at the book have told me that I got a lot of things dead-on, particularly some of the character portraits of people like Frank Quattrone, Henry Blodget and Jack Grubman. Frankly, the Wall Street people whom I have great respect for, people like George Needham, know that Wall Street has a legitimate core–and that they need to protect that core. It is a profitable business at its core and they want to protect its reputation. They don't want people soiling its reputation. From their perspective, they prefer to have somebody like me who is willing to tell these stories and try to connect the dots among some of the bad actors. There are plenty of these honest people on Wall Street who work hard–and they are as disadvantaged by the bad actors just as much as the average investor is, maybe more.

You sound like you're embracing the explanation that Wall Street has just been hit with an epidemic of "bad appleitis,"—which you explicitly rejected in your book.

It's way too simplistic. I obviously disagree with that. I believe that Wall Street's problems are systemic and endemic. But I also do believe that there are some good apples. I actually believe the bad apple metaphor is precisely backwards. I think the very nature of the investment business has become corrupted by financial organizations capturing regulation and by the increase in the complexity of transactions and by the cultural shifts. So I do believe that the business is rotten at the core. But I also believe that there are good apples out there and that the financial industry performs crucial functions for the economy. While it's convenient for the President, other politicians and industry leaders to blame a few bad apples, that's not how the government or the industry should be addressing these problems. My views have not changed since I wrote ***Infectious Greed***. Clearly, these problems are endemic to the business and to the regulatory structure and are not going to be solved by just hanging out a few of these colorful figures to dry. My experience, since writing the book, is that Wall Street's good apples recognize that. But does Morgan Stanley like the way I have portrayed them? No.

Nor are you surprised. The question is, who is Morgan Stanley anymore?

Exactly. That's a good question. I think people at Morgan Stanley are lost and wonder…

The ones still there. But that's an old story in the Street. Firms come and go. Even the biggest.

What I find interesting is that during the 10-15 year period that is described in ***Infectious Greed***, Wall Street was the one industry in the economy that really didn't change much. You are right, over time, many prominent brokerage houses have come and gone. But by and large, if you look at the league tables ranking the top investment banking deals–other than the appearance of the commercial banks and the effect of some mergers, the same folks have basically remained at the top of the industry throughout–and that is not true in virtually any other industry in the economy, where we have been going through a period of radical restructuring, technological evolution and subterranean destruction. Wall Street has largely been immune from all that. Even where it hasn't been, the changes have often amounted to nothing more than re-branding to try to get rid of a negative reputation. So when Salomon Brothers was mired in scandal, the solution was to keep all of the people, all of the infrastructure, but get rid of the name. It just re-branded. Now that is starting to change. But that is one of the interesting questions about how you police Wall Street. It looks like it's going to turn out that Refco had serious problems. But the people who are Refco (other, perhaps one or two at the very top), and the business that was Refco are not going to disappear. They and it will morph and move and reappear somewhere else. The natural gas and electricity traders who worked at Enron didn't die when that company went bankrupt. They went to work on other trading desks. The strategies didn't disappear; they just moved. So even as you see Morgan Stanley going through a bunch of changes, the nature of the business it was doing won't really change.

You paint a stark picture in your book: *"Any appearance of control in today's financial markets is only an illusion, not a grounded reality. Markets have come to the brink of collapse several times during the past decade…Today, the risk of system-wide collapse is greater than ever before…"* And you hang much of the blame on the investment culture of the 1990s. More specifically, runaway complexity—derivatives—the emergence of what I call imperial corporate managements, deregulation and outgunned cops. I don't as much disagree as quibble that your perspective is too foreshortened. You look at league tables through the 1990s and say Wall Street's basic structure hasn't changed. I'd contend, quite the contrary, that the basic economics of the business—and therefore, inevitably, it's structure—have gone through a wrenching secular, or once-in-multiple-generations-type, transformation over the last 30-40 years; basically since the end of "*The Go-Go Years*" immortalized by "Adam Smith," precisely because of a confluence of dramatic social, regulatory, technological and economic changes. Or because of unintended or unimagined consequences of those changes. You don't really go back far enough in your book to capture the enormous shift in the Street's ownership structure and balance of power that flowed, for instance, from the end of fixed commission rates on May Day, 1970. Or how that enslaved research to investment banking. Or how the corporatization of the

Street, traditionally dominated by private partnerships, loosened morals. And on and on.

I think that is very fair. But I had to pick a starting point for the book and what I wanted to describe in ***Infectious Greed*** is more modest. What you have described is a much more ambitious project, to describe the overall set of changes that have resulted in Wall Street's current predicament; to trace them back as far as is relevant to today. My book is a much more modest attempt to figure out the extent to which financial innovation has changed the way Wall Street works. To what extent can you run through the thought experiment of thinking about financial innovation as a virus? So if if you trace that back, how far do you go? I don't think you go back to the 1970s to run that experiment. I might not have hit exactly the right point, in starting with Andy Krieger's currency options trading for Bankers Trust back in 1988, but innovation started to take off somewhere around that time. Obviously, I can't explain everything in terms of the growth of derivatives and complex financial transactions and the changes in regulations that relate to them. But my objective in writing the book was to say, "Hey, they can explain a lot." These things–derivatives–are a way to tell a story that connects the dots. What's happened in all the Wall Street and corporate scandals was not caused, simply, by a bunch of individuals acting like bad apples. There is a way to understand how the last 15 years have happened through the lens of financial innovation and the increase in the complexity of financial instruments and the institutions that trade them, at the same time that markets were being excessively deregulated.

So it couldn't have happened, at least in the same ways, except against the backdrop of what started out being called the "Reagan Revolution?"

That is right. Although I don't focus so much on Reagan, the deregulatory culture clearly started in 1980. But with respect to the financial markets, I think the key time is really a little bit later than that. I think it is post-Drexel, too. I would really focus more on the Levitt era. I think a lot of problems have to do with the Clinton Administration taking a hands-off approach to Wall Street–certainly avoiding the use of criminal law to keep the Street in line. You know, one of the big differences under Reagan was that people were put in jail for breaking securities laws.

By Rudy Giuliani—which did not win him loads of fans on Wall Street back then, I must say. But whatever you say about Clinton, he's no dummy. He knew that the bull market --and Wall Street's shenanigans were the source of the burgeoning tax receipts that enabled his budget "miracles." Not to mention millions of political contributions.

Right. And I hope that comes through in the book. I am very critical of the tax law changes that created the incentives for companies to pay executives with stock options, which were made at the beginning of the Clinton Administration to appease populist anti-corporation forces among his supporters by appearing to do something about what, even then, was alleged to be excessive pay for corporate executives. Not to mention his Administration's hands-off approach to Wall Street. There's that great story–perhaps apocryphal–that I recount in the book about Clinton's famously crude remark when he discovered that voters cared much more about whether stocks were going up than his economic program.

Which needs no repeating.

Nonetheless, I do think Clinton deserves a lot of the blame for having Arthur Levitt mind the store as the longest-serving SEC chair; leaving Levitt at the helm all during this period of massive financial innovation. But maybe it's too easy to put blame on the shoulders of any President. I really think a lot of our troubles can be traced to the nitty gritty of what the heads of regulatory bodies were doing. Or not doing.

I'm not going to disagree. I happen to think Mr. Levitt's reputation is perhaps the second-most-overblown in Washington, or at least in economic circles in the capital. And Greenspan's is the first.

Have you seen the piece I did for Euromoney last month? It is called, "*The Case Against Alan Greenspan*" and it makes exactly this point. I can't tolerate all the accolades that are being thrown his way. I completely agree with you about Alan Greenspan. But you disagree with respect to Levitt?

I don't disagree as much as I'd suggest that he just doesn't have broad enough shoulders for all the blame you heap on him. Yes, it's ludicrous for Arthur Levitt to be credited, now, with being a hero for taking a few ineffectual stabs Wall Street's excesses at the tail end of his reign at the SEC—a period that largely coincided with their emergence and growth. But I'm cynical enough to not to expect much from the SEC. The agency is always chasing the previous cycle's scandal; going around shutting barn doors after all the horses have escaped. Sure, there were times Levitt could have shown some spine—but I'm not sure the SEC's cures wouldn't have been worse than its neglect. When it actually does something, The SEC has an unfortunate tendency to see its mission as playing nanny for "the little guy." That has a warm and fuzzy populist ring, but it all too often results, paradoxically, in rules that hamstring the institutions on which "the little guys" depend while doing less than nothing to prevent fraud, either by little guys or mega institutions.

That is clearly right. My biggest complaint, again, because of the focus of the book on financial innovation, is that both Greenspan and Levitt basically came into their roles in the Clinton Administration with this view of the derivatives piece of the puzzle that was essentially deregulatory–hands off. And that hands-off attitude created the bulk of the damage. But I agree with you that the SEC is largely dysfunctional. I have been commenting on various SEC proposals and regulations for the last 8 years, and not getting anywhere. Many times, for exactly the types of reasons you describe. I submitted comments on credit rating agency regulation most recently, which is just an area where I think it that I think is very important for somebody with an independent voice to be out there trying to say something to the SEC. But the SEC is a bureaucracy just like any bureaucracy and sometimes it is difficult to get through.

The bureaucrats at the SEC live in fear of Congress, just like FASB does. And what wonderful things that has wrought!

Right. There's that whole sorry story about the fight against options expensing and so forth. It's a very broad topic that I've covered in more detail in some of my other research. I touched on it in ***Infectious Greed***, but –

You wanted to be able to continue living in California?

Well, options are very popular all over the state, but I didn't go into that controversy in massive detail because the book is long as it is

and really getting into that could easily have doubled its size. The point I really wanted to make is that the SEC under Levitt made an enormous blunder with its hands-off stance on derivatives.

And my point is that Levitt deserves plenty of blame, but there was never any chance that he'd open that jurisdictional can of worms. It's a miracle that he woke up, as late as he did, and voiced disquiet with a few of the bull market's more obvious excesses.
I completely agree. I can't understand how so many journalists have permitted Greenspan's and Levitt's PR machines to roll over them. Maybe it is because they think they have to, to keep their access. Or maybe they think the Fed and the SEC are too big to fight. So one of things I wanted to do in my book was to put down on paper, with all the footnotes, just how conflicted Levitt was, what his background was, how inept he was during what turned out to be the longest tenure of an SEC chair in history. I didn't detail as much about Greenspan in the book, but I did some of it.

If I can summarize, you blame the epidemic of financial scandals not just on "rogue employees" but on the use of complex financial innovations to skirt outmoded rules, incentives for managers to employ financial malfeasance, the inability of shareholders to effectively monitor managers and a crazy quilt of deregulation that has left some markets entirely unregulated while keeping others on short leashes. And your central bogeymen are those innovations known as derivatives. Granted, you do list 6 or 7 "solutions" you 'd like to see tried. But they seem pretty pie-in-the-sky. Are you really that negative on the investment world's prospects?
That was a good description in a nutshell of what I am trying to say. It's a dark story. I am not optimistic at all–

Heaven forbid.
No, what I want to be is realistic. I want to to be honest and upfront about where the most serious problems are. Fact is, a lot of the derivatives world *doesn't* create problems, *but much of it does.* You can't paint a $250 trillion market with only one brush. I tried to isolate a few of the areas that might be problematic. But my big-picture perspective is that people have made money using financial innovations in essentially two ways. One is through taking advantage of the information asymmetry, which is a fancy way of describing the information gaps between participants in the market. Just big picture, in the transfer of capital there is an information gap and Wall Street has always made money off of that information gap. That is endemic. And that is fine. There is nothing that I could say that could close that gap, except that people should become more educated–which they *won*'t do.

And no Regulation FD is going to change that.
No. Reg FD is a mistake. I think trying to tinker with information asymmetry is a mistake. That it is just part of the system and people should know and understand that it exists. It is important to lift the lid on that. People should understand that the way Wall Street makes money first and foremost is by taking advantage of this information gap. But my point with respect to financial innovation and increased financial complexity is that they substantially widen that gap. So financial statements are much more complex than they used to be. The footnotes are more complicated. The ways that CEOs or corporate executives can take advantage of their shareholders are much more subtle and complex. That is really the central piece of point No. 1. So some of the proposals I list in my book might not seem practical–and some of them more than others–but actually a fair number have been implemented at least in part, already. For instance, shifting from rules-based regulation to standards. International accounting standards, at least, are moving in that direction.

Ever so slowly, yes. But whether FASB follows is another question.
Another step that is starting to be taken is eliminating the oligopoly lock of the gatekeepers, like the credit rating agencies. There is legislation that would do this now under consideration. I testified before the House on that legislation and think there is some movement in that direction. There's also more effort being made to prosecute complex financial frauds. We will see what happens with the Skilling case. but there certainly have been a large number of criminal cases brought in the last few years. Many, many more than were brought during the previous 15 years. Then there's also been the lifting of short sale restrictions to make it easier for investors to bet against stocks.

Assuming that the experiment survives the trial stage.
Right and that might be problematic. It has created all sorts of new issues, as you know, if you've followed the Icahn-Mylan Pharmaceuticals story. There are all sorts off issues involving hedge funds and corporate governance now. My sixth proposal, that investors be encouraged to control and monitor their own investments maybe is unrealistic. Because investors are unlikely to spend the time. But the point I want to make is that *it is your fault as an individual if you don't spend the time*. People spend a lot of time worrying about what a can of soup costs.

Or a gallon of gasoline at the pump.
While they don't think at all about some of the most important financial decisions that they make–Who they have managing their money. They all too easily give money to financial managers who will take advantage of them. So one thing I wanted wanted to do if anybody actually picked up this book and read it to the end is make them actually feel responsible for their own investment decisions.

Good luck. I certainly hear you. But having spent a large chunk of my life writing or editing *Barron's* stories exposing scams and financial frauds, it's quite clear to me that some people can't be saved from themselves.
Right. I do a fair amount of consulting work and I see cases that are just astonishing. It is amazing who people will give their money. Which is an argument why the information gap persists. There is nothing you can do about it. But that doesn't mean that we shouldn't acknowledge that it exists. As an academic, I want to observe it and come to an understanding of this phenomenon and tell it like it is. Actually, one of the best descriptions of what has changed so much in the last 15 years is that the information gap has widened dramatically.

Considering that you left Wall Street to become a lawyer, I can't resist noting that the legal profession has had a hand in widening that gap. I've read many a "disclosure" document crafted by some lawyer intent on doing as little of that as possible.
I think that is right. Although I also think that if you look at financial documents and you can't understand them, you just shouldn't buy that stock.

What? And follow Warren Buffet's advice?
Absolutely. I think Warren Buffet is incredibly astute on these issues. He generally stays away from companies he doesn't understand. And when he has bought things that he didn't understand, he has gotten burned. By credit derivatives, right on his General Re investment.

Sure, but most investors—even pros—know they're not the Sage of Omaha. When they don't understand an annual, they tend to think it's their own fault, not the company's.
The real problem is that no one reads the financial statements. Even the institutions don't read them. Even the hedge funds, by and large, are not particularly sophisticated. You are right, the documents are drafted by lawyers–but for that very reason they're often filled with red flags. So if anybody read them– As I recall there were 16 red flags in Enron's 2000 annual report. If anyone actually read it, there was no way in hell they would have bought Enron stock. They would have been extremely worried about what was going on in the company. But your point is fair. Maybe I am expecting too much of people. But if that is the case, no one should be surprised when these scandals occur over and over again. And the broader question–if no one is out there in the market doing enough digging and then trading, is how are assets going to be priced? Because the assumption, under the efficient market theory, is that enough people are doing that so that all the necessary information is out in the marketplace and becomes instantly reflected in market prices.

I realize that you're an academic, so this may come as quite a shock, but the markets aren't efficient. Certainly not always.
Obviously. I didn't write a book about efficient market theory, it is a book about how markets have *not* been efficient. And if you're looking at why the financial assets might not reflect the information that is available, an important piece of the explanation is this wave of financial innovation that has made the markets immensely complicated. Take a look at JP Morgan's most recent 10K, it is unbelievable.

Is it fatter than a Manhattan phone book?
It is 150-something pages, maybe longer of fine print. It has pages and pages of disclosures on credit derivatives alone. The bank has a trillion dollars of credit derivatives. They have unfathomably complex descriptions of how they value their derivatives portfolio– which is much bigger than just the $1 trillion of *credit* derivatives. If you actually read those descriptions, you would be horrified because a lot of what they are saying is that they use mathematical models, not markets, to value their positions. That's the same thing that David Askin did–that lead to his demise. The simple phrase "mark to model" makes me shudder...

As well it should.
But this is *JP Morgan*. This is a very substantial financial institution. Part of the problem is that JP Morgan can put out this 100-plus-page form 10K that no one will read. Then, to counter the potential negative effect of all that scary information, they sponsor the U.S. Open tennis tournament. And turns out to make more of an impression on investors. *Obviously*, JP Morgan is a good company that they can trust. People buy its stock notwithstanding the fact that buried in the footnotes are all sorts of potential time bombs that nobody knows about. And it's not just JP Morgan. What about Refco's financials? My point is that financial statements from companies of all sorts have become so unfathomably complex that basically everyone has thrown up their hands and said, "We can't understand this stuff." And I am including a lot of very sophisticated individuals. People running hedge funds or institutional funds.

They often rationalize that they *could* read the financials, but if they devote the time, they miss out on their next three deals.
That state of affairs makes me very nervous. Why? Because I think a lot of Wall Street participants just haven't taken the time to step back and look at how much the world has changed. And meanwhile, the world has gotten much more complicated.

Okay, but if investors everywhere were to suddenly follow your suggestion and dig deeply, before investing, wouldn't that effectively throw a ton of sand into the markets' gears?
It might. But it is better to expend the resources needed to narrow the information gap. I am sympathetic to the argument that it might be very costly to do. But what is the alternative? Once you create a regulatory structure, it can get out of control and become extremely costly. There's a lot of that in Sarbanes Oxley, for example. But I also am aware that there are also costs attached to simply having a free market. So what we are talking about is a choice of second bests. What you want to compare is how bad off we would be if we just let people run wild versus how costly it would be to at least partially close the information gap. Where I come out is that I don't think we have done enough to recognize how much wider the information gap has gotten. So I'd like to undertake some efforts to try to narrow it either by forcing companies to disclose more information, by making them worried about what will happen if they don't disclose, or by creating a culture that encourages the most sophisticated actors in the markets to go out and find some of the problems buried in financial statements by making it possible for them to profit from those discoveries. That is why I am such a big proponent of making it easier for people to short stocks. The technological revolution has enabled all sorts of complex financial innovations. Fifteen or 20 years ago, Citigroup probably had one or two computers, now there Ph.D. physicists working all over the Street using very sophisticated models, lots of computing power, to trade. So the world has changed and that has widened the information gap that Wall Street exploits to make money. Meanwhile, the other way that Wall Street makes money–and this is just as important–is by taking advantage of regulation. And there are two sides to that story, as well. One side of the story is that you need to regulate because there is this information gap. It creates a moral hazard problem so you need to have legal rules.

But the other side of the story is, the Street can work around virtually any rule.
Yes, people on Wall Street are very smart.Once you create legal rules, they are going to (a) figure out ways around them and (b) figure out ways to take advantage of them to make money. There are lots of examples. That was what Long-Term Capital did. I think that a lot of the growth of credit derivatives has been motivated by regulation. Many people, especially regulators, I think, don't understand that dynamic well enough. It's an interplay--what I call regulatory arbitrage. It's inevitable, I think, that when you create a rule, you create all sorts of second-order effects– and we live in a rule-based economy. That is how Enron was able to get comfortable with thinking that it was complying with the letter of the law,

when what it was doing was clearly not what any reasonable person would say the law should have required of it. And the difference also was quite dramatic I think–the difference between how people thought about accounting and taxes and credit ratings and a whole range of regulation 15 years ago was fundamentally different from the way people think about it now. Sarbanes Oxley changed that a little bit, the willingness of prosecutors to go after complex frauds changed that a little bit; on the international scene, the prospective shift to standards has changed that a little bit. But by and large, we still have this huge regulatory web, the massive stet of rules that in some sense, is *feed* for Wall Street.

Sure, rules are a challenge. How do you get around them? That's the Street's natural response.

Right. But one reason my book is so dark and depressing is that both the information gap and the urge to end run regulations are intractable issues. If you have no rules, people run wild, and that is a cost. But if you do have rules, you create a problem immediately, because people are rational economic actors. They are going to look at the regulation and then ask, "What is the expected cost to me, if I violate a rule? And what are the expected benefits?" And if the expected benefits outweigh the expected costs, expect to see the rule violated.

Except that investors, like the people they are, are not always rational. Some care about reputations, even morality.

Sure. Some people will be risk averse. But if you have stock options –if you are incentivized to violate the rules–those benefits might compensate even for that risk aversion. People tend to be risk averse with respect to their reputations, but they still will be persuaded. The notion is that everyone has his or her price, right?

I'm not so sure.

Consider this: There is a stop sign coming up. You are driving along at 15 miles an hour. You would normally stop at the stop sign. If I paid you a million dollars, would you stop at the stop sign? Maybe some people would say no, but a lot of people would say yes. I think that is because there are so many rules, the rules aren't respected any more. People don't think that they are really doing anything wrong. It is just a stop sign that is there, it really shouldn't be there and nobody is ever coming the other way. It is just stupid to have a stop sign there. So why shouldn't I run the stop sign? Nobody is going to think anything bad of me if I run the stop sign and if you are paying me a million dollars to run the stop sign. Well, that is a no brainer, right?

Unless I see a truck coming down the cross street at 65 mph.

That is a point. But my most important recommendation is that regulators stop treating derivatives differently from other financial instruments, especially when they are economically similar. Differing rules have resulted in an orgy of regulatory arbitrage, using derivatives instead of other securities simply to avoid certain laws, regulations or restrictions. It has also been foolish to exempt derivatives from regulation simply because they are traded by large institutions instead of individuals. The enormous losses suffered by large institutions (and ultimately the individuals whose money they manage) are proof enough of that. What legislators and regulators have to remember, moreover, is that the more they carve up markets and divide their regulation, the harder it is for anyone–regulators or corporations–to keep track of risks. The Inescapable reality is that much of the $100 trillion-plus derivatives market exists because private parties use it to do deals to avoid the law. Whether you favor more government, or less, that is not a healthy development in the markets. I understand that there are political impediments that stand in the way of fully implementing some of the suggestions I make in my book, but I believe the world would be better off if my recommendations were adopted.

You're not holding your breath, are you?

No, although the one message I think is getting through to the SEC (though Congress didn't get it, when they passed Sarbanes Oxley) is that they need to take into account the second-order effects of any rules that they adopt. The fact is that when they adopt a rule people are going to react two ways: figure out a way around it and figure out a way to take advantage of it. And there's simply no way for regulators to stay ahead a step ahead of such innovation in today's highly complex and fast-evolving markets.

Isn't it just as unrealistic to think that any amount of regulation could control it, or that any required disclosure would actually be meaningful to investors in sizing up derivatives transactions?

That might be. But if it is, people should be shaking in their boots because that basically means that complex institutions have a license to do whatever they want to do. That essentially means we have ended up in the worst case scenario, where we have an incredibly costly regulatory structure but we still have companies running wild. The reality would be even worse than companies running wild because we would have the illusion, the veneer, of them complying. The illusion of having solid information, when that might not be the case. I am not persuaded that our situation is that dire, however. I think that's just a smokescreen from people who don't want to make any disclosures.

Let's hope so. Thanks, Frank.

W@W Interviewee Research Disclosure: Frank Partnoy is a law professor at the University of San Diego School of Law. He teaches and writes in the areas of corporate law, corporate finance and financial market regulation. He is the author of two books and many articles on those topics. Before joining the USD faculty in 1997, Prof. worked as an investment banker at CS First Boston and Morgan Stanley in New York and as an attorney at Covington and Burling in Washington, DC. Nothing in this interview should be interpreted as an offer to sell or a solicitation of an offer to buy any security or derivative or the dark side of the moon. Prof. Partnoy's views are based on his research and information believed reliable, and aren't likely to change, but no guarantees are expressed or implied. There is no specific investment advice in this interview and none should be read into it. For more information, read the Professor's books or contact him at USD, 619 260 4600.

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