Wall Street Versus Main Street: How Ignorance, Hyperbole, and Fear Lead to Regulation

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For two years in the early 1990s, Frank Partnoy worked for a couple of investment banks (CS First Boston and Morgan Stanley) selling derivatives. He made a lot of money doing this. Now he is trying to make a little more money from his experience by writing a sensationalist book about his time at Morgan Stanley. The book is clearly patterned after Michael Lewis’s bestseller, Liar’s Poker, which chronicled the author’s life as a bond salesman for Salomon Brothers in the 1980s.¹

What F.I.A.S.C.O.² and Liar’s Poker have in common, and the reason they are of interest to those studying the regulation of the financial markets, is the way the two books depict the relationship between investment banks and their clients. These books provide significant ammunition to those interested in regulating

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² “F.I.A.S.C.O.” stands for “Fixed Income Annual Sporting Clays Outing,” an acronym used by those at Morgan Stanley to describe an annual outing to a private shooting range (p 14).
the securities markets by characterizing the investment banks as
ingning and able to take advantage of their clients' naivete. Similarly,
they are of interest to those of us concerned with norms, particu-
larly the reputational norms that operate in business envi-
ronments.

In its depiction of the norms at work in the investment
banks, the perspective presented in F.I.A.S.C.O. is fundamentally
at odds with economic theory. Morgan Stanley is portrayed in
F.I.A.S.C.O. as interested only in short-term profits at the ex-
pense of long-term relationships. Partnoy details a world where
customers are routinely and systematically swindled and tricked
into buying inappropriate, high-risk derivative securities that
provide ultra-high commissions to the Morgan Stanley traders. In
one vignette, for example, Partnoy even suggests that the in-
vestment bank's conduct was scarcely different than that of an
organized criminal operation:

Overall, Morgan Stanley's actions were barely distinguish-
able from those of a drug kingpin seeking an appropriate tax
haven to launder money. Morgan Stanley was taking pre-
cisely the same steps drug dealers took to evade U.S. regula-
tors. The only real difference between the actions of a drug
kingpin and those of Morgan Stanley was that $12,000 of
drug money rarely found its way to a charity for Bermuda
schoolgirls (p 83).

Clearly, Partnoy's incomplete understanding of how markets
work skewed his perception of the environment in which he found
himself during his brief stint on Wall Street.

This Review begins with an analysis of the derivative trans-
action that lies at the core of Partnoy's book and that sets the
stage for everything that follows. I argue that F.I.A.S.C.O. fund-
damentally mischaracterizes the transaction it purports to de-
scribe. Next, I provide an alternative account of a securities
transaction that I believe more accurately portrays both the eco-
nomic reality and the underlying social agenda of a modern in-
vestment banking firm like Morgan Stanley. In the final Section
of this Review, I pay further attention to Partnoy's claim that de-
rivatives should be regulated more extensively than they are
now.
I. FRANK PARTNOY'S VISION OF THE WORLD

A. Ripping Off Faces: The Story of the PERLS Transaction

1. Partnoy's account.

Partnoy's spin on the events he is describing in *F.I.A.S.C.O.* is most clear from his description of the sale by Morgan Stanley of a derivative security called PERLS ("Principal Exchange Rate Linked Security"). A look at Partnoy's version of events, followed by a skeptical analysis, exemplifies the faulty reasoning at work in *F.I.A.S.C.O.*

PERLS are fixed-income investments in which the issuer calculates the amount of principal owed at maturity by taking the nominal or stated principal amount and multiplying it by a formula linked to foreign currencies (p 55). Thus, PERLS permit investors and issuers to hedge and speculate on foreign currency movements. Partnoy explains one type of PERLS security this way:

> [O]ne popular PERLS, instead of repaying the principal amount of $100, paid the $100 principal amount multiplied by the change in the value of the U.S. dollar, plus twice the change in the value of the British pound, minus twice the change in the value of the Swiss franc. The principal repayment was linked to these three different currencies, hence the name Principal Exchange Rate Linked Security (p 56).

Partnoy forcefully asserts that his colleagues at Morgan Stanley sold PERLS to unsuspecting customers who thought they were buying simple AAA-rated bonds. These buyers, according to Partnoy, had absolutely no idea what they were doing, or what risks they were assuming. Such customers "looked at a term sheet for PERLS, and all they saw was a bond. The complex formulas eluded them; their eyes glazed over. The fact that the bonds' principal payments were linked to changes in foreign currency rates was simply incomprehensible" (p 57). Furthermore, Partnoy insinuates that Morgan Stanley customers were not only too unsophisticated to realize the risks they were assuming, but that Morgan Stanley salesmen systematically duped them into making highly leveraged bets on foreign exchange rates. The motivation for this deception was the fact that salesmen earned a higher commission on the sale of PERLS than on the sale of ordinary bonds (p 57).
To support his allegations, Partnoy recounts a story that he claims to have heard shortly after joining the derivatives product group at Morgan Stanley. A derivative salesman told Partnoy about a conversation he had with a "senior treasury officer" from an insurance company that had recently bought $85 million in face amount of PERLS. The officer called the Morgan Stanley salesman who had consummated the trade to find out the current value of the investment. The salesman broke the news that, in a matter of weeks, the PERLS had plummeted to a fraction of their original value. When the insurance company official expressed shock and incredulity, the salesman went on to explain that, in purchasing the PERLS, the officer had assumed a foreign exchange risk that went sour (pp 60-61).

According to Partnoy, "[t]his salesman had earned a giant commission on this PERLS trade, and he laughed uncontrollably at his story. When [the salesman] finished his story, he asked me if I knew what it was called when a salesman did what he had done to one of his clients. I [Frank Partnoy] said I didn't know. He told me it was called 'ripping his face off'" (p 61). Partnoy goes on as follows:

"Ripping his face off?" I asked, wondering if I had heard him correctly. "Yes," he replied. He then explained, in graphic, warlike detail how you grabbed the client under the neck, pinched a fold of skin, and yanked hard, tearing as much flesh as you could. I never will forget how this salesman looked me in the eye and, with a serious sense of pride, almost a tear, summed up this particular PERLS trade. "Frank," he said, "I ripped his face off" (p 61).

2. The real story.

This account of the experience of an anguished Morgan Stanley derivatives customer captures the essence of F.I.A.S.C.O. Partnoy is clearly under the impression that the investment banks and their salesmen, motivated by greed, purposely mislead investors. The question is whether his story is credible.

At least three things suggest that the salesman's account should not be taken at face value. First, contrary to Partnoy's repeated assertions to the contrary, no special sophistication is required to understand this kind of trade. Indeed, by the author's own account, the salesman who arranged this trade was able to explain the transaction in seven words: "You made a big foreign exchange bet" (p 60). Unless the salesman fraudulently characterized the PERLS security prior to sale or the investment offi-
cers of this insurance company were truly incompetent, it is difficult to understand how the customer could fail to understand the nature of this transaction. Put another way, while the exact methodology used to value this derivative instrument is highly complex, the basic dynamics of the pricing is simple. It can basically be described like this: when foreign currencies weaken against the U.S. dollar, this particular PERLS loses value; when these currencies strengthen against the dollar, the PERLS gains value. Surely the customer could have understood this simple explanation.

Second, it is hard to credit the customer's fundamental misunderstanding about the basics of this trade in light of the fact that the PERLS sold in this transaction were priced to give the customer a rate of interest well above the market rate for a simple bond. Even more telling, the very name of this security, PERLS, clearly indicates that the principal payment is linked to foreign exchange rates. After all, these instruments are called "Principal Exchange Rate Linked Securities" and not "bonds." Again, absent outright fraud (for example, a salesman making up a false acronym for these securities) or incompetence on the part of the insurance company officials, it is impossible to imagine how a customer could be duped about the fundamental nature of this transaction in the way Partnoy describes.

A third indication that the events being recounted (third-hand) probably did not happen in precisely the way that Partnoy asserts is that the salesman telling this story is claiming that he was "ripping his customer's face off" at the same time that he was issuing detailed and specific warnings to his customer about the risks the customer was taking. When the customer complained to the salesman, the salesman purportedly reminded him that, prior to the sale, the salesman had explained the foreign exchange risks inherent in the transaction, and the fact that these risks accounted for the above-market rate of interest on the security: "When you buy PERLS, you take foreign exchange risk. That's why you were getting an above-market coupon on the bond. I told you that. . . . Come on, why did you think you'd be getting such a high coupon if you weren't taking any risk?" (p 61). The Morgan Stanley salesman's account of what actually took place is fundamentally at odds with the suggestion that the salesman set out purposely to take advantage of the insurance company by selling a very risky, highly leveraged derivative instrument that the client thought was a plain-vanilla bond. More accurately understood, the insurance company officer has taken an interest bet and lost. It hardly seems surprising that ex post, after the loss,
the customer has a strong incentive to complain that he didn't understand the nature of the transaction. The customer's declaration of ignorance is not only not surprising, it is also not credible. As the Morgan Stanley salesman pointed out, the risks of the trade were suggested by the security's price (in the form of the interest rate), and no reasonably sophisticated customer could have been unaware of that.

Partnoy's characterization of the salesman's motives is most likely as inaccurate as his depiction of the transaction. Partnoy claims that Morgan Stanley salesmen pushed risky derivatives on unsuspecting customers in order to earn the higher commissions associated with selling derivatives. However, if customers were this easy to rip off, it would make more sense for an unscrupulous salesman simply to sell a security suited to the customer's investment needs, but at an artificially inflated price. This would allow the salesman to earn a higher commission while preserving a valuable business relationship.

The plausibility of Partnoy's characterization is further weakened by noting that he describes the allegedly victimized client as a "stodgy insurance company" (p 60). By "stodgy," the author wants us to believe that derivative securities were unsuitable to the buyer's needs. But the more important piece of information is that the buyer is an insurance company. This fact is relevant because the insurance industry is highly regulated. Insurance companies' investments are restricted, and, in particular, insurance companies often are not permitted to speculate in foreign currency transactions. PERLS were often used by insurance companies as a device that provided the risk-return characteristics of foreign exchange trading but had the appearance, from a regulatory perspective, of a generic fixed-income investment. In other words, PERLS were used by unscrupulous insurance company portfolio managers as a means of creating loopholes, either in existing insurance company (or pension fund) regulations or in company policy. Similarly, professional investors often are limited to making investments with certain ratings from credit agencies, or with companies whose payoffs are denominated in certain currencies. Derivatives can permit these investors to make riskier investments while staying within the confines of these restrictions.

Partnoy himself appears to recognize this fact. He points out that "PERLS were especially attractive to devious managers at insurance companies, many of whom wanted to place foreign currency bets without the knowledge of the regulators or their bosses. PERLS were designed to allow such cheater managers to gamble in the volatile foreign exchange futures and options markets" (p 57).
Accordingly, it appears far more plausible that the unscrupulous party in the trade Partnoy is describing was not the Morgan Stanley salesman, but rather the insurance company purchaser. After all, it was the purchaser who tried to renege on the deal by playing dumb when foreign exchange rates went the wrong way. And, more fundamentally, it was the purchaser who, in all likelihood, was using PERLS in order to evade some regulation or intrafirm rule restricting precisely the sort of gamble contained in these investments.

Furthermore, there is nothing in Partnoy's account to suggest that these customers were unknowing dupes. It was purchasers who initially wanted complex derivative instruments in order to avoid restrictions on the sorts of investments they might make. The supply of derivatives created by First Boston, Morgan Stanley, and other firms came partially in response to this demand. There was nothing illegal about the trades, and the customers knowingly accepted the huge risks associated with derivatives. Partnoy claims that all PERLS buyers fell into one of two basic categories: "widows and orphans" and "cheaters" (p 56). He spends a lot of time talking about the widows and orphans, but precious little time talking about the cheaters. Interestingly, however, he doesn't describe any actual transactions with widows and orphans, only with cheaters. Indeed, despite Partnoy's claims to the contrary (p 60), the "stodgy insurance company" left so bereft after the PERLS transaction was not a widow or an orphan. On the contrary, the insurance company was most likely a cheater.

B. The AMIT Episode: Another Distortion

In addition to hedging and speculating—and avoiding investment restrictions in the case of insurance and pension funds—derivative instruments are created to clean up the balance sheets of certain corporate clients. Sometimes these balance sheet operations are ethical, and sometimes they are not. Partnoy, however, once again mischaracterizes a useful, and demanded, financial tool as highly unethical.

Among the myriad of benign uses for derivatives, a manufacturing firm might employ a single-swap transaction to exchange a floating-rate payment obligation for a fixed-rate payment obligation, or to exchange an obligation to make payments in German marks for an obligation to make the payments in U.S. dollars.  

4 For simple, but more detailed accounts of both a foreign currency swap and an interest rate swap, see Jonathan R. Macey, Derivative Instruments: Lessons for the Regula-
These sorts of transactions are desirable to firms because such exchanges can make the firms' balance sheets more transparent, rendering them easier for investors and regulators to evaluate. For example, a firm that swaps payment obligations in marks for payment obligations in dollars might be more readily valued if the firm's balance sheet is denominated in dollars. (However, foreign exchange risk has not been eliminated; the risk has merely shifted from risk about the value of a mark to risk about the value of a dollar.)

However, derivatives may also be used for less benign ends. Firms in countries with lax accounting standards or compliant regulators can use derivatives to mask holes in their balance sheet. Perhaps the best example of how derivatives might be used for purposes of accounting or regulatory obfuscation involves the Japanese banks. According to F.I.A.S.C.O., Japanese banks liked to use U.S. investment banks with branches in Tokyo rather than Japanese investment firms when structuring fraudulent transactions because Japan's Ministry of Finance had no regulatory authority over U.S. investment banks (p 214). Partnoy's characterization would come as a surprise to these American banks, who believe themselves to be regulated by the Ministry of Finance. The appeal of U.S. investment banks to Japanese investors is more accurately explained by the wealth of American expertise. As Partnoy acknowledges, U.S. banks were the only firms with the sophistication and creativity to structure the complex transactions that the Japanese clients wanted (p 214). This was the real reason many Japanese firms gave their business to U.S. investment banks.

The derivative instrument Morgan Stanley created for the Japanese was called an AMIT ("American Mortgage Investment Trust"). An AMIT is comprised of two components: a particular type of CMO ("Collateralized Mortgage Obligation") called an IOette and a zero coupon bond. The first part of the AMIT, the customized CMO, is created from mortgage-backed securities, which are bonds where the cash used to make principal and interest payments comes from bundling together pools of home mortgage obligations. To create a CMO, the issuer combines the principal and interest payment obligations on a mortgage-backed security and divides it into sub-parts, called strips. Usually the strips are either interest-only strips (IOs) or principal-only strips (POs), but other, more exotic combinations exist. An IOette is a strip that is comprised of a particular combination of IOs and

[tory State, 21 J Corp L 69, 73-75 (1995).]
POs. In an IOette, the IO portion of the security is many times the size of the PO portion (pp 222). Because the interest portion of an IOette vastly dominates the smaller principal portion, the market price of these securities is a large multiple (called a premium) of the face amount of the bond components.

Morgan Stanley created IOettes by buying large amounts of mortgage-backed securities and carving out most of the principal payment obligations. Morgan Stanley then kept the majority of the principal payment obligations in its inventory, and sold the interest payment obligations as the first component of the AMIT. The customer who purchased the IOette was then obligated under the terms of the trade to give Morgan Stanley an option with respect to the inventoried principal payment obligations. Specifically, the client had to agree to make up for any losses that Morgan Stanley might suffer from market fluctuations that caused the principal-only portion of the IOette to lose value. Besides the IOette, the second part of an AMIT is comprised of a simple zero coupon bond. These are bonds that do not make periodic interest payments. The investor's return comes from the difference between the price he initially pays for the security and the price he receives from the issuer at maturity. Zero coupon bonds are the opposite of IOettes in that they trade at a large discount from the face amount of these bonds.

As created by Morgan Stanley for its Japanese clients, an AMIT is a combination of IOettes and zero coupon bonds in equal face amounts. While the face amounts of the two parts of the AMIT were the same, the market value of the components, if traded separately, would be much different because of the different intrinsic characteristics of IOettes and zero coupon bonds. In particular, the IOettes would be worth a lot more than the zero coupon bond. In addition to receiving the face amount of the IOette as a return on their investment, buyers would also receive a series of future payments, namely the interest portion of the IOette. By contrast, from the zero coupon bond, investors would receive only the principal payment, which would not be realized for quite some time. Despite the fact that the two pieces of these AMITs were worth vastly different amounts, the Japanese investors would pay the same price for each half of the AMIT. This, of course, meant that the investors were paying too little for the IOette portion, and too much for the zero coupon bond portion.

According to Partnoy's account of Morgan Stanley's AMIT trades, immediately after purchasing the AMITs, the Japanese investor would resell to Morgan Stanley the one-half of the face amount of the AMITs that was comprised of the IOettes. By re-
purchasing the IOette at the market price shortly after selling the securities at a drastically discounted price, Morgan Stanley permitted the Japanese investors to book a huge paper profit. Of course, the Japanese bank should show a huge loss from the zero coupon bond component of the AMITs, because it had overpaid for them. However, apparently the firms to which Morgan Stanley was selling these derivatives did not have to account for the market value of these instruments on their books, so they would not have to show the loss for many years (p 215). Furthermore, although Morgan Stanley took a loss in repurchasing the IOettes at market price after recently selling them at a discount, the investment bank did not mind, because it was more than able to make up for the losses on repurchase through a combination of its profits from the sale of the zero coupon bond portion of the AMITs and the huge fee it collected for structuring the transaction. To bring things full circle, after Morgan Stanley repurchased the IOettes, it would recombine the interest and principal components of the IOette with the remaining principal component that it had stripped out and inventoried when originally creating the IOette. Morgan Stanley would then sell these reconstituted mortgage-backed securities back to Fannie Mae, the government agency from whom it had bought them in the first place.

As evidence of Partnoy's condemnation of the AMIT episode, F.I.A.S.C.O. contains an account of a particularly large pair of AMIT trades ($471.48 million) that took only two weeks to put together and thanks to which Morgan Stanley made an astronomical profit of $75 million (pp 217-33). As Partnoy explains, the lion's share of the $75 million profit came from the fact that there were large increases in the bond market during the period after the Japanese investor had purchased the AMITs but before Morgan Stanley repurchased, repackaged, and resold the IOettes to Fannie Mae. This bond market made the principal-only portion that Morgan Stanley placed into its inventory when it created the IOette extremely valuable.

Partnoy suggests that there was something unethical about the large profit that Morgan Stanley earned on this particular AMIT trade (which, for some reason, was called the “MX trade”). He asserts that the firm “arguably would be violating the client’s trust” by keeping such a huge profit (p 231). Curiously, Partnoy makes this suggestion despite the fact that the agreement “clearly allowed Morgan Stanley to keep all the profits” from the MX trade (p 231). His argument is unconvincing. The Japanese client (whom Partnoy assumes to be a large institutional investor) could easily value the principal-only portion of the invest-
ment by looking at bond prices. Moreover, Morgan Stanley's profits came from general movements in interest rates during the period of time that the transaction was outstanding: Morgan Stanley did not manipulate the market or exploit an informational advantage in order to realize this profit.

The more interesting aspect of these AMIT transactions is that they were designed specifically to exploit accounting loopholes in order to permit the clients purchasing these derivatives immediately to book huge gains for accounting purposes, while postponing for years the need to show the concomitant losses. As Partnoy observes, "the AMIT proved to be the most efficient means anyone has been able to devise for generating false income for Japanese investors" (p 233). Partnoy fails to recognize the fact that the Japanese investor probably did not want to call attention to this quasi-clandestine trade by falsely claiming a share in the profits Morgan Stanley realized on the principal-only portion of the transaction. The point of the AMIT transactions is that these derivatives were not designed and sold as a means of defrauding customers. Rather, at worst, they were designed and sold in order to permit sophisticated Japanese customers to hide corporate losses from regulators by showing huge profits in other areas. And, frankly, I am skeptical that the regulators were really fooled. In light of the pattern of complicity between Japanese regulators and Japanese financial institutions, it seems more likely that both regulators and firms were working together to mask these losses, because such losses would make them both look bad.

C. PLUS Notes: Yet Another Distortion

Japan was not the only venue in which Morgan Stanley may have helped sophisticated customers use financial alchemy to accomplish accounting gimmickry. In 1994, Morgan Stanley created a new derivative, called PLUS notes ("Peso-Linked U.S. Dollar Secured Note"), to permit certain Mexican banks (particularly Banco Nacional de Mexico) to remove what Partnoy describes as "undervalued and illiquid" inflation-linked bonds from their balance sheets without having to record any losses for accounting purposes. Banco Nacional was unwilling to simply sell the bonds, which are known as Bonos Ajustables del Gobierno Federal (adjustable bonds of the Mexican government), because a straightforward sale would have forced the bank to record an accounting loss. The story of the derivative transactions executed by Morgan Stanley on behalf of Banco Nacional provides the setting for one of F.I.A.S.C.O.'s more misleading moral lessons.
Investment banks trying to help Banco Nacional and other Mexican banks sell Mexican sovereign debt to institutional investors in the United States and Europe faced the problem that these investors wanted highly rated (that is, investment grade) securities, and they wanted them denominated in U.S. dollars rather than in Mexican pesos. These twin preferences were problematic because only Mexican debt denominated in pesos was investment grade. This was due to the fact that rating agencies are very comfortable in assuring investors that the Mexican government will pay back its obligations that are denominated in pesos, because the government can always simply print more pesos to cover its debt. But if the peso falls in value against the dollar, the Mexican government might not be able to meet its obligations to repay in dollars. It might, for example, suspend the convertibility of its currency, as it had done in the past. Thus, the Bonos Ajustables that Banco Nacional wished to sell were given a high, investment grade AA- rating by Standard & Poor's, but they were payable in Mexican pesos rather than in U.S. dollars.

In order to rid Banco Nacional of its Bonos Ajustables, Morgan Stanley created a Bermuda corporation, which in turn created and sold its own bonds backed by the Mexican securities. These were the bonds known as PLUS notes. Unlike the Bonos Ajustables, the PLUS notes were denominated in U.S. dollars. Morgan Stanley convinced Standard & Poor's to give the new bonds issued by the Bermuda company the same AA- rating given to Mexico's peso-denominated sovereign debt, instead of the much lower rating given to Mexico's U.S. dollar-denominated debt.

Although Partnoy suggests that the PLUS notes did not deserve an investment grade rating, the Standard & Poor's rating was sound for two good reasons. First, the bonds were not issued on a one-for-one basis. In other words, each $1 in bonds sold were backed by more than $1 of Bonos Ajustables. This gave buyers a cushion against interest rate fluctuations. To provide an even further layer of protection, the Bermuda company bought U.S. treasury bonds in order to use their interest and principal to repay purchasers. Second, Morgan Stanley caused the issuing company to enter into a swap transaction in which it would commit to convert the payments made in pesos by Mexico on the Bonos Ajustables into U.S. dollars, thereby protecting against the currency risk that had troubled investors.

The PLUS notes enabled Banco Nacional to do what it wanted—rid itself of the Bonos Ajustables without recognizing a sale for accounting purposes. Banco Nacional did this by assuming ownership of the Bermuda company that bought the peso-
denominated Bonos Ajustables and issued the dollar-denominated derivative bonds. This ownership allowed Banco Nacional to include the assets of the Bermuda company as its own assets. Because the assets of the Bermuda company included the Bonos Ajustables, Banco Nacional had not sold these securities and therefore did not need to show an accounting loss (pp 80-85).

Partnoy tries to create the impression that every aspect of the PLUS notes sale contains some element of sleaze. First, he suggests that the public did not want the bonds being sold, claiming that the seller “was looking to do the impossible: sell bonds into a market that didn’t want the bonds, without having to admit publicly that it was selling them” (p 80). This is false; the public did want the bonds that were sold. What buyers didn’t want were peso-denominated bonds, and the public was not asked to buy those. Further, Partnoy incorrectly suggests that the PLUS transaction involved “convincing someone to buy” the peso-denominated Bonos Ajustables (p 81). In fact, the deal was structured in order to satisfy the interests of buyers: they were purchasing dollar-denominated bonds with significant credit enhancements.

Second, Partnoy struggles to convey the image that this transaction bordered on illegal fraud, and could only have been consummated with the help of a corrupt government in Bermuda. He claims that the small franchise fees and taxes ($1,600 per year) paid by Morgan Stanley and Banco Nacional “looked like kickbacks” (p 83). This statement borders on the farcical. It is no more corrupt for Bermuda to charge franchise fees and taxes to foreign firms wishing to incorporate there than it is for Delaware to charge such fees. Moreover, there is not the slightest suggestion that Bermudan officials benefited personally from these transactions. Partnoy even manages to suggest that something nefarious lay behind the requirement in Bermuda law that a qualified charitable institution be the owner of the new company’s stock (pp 82-83). There is nothing corrupt, however, about creating regulations that benefit local charities. That is what 26 USC § 501(c)(3) status does for not-for-profit institutions in the United States. Additionally, the combination of educational and charitable entities involved in this particular transaction (the Bermuda High School for Girls and the Lady Cubitt Compassionate Association, among others) hardly seems objectionable (p 83).

Partnoy even suggests that the rating agency Standard & Poor’s was corrupt in giving the PLUS notes an investment grade rating. He insinuates that the fact that “private entities can pay for their credit rating” (p 83) means that the rating agencies sell
their ratings for cash, and he implies that the general impression that "credit rating agencies are principled and accurate" is misguided (p 83). Worst of all, Partnoy creates the false impression that Standard & Poor's did not agree to give the new bonds a high rating until it was paid a "huge fee" (p 85). Rating agencies, however, do not charge higher fees for better ratings. Indeed, the only reason that rating agencies are able to charge fees at all is because the public has enough confidence in the integrity of these ratings to find them of value in evaluating the riskiness of investments.

Partnoy's account of the rating of the PLUS notes reveals the basic analytical flaw that lies at the heart of F.I.A.S.C.O. The author does not understand the important role reputation plays on Wall Street. The following Section provides an alternative depiction of the dynamics of the derivatives industry that contrasts sharply with the one created by Partnoy. It is an alternative that I find far more plausible.

II. AN ALTERNATIVE REALITY

The goal of F.I.A.S.C.O. is to create the impression that the derivatives market in general and the Morgan Stanley derivatives group in particular is in business to dupe unsophisticated, unsuspecting customers. According to Partnoy, the only norm at work among those who sell derivative securities is the desire to create a false sense of security in order to induce customers to buy, and to "lure people into that calm and then just totally fuck 'em" (p 66). Not only does the entire industry make "huge amounts of money . . . by trickery and deceit" (p 30), but the way "you made money selling derivatives was by trying to blow up your clients" (p 65). As Partnoy tells it, derivatives trades are simply the most recent example of a basic theme in the history of finance: "Wall Street bilks Main Street" (p 251). The reality is that the story of derivatives contained in this book is, at worst, "Wall Street and Main Street bilk regulators." Main Street comes out pretty well.

For example, despite the dozens of examples of derivatives trades in F.I.A.S.C.O., Partnoy does not provide a single first-hand account of Morgan Stanley or any other investment bank taking advantage of an unsuspecting customer. Indeed, the book includes only one description of a derivatives transaction with an individual investor. This trade was an equity swap between Bankers Trust and A. Lorne Weil, chairman of Autotote Corporation (p 184). Bankers Trust paid Weil $13.4 million for 500,000 of Weil's Autotote shares plus floating interest on the $13.4 million.
Weil, in exchange, agreed to pay Bankers Trust all of the dividends on the shares, and to make additional payments after five years if the stock price increased. (Weil would receive additional payments if the stock prices decreased.) The swap effectively allowed Weil to sell his Autotote stock without having to pay capital gains taxes on the sale, and without having to give up his voting power in the company. As Partnoy points out, these so-called "Equity Swaps" "were a pure, unadulterated tax scam" (p 184). In other words, this trade comports with the trades described in the previous Section. They were motivated by regulatory and accounting concerns. They were not the result of an effort by Wall Street investment banks to defraud their customers.

Similarly, there is unquestionably ample evidence that the derivatives buyers that Partnoy describes were taking huge bets. However, there is no evidence that they were making unreasonable bets in the sense that they were taking gambles for which there was a significant downside without any corresponding upside. Moreover, far from being kept in the dark, there was plenty of voluntary disclosure in the derivatives trading that Partnoy describes (pp 61, 63-65).  

Although Partnoy does not give any concrete examples of derivatives salesmen cheating their customers, the circumstances Partnoy describes may nonetheless create at least an opportunity for such deception. What Partnoy fails to recognize, however, is that the investment banks for which these salesmen work have strong incentives to avoid such conduct. In economic jargon, the transactions that Partnoy describes might be explained as the result of a combination of agency problems and time-inconsistency problems within Wall Street firms. The agency problems refer to the fact that investment banking employees such as traders and salesmen are agents of the principals who own the firm. As agents, sometimes their private interests diverge from the interests of the firms' owners. The time-inconsistency problem results from the fact that the losses associated with derivatives trades sometimes will not be recognized for some period of time. For example, in the PERLS transaction described above, Partnoy claims that "selling a . . . PERLS to a widow or orphan buyer meant that you didn't have to worry about the repayment of principal for five years—an entire career on Wall Street" (p 60). And, of course, the

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6 Perhaps not surprisingly, Partnoy characterizes such disclosures as evidence of the investment banks' willingness to take advantage of their customers. He transforms a series of routine disclaimers on an offering memorandum prepared by CS First Boston for some Thai baht basket-linked notes it was selling into a "remarkable" attempt by First Boston at "covering their asses" (p 64).
whole point of the IOettes trades described in the previous Section was to permit buyers to book huge profits immediately, while postponing the accompanying losses.

The time-inconsistency issue combined with the agency cost problem could potentially create an opportunity for an unscrupulous salesman. Such a salesman could try to gain a short-term advantage by selling unsuitable derivative securities to an unsuspecting customer, provided that the true nature of the trade would not be revealed until after the salesman had left the firm. But the critical point, which Partnoy does not appear to understand, is that the investment banking firms whose salesmen were peddling these securities generally stood to lose far more than the customers. An investment bank that systematically tried to cheat its customers would lose its reputation, and, because capital is fungible, reputation is the only thing that enables investment banks to distinguish themselves from their competitors. Thus, although the huge commissions to be made on individual trades may give Wall Street salesmen an incentive to cheat their customers, the firms that these salesmen work for have strong incentives to police against this kind of conduct.6

Even Partnoy recognizes that investment banks depend a great deal on their reputations. He devotes considerable space at the outset of *F.I.A.S.C.O.* to rhapsodizing about the exalted reputation of his former firm, Morgan Stanley. Also, the characterization of Morgan Stanley as "among the most prestigious investment banks" is a recurring theme throughout the book (p 251). Furthermore, Partnoy acknowledges that when considering mergers with other investment banks, Morgan Stanley was careful not to do anything that "jeopardize[d] its hallowed name" (p 176).

From an economic perspective, Morgan Stanley simply has too much invested in its reputation to risk it all on short-term profits from unscrupulous derivative trades. It is more plausible that individual traders may have attempted to free-ride on the firm's reputation by engineering unscrupulous derivatives trades. For the salesmen to be successful, however, not only must these individual traders have short-term time horizons, but the firm itself must have extremely weak monitoring systems in place. This

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6 Other writers about derivatives have similarly failed to distinguish between the incentives of salesmen and the incentives of the firms for which they work. See Henry T.C. Hu, *Misunderstood Derivatives: The Causes of Informational Failure and the Promise of Regulatory Incrementalism*, 102 Yale L J 1457, 1492-93 (1993) (arguing that derivatives are one of the few areas on Wall Street where it is still possible for traders to cheat, because of the large amounts of money involved).
latter claim is highly implausible in light of the fact that the complex financial engineering in derivatives creates massive amounts of leverage, which pose huge risks to the investment banks. Any firm involved in derivatives must have credible internal monitoring and governance systems in place if it is to have long-term hopes for survival. This is the lesson of the failure of the venerable British investment bank, Barings PLC. As I have pointed out before with regard to the Barings collapse,

shockingly bad internal control systems permitted a single rogue trader to engage in a pattern of highly speculative trading, which resulted in losses to Barings of approximately $1 billion. . . . The Barings insolvency demonstrates that derivative securities trading presents garden variety problems of corporate governance and oversight: nothing more and nothing less. Barings got what it deserved for its lax monitoring practices.\(^7\)

Partnoy's highly conjectural depictions of Morgan Stanley's business practices stand in sharp contrast to actual industry behavior. In investment banking more than in most businesses, relationships with customers matter more than short-term gains. This is not a result of abstract moral considerations. Businessmen are ethical because it is in their rational self-interest to act ethically. For example, in late 1996, CS First Boston Europe gave up $80 million in legally earned trading profits in order to protect the firm's relationship with the Republic of Italy.\(^6\) The trade involved securities called *buoni postali fruittiferi a termine* (nicknamed "golden bonds") issued by the Italian postal service but backed by the full faith and credit of the Italian government.

These securities were unusual in a number of ways. In particular, the rate of interest they offered investors could only be altered by an act of the Italian parliament. Unfortunately for Italian taxpayers, when Italian interest rates started to fall as a result of the convergence of interest rates among European countries preceding the European monetary union, the interest rates on the *buoni postali fruittiferi a termine* remained high. At one point, the return on the *buoni postali fruittiferi a termine* was 9.58 percent when comparable government bonds were offering returns of only 7.80 percent.\(^9\)

For clever bond traders, the spread between the rate of returns on the *buoni postali fruittiferi a termine* and the rate of re-

\(^7\) Macey, 21 J Corp L at 79-80 (cited in note 4).
\(^9\) Id.
turn on other government debt offered a hugely tempting arbitrage possibility. To exploit this possibility, CS First Boston traders not only purchased a large number of bonds for investment purposes, they also planned to act as lead manager for a public issue of the lira equivalent of $400 million of the bonds. CS First Boston planned to consummate a large currency swap transaction that would allow it to offer repayment in dollars instead of lire for the notes. *Euromoney* magazine estimates CS First Boston’s profits from its buoni postali fruittiferi a termine transactions at $80 million.\(^\text{10}\) These profits were earned over a very brief period of several days, were entirely riskless, and were legal.

But the trade was deeply embarrassing to the Italian government. CS First Boston decided that the firm’s long-term relationship with the Italian government—and its reputation as an ethical actor—was worth more to it than even an extraordinarily large profit on a single transaction. So CS First Boston decided to forego its profits on the transaction by unwinding the swap transactions and accompanying hedges that constituted the profitable public issue the firm had concocted to take advantage of the buoni postali fruittiferi a termine arbitrage opportunity. This transaction transformed a huge profit for CS First Boston into a modest loss. As David Mulford, Chairman of CS First Boston Europe, explained:

> If you’re a major global firm that is, “a relationship bank,” then in most cases like this where there are conflicts of interest, the overall relationship will prevail . . . .

The implications are much broader than just Italy. We have important advisory roles around the world. We cannot afford to send out the message, “Well, you’re a valuable client for our advisory business, but I’m sorry, if we can do a profitable one-off trade that may be against your interest, we’ll do it.” This is not a theme we should put in the market.\(^\text{11}\)

Like CS First Boston, Morgan Stanley has huge incentives to monitor its salesmen to make sure that the value of the firm’s reputation, which has taken decades to create, is not destroyed by a group of rogue derivatives traders. Accordingly, the firm must make sure that the derivatives sold by Morgan Stanley are used for their intended functions. Partnoy’s implications notwithstanding, derivative securities do, in most circumstances, serve legitimate investment functions. Specifically, derivative instru-

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\(^\text{10}\) Id at 38.

\(^\text{11}\) Id at 39.
ments are securities designed primarily to assist firms in their own risk management. Derivatives serve a number of other worthwhile functions as well. For example, they can be used to help firms reduce the transaction and agency costs of doing business. A firm that wants to extend credit to another firm but is worried that the borrowing firm will change its behavior in the future in ways that create more risk for the lender can design option-like derivative instruments that force the borrower to buy the securities under certain conditions. Similarly, interest rate reset notes cause interest rates to adjust when there are changes in a borrower's credit rating after a loan has been made, reducing borrowers' incentives to increase risks ex post. And, as noted above, customers also want derivatives in order to avoid taxes and other regulations, and to maximize revenues by making leveraged bets on interest rate and currency fluctuations. Only Partnoy's rather grasping and wholly irresponsible sensationalism could transform these very ordinary business objectives into a vast international Wall Street conspiracy.

For firms interested in surviving beyond the short term, ethics is good business. Those firms that develop a reputation for ethical practices will find it easier to keep old customers and to attract new customers in an increasingly competitive industry. One passage from F.I.A.S.C.O. in particular reveals this point. Partnoy recounts the story of one of his immediate supervisors (whom Partnoy strangely refuses to identify except by the code name "Scarecrow") who changed positions within Morgan Stanley, moving from the derivatives products group to the asset management group. Partnoy recounts that:

It had been difficult for him to get the job, and he had been forced to compete against numerous candidates outside the firm. The key question in his interviews had been, What are the most important qualities a salesman can have? The interviewer told Scarecrow the firm had recently conducted a survey about such qualities and asked him to pick his favorite among: product knowledge, intelligence, relationship ability and integrity. Scarecrow said he had answered, "Without a doubt, integrity. This is a trust business, and we are selling our trust." That answer had clinched the job (p 250).

III. REGULATORY ISSUES

F.I.A.S.C.O. portrays the business of creating and selling complex derivative instruments as one in which norms of good behavior are completely lacking. And of course, when norms or incentives do not push human behavior in socially acceptable directions, cries for regulation become more plausible. Unsurprisingly, Partnoy's solution for the lawlessness he sees in the derivative industry is regulation. He blames the lack of regulation of the derivatives industry on a combination of "healthy campaign contributions" and the fact that high powered lobbyists "have persuaded our elected representatives to reduce the amount of derivatives regulation, [by] arguing that derivatives are used primarily for 'hedging' and 'risk reduction purposes'" (p 252). Partnoy bemoans the fact that "regulators lack both power and money, and are doomed to remain several steps behind the finance industry" (p 252).

Partnoy's argument about the lack of regulation in the derivatives industry is unconvincing for three reasons. First, it fails to account for the fact that the securities industry in general is heavily regulated. It makes no sense to argue, as Partnoy does, that firms like Morgan Stanley have the political clout to avoid regulation of their derivatives business but not to avoid regulation of the rest of their business. This argument applies with particular force to commercial banking firms like Bankers Trust that have been heavily involved in derivatives, yet are shackled in other areas of their business by outmoded regulations like the Glass-Steagall Act.

Second, and even more fundamentally, Partnoy fails to understand the basic regulatory point that regulation would improve rather than harm the competitive position of industry giants like Morgan Stanley. The fixed costs associated with regulation inevitably would impose barriers to entry on new competitors, thereby permitting firms like Morgan Stanley to solidify their existing market positions. Long ago George Stigler recognized that regulation, including regulation of the securities markets, provided significant benefits to competitors by cartelizing the industry. Partnoy's naïve claim that industry participants like Morgan Stanley would be harmed by regulation shows a remarkable lack of understanding of the economic theory of regulation. In particular, because investors are a diffuse and poorly
organized interest group, it seems particularly likely that regulations would benefit market participants rather than the public.

Finally, Partnoy's ill-informed musings about the lack of regulation of the derivatives markets do not account for the fact that disinterested federal judges who have considered the issue have refused to interfere with derivatives markets, despite clear authority to do so. The failure to regulate thus comes not only from politically malleable legislators but also from federal judges who are immune to what Partnoy describes as multi-million dollar securities industry payments "to lobbyists and congressional campaigns to fend off regulation" (p 252).

Judicial authority to intervene in the derivatives market comes from the securities laws, which provide broad protection for both sophisticated and unsophisticated investors against fraudulent conduct by securities firms. In particular, courts have interpreted Section 10(b) of the Securities Exchange Act of 1934 and SEC Rule 10b-5 as prohibiting securities brokers from recommending or purchasing securities with an intent to defraud or with reckless disregard for the customer's interests. Courts also use these laws to prohibit brokers from fraudulently misrepresenting that a particular security is suitable for a customer's investment objectives or from failing to disclose that a particular security is not suitable for a customer's objectives. Moreover, courts are likely to impose liability on securities salesmen when they find that a relationship of trust and confidence has developed between the broker and the customer. At the core of the legal regime regulating this relationship between securities firms and their customers is the so-called "suitability doctrine," which sets forth a general requirement that a securities salesman must have a reasonable basis for the recommendations made to customers. Under the doctrine, the salesman must take the customer's financial circumstances and investment objectives into account when making his recommendations.

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See, for example, O'Connor v R.F. Lafferty & Co, 965 F2d 893, 898 (10th Cir 1992).

See, for example, Brown v E.F. Hutton Group, Inc, 991 F2d 1020, 1031-32 (2d Cir 1993); Lefkowitz v Smith Barney, Harris Upham & Co, 804 F2d 154, 155-56 (1st Cir 1986).

See, for example, Vucinich v Paine Webber, Jackson & Curtis, Inc, 805 F2d 454, 460 (9th Cir 1986).

The "suitability doctrine" finds its origins in the internal governance rules of the National Association of Securities Dealers, the New York Stock Exchange, and the Mu-
The contrast between Partnoy's view of derivatives and that held by courts is reflected in the Fourth Circuit's recent holding in *Banca Cremi v Alex Brown & Sons, Inc.* Banca Cremi involved collateralized mortgage obligations ("CMOs"), which are discussed extensively in *F.I.A.S.C.O.* (pp 219-33), and which Partnoy describes variously as "extremely risky," "misleading," "deceiving," and "especially dangerous," despite the fact that "they can appear quite safe" (p 220). Indeed, in *Banca Cremi*, the plaintiff, a Mexican bank, made the same sort of allegations against an American broker-dealer firm that Partnoy makes throughout *F.I.A.S.C.O.* The plaintiff bank maintained that it was an unsuspecting customer, misled into thinking that CMOs in general were not risky and that they display trading patterns similar to other fixed-income securities like bonds, rather than to more volatile derivatives. Further, the *Banca Cremi* plaintiff alleged that the defendant failed to disclose precisely the sort of information about CMOs that Partnoy claims makes them so dangerous. In particular, Partnoy emphasizes the risks of prepayment, which make CMOs "so unpredictable" (p 220). Likewise, in *Banca Cremi*, the customer complained that the investment bank failed to provide information about how CMOs work, including information about prepayment and the effects of interest rate changes on the market value of CMOs.

This line of argument would have fooled Partnoy, but it did not fool the Fourth Circuit in *Banca Cremi*. In fact, the analysis of CMOs in *Banca Cremi* is far more nuanced and sophisticated than any of the analysis contained in *F.I.A.S.C.O.* First, unlike Partnoy, the court was able to comprehend the social utility of CMOs: "CMOs were designed to make home mortgage investments more attractive to institutional investors, increase the liquidity in the secondary home mortgage market, and reduce the interest costs to consumers buying homes." Second, the court understood that some CMOs are far less risky than others, and thus did not commit Partnoy's error of treating all CMOs as highly risky. Third, the court in *Banca Cremi* seemed to understand, as Partnoy does not, that dissatisfied investors sometimes will resort to the securities laws to redress errors resulting not

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20 Id at 1022.
21 Id at 1023.
from fraud or a breach of fiduciary duty on the part of the investment bank but from the investor's own misjudgment. The court wisely observed that people should "invest carefully," and that "[a] dissatisfied investor cannot recover for a poor investment on the basis of a broker's alleged omission or misstatement where, through minimal diligence, the investor should have discovered the truth." In other words, the court was aware that placing too heavy a burden on derivatives sellers would create inefficiencies and market distortions by providing buyers with strong disincentives to educate themselves about the nature of their trading activities.

The court also drew a distinction between sophisticated investors and unsophisticated investors, realizing that, to recognize the risks of an investment and to discern when misrepresentations are being made, sophisticated investors need less information than unsophisticated investors. The court looked at the nature of the relationship between the investment bank and the customer to see if a relationship of trust and confidence had developed that would have entitled Banca Cremi to enjoy the benefits of the higher standard of care enjoyed by beneficiaries of fiduciary duties. The court concluded that it is possible for investment banks to deal at arms length with their institutional investor clients. As a result of the arm's length relationship between Banca Cremi and the American salesman, the salesman did not owe Banca Cremi a fiduciary duty, and the court explicitly refused to create a new legal duty requiring a principal selling a security to "warn another principal that an investment may be imprudent or may not meet all of a buyer's investment goals." As the Banca Cremi decision illustrates, courts, unlike Partnoy, do not simplistically view the world as divided between lawless securities firms and unwary investors, who are not only duped by these unscrupulous sellers but who also return repeatedly to the same firms for more abuse. A more realistic view of the relationship between investment firms and their customers is one that I have offered previously:

Well developed financial markets are an integral part of the economic life of every industrialized nation. Financial markets are the engine through which a society's capital is allocated and through which its investment decisions are made. The trading firms that have flourished over time are the

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23 Id at 1027-28 (citation omitted).
24 Id at 1030.
25 Id at 1038.
ones that have been able to keep credible commitments to investors—including the commitment to develop and maintain adequate systems of internal monitoring and control.\footnote{Macey, 21 J Corp L at 93 (cited in note 4).}

**CONCLUSION**

It would be too easy to dismiss *F.I.A.S.C.O.* as a total waste of the reader's time. To its credit, the book contains some nice institutional details about the derivatives market. There is, for example, a very accessible description of options and forwards, which are the building blocks of derivatives, toward the beginning of the book (pp 30-32). But the vast bulk of *F.I.A.S.C.O.* is misleading or inaccurate. Partnoy does not convey any sense of the multitude of socially beneficial purposes that derivatives can provide to purchasers, and he fails to understand the strong incentives that motivate rational, survival-oriented firms like Morgan Stanley to discourage the opportunistic behavior that might give rise to the conduct *F.I.A.S.C.O.* maintains is endemic in the derivatives industry. Moreover, Partnoy displays a calculating lack of understanding of the environment in which he briefly worked. My guess is that he read *Liar's Poker* and thought that he had found a successful formula for a best seller: an insider's depiction of a corrupt world of rich Wall Street insiders profiting at the expense of honest and hard-working, but unSophisticated, outsiders.

There is, however, one important reason to read *F.I.A.S.C.O.*: it provides a window into the world of ill-informed, misleading analysis-by-way-of-anecdote that provides the predicate for much regulation. If someone wanted to regulate the derivatives market, *F.I.A.S.C.O.* provides the pretense of a justification. But for an honest student of derivative markets, the book's sensationalism is only surpassed by its intellectual dishonesty. Partnoy tries very hard, for example, to create the impression that firms like Morgan Stanley are about to start peddling the sorts of complex derivative securities described in *F.I.A.S.C.O.* to unsuspecting members of the general public. In the closing pages, for example, Partnoy writes that Morgan Stanley, "not content to sell sophisticated financial instruments to insurance companies and state pension funds, is now seeking out even less-sophisticated investors—you, for example—by agreeing to merge with Dean Witter" (p 251). Of course only a rather careful reader who comes to this book with some advanced knowledge of the securities industry...
will notice that 219 pages earlier Partnoy distinguishes between the more liquid and more highly regulated derivatives that trade on organized exchanges—the kind that are available to small retail customers—and the more exotic privately negotiated over-the-counter derivatives that he is describing in this book (p. 32).

Upon reading *F.I.A.S.C.O.*, it is more clear to me why regulation is so often built on sensationalism and faulty thinking rather than on careful analysis and genuine need. It is also evident why teaching economics to policymakers is so important. Economic analysis provides the tools necessary to see through the misleading hyperbole of writers like Frank Partnoy.