Event: Telecon w/ Professor Frank Partnoy regarding the role of derivatives and complex securities in the financial crisis

Type of Event: Conference call

Date of Event: February 22, 2010

Team Leader: Chris Seefer

Location: Chris Seefer’s office

Participants - Non-Commission: Professor Frank Partnoy, George E. Barrett Professor of Law and Finance and director of the Center on Corporate and Securities Law at the University of San Diego

Participants - Commission: Chris Seefer, Clara Morain

MFR Prepared by: Clara Morain

Date of MFR: March 5, 2010

Summary of the Interview or Submission:

Chris Seefer opened the call by explaining that he is interested in a broad overview of (1) how derivatives contributed to the financial crisis, (2) what areas within the field of derivatives the FCIC should focus on, (3) what experts should the FCIC talk to about the role of derivatives in the financial crisis, and (4) what institutions should the FCIC focus on for its report and/or hearing on the role of derivatives in the financial crisis.

Prof. Partnoy said that in his view, derivatives and financial innovation were the key cause of the financial crisis. He explained that he views the current financial crisis through a historical framework, and he says that although it’s easy to become mired in the details and complexities of the $6 trillion derivatives market, he thinks it is instructive to consider that there was a fundamental change over the last decade in financial markets with financial innovation that was very similar to what occurred in the 1920s. He said that the fundamental change occurred when markets became increasingly complex, based on “byzantine financial instruments,” and that financial innovation was used as a tool to avoid disclosure and risk. He said that over the decade, a “gap between reality and perception” grew, and “markets became manic, unstable, and finally collapsed.

The crux of his argument is that innovation in financial markets avoided disclosure and enforcement - the “underlying bedrock of stability,” according to Prof. Partnoy. He said that disclosure and enforcement eroded in the same way in the 1920s.

Professor Partnoy said that the roadmap for reform is uncomplicated – that mandatory disclosure and enforcement would restore discipline in the derivatives market. He advised us to not “get lost in the details, or sucked into talk about centralized clearing and exchanges,” which he described as a “sideshow” that is “an attractive proposition, but it’s uncontroversial. The larger question is how to integrate the bedrock principles (disclosure and enforcement) into the financial markets for all instruments, not only those on exchanges.

He described the crisis as the “absolute failure of transparency in financial institutions, enabling them to take massive risk without disclosure or the credible threat of enforcement.” As an illustration of that point, he said that looking at financial statements gives “no clue about the causes of the massive losses and write downs” at financial institutions.

Commenting on the CDS market specifically, Prof. Partnoy said that CDS spreads were actually very useful indicators of risk and regulators ignored them. He said that CDS spreads were “the canaries in the coal mine screaming trouble in August 2007” and that regulators should “harness the power of the market,” using CDS spreads rather than credit rating agencies, which were “abysmal at responding to changes in risk,” he said. He emphasized that CDS markets themselves are potentially very valuable regulatory tools. He said that they are “as efficient as equity markets in responding to new information and are exponentially more useful than credit ratings.”

Prof. Partnoy said that in his view, if the major financial institutions were forced to mark to market in 2007, all would be either insolvent or close to insolvent, with the possible exception of Goldman Sachs. He said that the “CDS market was telling you in 2007 that if banks had market to market, they would’ve been insolvent.” He recommended asking Citi’s Board of Directors whether they thought it was solvent in August 2007 timeframe. He said that Citi’s CFO “got pretty close to admitting that fact recently,” and “that in a private Q&A, Rubin admitted that he didn’t understand Citi’s level of risk.”

Prof. Partnoy also said that the volume of naked CDS is another indicator like CDS spreads, despite the perception that it seems “un-American” to bet against the market. He said that both short selling and naked CDS trades occur because somebody found out bad information about a company – he said “look, these aren’t Peace Corps volunteers, but they’re they’re wrong, they lose money.” He said that restrictions on shorting just contributes to bubbles.

When Chris Seefer asked what he would say to people to argue for banning naked short selling, Prof. Partnoy said “if anything, I’d say subsidize shorting. There’s no empirical evidence that manipulative short selling does anything.”

He said that the CDS market “accelerates the demise of an institution if telling the truth is acceleration – banks had done the damage,” he said, “and CDS and shorting accelerated the realization of the truth of the demise.” He explained that derivatives masked transparency because “derivatives that caused losses weren’t disclosed, swaps weren’t on balance sheets, and there were nothing but opaque references to footnotes – anyone who read the footnotes couldn’t understand the banks’ risks. There’s no way to run scenarios without information and if you look at AIG and Citi’s annual reports, it’s clear that there’s a disconnect between disclosed risk and real risk.” He said that by looking at AIG’s financial statements “you would have no clue about an entire pillar of derivatives – it’s balance sheet looks completely healthy for a company that was about to go under.” Similarly, he said that Citigroup’s balance sheet looked healthy through 2008 because it was able to hide most of its most important liabilities. He said it is notable that the words “CDS” and “subprime” were not even mentioned in financial statements until 2007.

He said that “if you as an individual could hide your debts, you could take on more risk. We let banks hide their debt, and its’ no surprise what they did.”

Prof. Partnoy suggested that the FCIC look at Citigroup and AIG to illustrate in role of derivatives in the financial crisis. He also suggested that the FCIC look at the white papers produced by the Roosevelt Group for the March 3 conference on “Plan B for Financial Reform.” He said talking with Eliot Spitzer, Josh Rozner, Lynn Turner, Bill Black and John Paulson would be instructive. He also recommended the Coughlin lawsuit against AIG, in addition to the Kirby McInerney Citigroup lawsuits. He said that conducting an open source investigation into AIG’s emails would be valuable.

Prof. Partnoy expressed his strong support and encouragement for the FCIC’s work, and said he would be happy to help however he could, although he would be reluctant to testify unless the Commission thought it would be substantively useful. Chris Seefer thanked him for his time, said that he would be in touch again, and ended the call.

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