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February 13, 2012

Ms. Jennifer Johnson
Secretary to the Board of Governors of the Federal Reserve System
20th Street and Constitution Avenue, NW
Washington, DC 20551
RIN: 7100 AD 82

Mr. Robert Feldman
Executive Secretary, Federal Deposit Insurance Corporation
550 17th Street, NW
Washington, DC 20429
Rin: 3064-Ad85

Ms. Elizabeth M. Murphy
Secretary, Securities and Exchange Commission
100 F Street, NE
Washington, DC 20549
Rin: 3235-Al07

David A. Stawick, Secretary of the Commission
Commodity Futures Trading Commission
Three Lafayette Centre, 1155 21st Street, NW.
Washington, DC 20581
RIN: 3038–AC

Office of the Comptroller of the Currency
250 E Street SW, Mail Stop 2-3
Washington, DC 20219
Rin: 1557-Ad44

RE: Proposed Rule to Implement Prohibitions and Restrictions on Proprietary Trading and Certain Interests in, and Relationships with, Hedge Funds and Private Equity Funds

Dear Sirs and Madams:

I am writing to express my support for a strong and robust implementation of the Volcker Rule.

It is essential that policymakers approach this issue with respect for the lessons of history, which are often sadly neglected in policy discussions of financial regulation. Proper attention to history suggests that while the Volcker rule may result in some modest and short-term adjustment costs, it is nevertheless a sensible and perhaps essential investment in our economic future. It will greatly reduce the problem of systemic risk that fueled the recent financial crisis, and in the long run substantially improve the performance of our financial markets by eliminating both dangerous conflicts of interest and irrational risk taking behavior by banking institutions at the heart of the financial system.

In past decades, your agencies and the U.S. Congress engaged in a risky experiment to allow commercial banks to engage in speculative trading activities previously restricted to investment banks and securities firms.[1] The results of that experiment are clear for all to see. The banks, with lower borrowing costs and hefty balance sheets, seized this opportunity to shift away from traditional banking activities and began to focus instead on large hedge fund-like trading operations that produced private profits for some at the expense of others. Although many financial institutions publicly characterized their activities as "hedging," in fact they were primarily speculative in nature, intended not to reduce risk but to generate trading profits. As a result, far from reducing overall risk, proprietary trading increased risk, just as casino gambling increases risk among gamblers. When some of the banks' speculative bets went bad--as inevitably happens in any casino--the effects were catastrophic. Trillions of dollars of wealth vanished, credit froze, and the world economy faltered.

The Volcker Rule is a critical response to this problem, and the proposed rule takes an important step forward in putting into place the prohibition on banks engaging in proprietary trading and creating what are essentially hedge funds. Put simply, it puts back into place some of the basic protections that had protected our banks and their affiliates for six decades prior to the deregulatory frenzy of the 1990s.

It goes without saying that some financial institutions can be expected to devote enormous resources to trying to prevent effective implementation of the Volcker rule. It can also be anticipated that many in the banking industry will claim that their "hedging" and "market making" activities are essential to economic growth and that any attempt to restrict these activities will stifle innovation, increase risk, and harm the U.S. economy.

History teaches the opposite. Historically, legal systems that encouraged and subsidized speculative trading suffered reduced returns, increased risks, and boom-and-bust cycles as a result.[2] The concentration of financial activity in a few large financial institutions is historically associated

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1 For a survey of how de-regulatory efforts contributed to the crisis, see, e.g., Lynn A. Stout, *Derivatives and the Legal Origin of the 2008 Credit Crisis*, 1 HARV. BUS. L. REV. 1 (2011). See also, Saule Omarova, *The Quiet Metamorphosis: How Derivatives Changed the "Business of Banking"*, 63 U. MIAMI L. REV. 1041 (2009).

2 For a survey of the economic effects of excessive speculation and traditional anti-speculation rules see, e.g., Lynn Stout, *Why the Law Hates Speculators: Regulation and Private Ordering in the Market for OTC Derivatives*, 48 DUKE L.J. 701 (1999).

with economic fragility, not stability. Finally, financial markets have proven themselves time after time competitive enough that excluding one set of players from a particular activity has only encouraged others to take their place.

Still, in the 1990s, free market ideology combined with a lack of attention to business history combined with massive political pressure from the finance sector resulted in the removal of decades-old (and in some cases centuries-old) legal structures designed to dampen speculative financial activity in general and speculation by banking institutions in particular. At the time, I was one of a small handful of experts who expressed concern over the wave of deregulation and predicted that it would increase risks while eroding returns.[3] Our expressions of concern went, of course, unheeded, with disastrous--but sadly predictable--results. I urge you not to repeat the mistakes of the 1990s.

Thank you for the opportunity to comment and for your consideration.

Sincerely,

Lynn A. Stout
Marc and Beth Goldberg Distinguished Visiting Professor of law, Cornell Law School
Paul Hastings Distinguished Professor of Corporate and Securities Law, UCLA School of Law

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[3] See, e.g., Lynn Stout, *Betting The Bank: How Derivatives Trading Under Conditions of Uncertainty Can Increase Risk and Erode Returns in Financial Markets,* 21 J. CORP. L. 53 (1995).