Comment to Antidisruptive Practices Authority Contained in Dodd-Frank Wall Street Reform and Consumer Protection Act (Document ID CFTC-2010-0154-0001)
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The root problem of this mess is the transition of Wall Street firms from partnerships to corporations. By doing so, the ownership of these firms effectively shifted the risk of events like the sub-prime crisis from the private sector to the public sector. This shifting was enabled by the feature of limited liability afforded to corporations by government as a subsidy for their operations. To invoke the language of free markets, it literally caused a "market failure."

Limited liability has the effect of distorting risk and risk is important because we use it to calculate value. We perform this calculation intuitively. We've got all sorts of old-timey sayings that implicitly recognize the effect of risk on value. For instance, a bird in hand is worth two in the bush.

Basically, the value of any outcome must be discounted by the risk of that outcome's nonoccurrence. In the words of proverbs, the value of the aforementioned birds in the bush must be discounted by the risk you miss shooting both, or worse.

Corporations do the same when making investment decisions. They've got $1M sitting around burning a hole in their balance sheet so they start looking for various investment opportunities. Some dude comes forward with Investment A that has a potential outcome that would yield $100M. As any good poker player knows, provided the outcome occurs more than 1 out of every 100 outcomes, Investment A is a good bet.

This logic makes sense only in the context of limited liability. Limited liability creates for the corporation the illusion of cost certainty. It makes finance the equivalent of a poker buy-in.

No matter how Investment A turns out, the most the corporation can lose is the $1M investment. However, that's not how the real world works.

In the real world, as demonstrated by events like the sub-prime crisis or the BP oil spill, things go horribly wrong. When evaluating whether to forego the bird in hand for the two in the bush, we consider not only the possibility that we may lose the bird in hand but that, even if we act with appropriate care and attention in going after the two in the bush, something more horrible could occur. We could break a leg, the gun may explode , or we could shoot our buddy in the face.

In the context of limited liability, corporations may disregard all of the outcomes that are far worse than simply losing the bird in hand. They underestimate the risk associated with their conduct because, by virtue of the shield of limited liability, they are permitted offload this risk to the public sector. The result is necessarily a suboptimal allocation of resources.

It is implicit in any system of limited liability that the government acts as a proxy for taxpayers act as the insurer of last resort. When a corporation goes after the two in the bush and ends up tripping over itself and bringing down not just its investment but the country's economy, the corporation is just on the hook for its investment. Limited liability requires taxpayers foot the bill for the remainder.

By allowing banks to take the corporate form and invoke limited liability protections, the taxpayers implicitly wrote the financial industry - Goldman Sachs, AIG, Bear Sterns, Lehman, Citi, BofA... the whole lot of them - a free insurance policy to insure against the financial destruction its bankers wrought. Greed doesn't cause bankers to take on too much risk, limited liability does.

While not a perfect solution (I'd much prefer a requirement that banks simply be prohibited from adopting the corporate form and the trappings of limited liability), the Volker Rule has the effect of putting a ceiling on the amount of risk banks can undertake and thereby mitigates the effect of the market distortion caused by limited liability. The rule effectively states, if you are going to take advantage of the opportunities afforded to you by the corporate form and limited liability specifically, we the taxpayers will only going insure you for certain types of losses – those losses that relate to the advancement of public interest. We will not insure you for losses that you incur as a result on activity undertaken on behalf of purely private interests. And that, in my opinion, is a good first step in addressing the fundamental market distortions that precipitated the banking crisis.