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Common Law Rules for Regulating Derivatives

Friday, 15 October 2010, 1:00 – 2:00 pm

Theatre 2, Meng Wah Complex, University of Hong Kong – NEW VENUE

When credit markets froze in the Fall of 2008, many economists pronounced the crisis both inexplicable and unforeseeable. That's because the roots of the catastrophe lay not in changes in the markets (the focus of economists' expertise), but rather changes in the law (the field of lawyers). In particular, the 2008 crisis was the direct result of first the U.K.'s, and then the U.S.'s, decision to abandon long-standing common law rules in favor of legislative regulation of off-exchange trading in derivatives. At common law, derivatives contracts that could not be proved to serve a commercial hedging purpose were treated as legally unenforceable gambling contracts. This rule of legal unenforceability drove speculative derivatives trading onto private exchanges, where private ordering ensured that speculative trading was kept within reasonable limits and did not contribute to systemic risk. The common law rule, however, was first codified and then eliminated by the UK (in the mid-1980s) and by the U.S. (in 2000). The predictable result was the sudden and explosive growth of an over-the-counter market in speculative derivatives trading that by 2008 had reached a notional value in excess of \$600 trillion. Equally predictably, there was a dramatic increase in systemic risk due to widespread speculation in OTC derivatives that eventually led to the failures of Lehman Brothers, Bear Stearns, and insurance giant AIG, and the ensuing credit crisis. Only a massive U.S. government-funded bank bailout prevented the system from imploding. This could have been avoided if we had not abandoned common law principles for regulating derivatives trading.

About the Speaker

Professor Lynn A. Stout is the **Paul Hastings Professor of Corporate and Securities Law** at the **University of California, Los Angeles School of Law**. Professor Stout is an internationally recognized expert in the fields of corporate governance, securities regulation, financial derivatives, law and economics, and moral behavior. She is the author of numerous articles and books on these topics and lectures widely. Her most recent book is *Cultivating Conscience: How Good Laws Make Good People* (Princeton University Press, 2011).

Professor Stout also serves as an Independent Trustee and as Chair of the Governance Committee for the Eaton Vance family of mutual funds; as an Adjunct member of the RAND Corporation; as a member of the Board of Advisors for the Aspen Institute's Business & Society Program; and as a Research Fellow for the Gruter Institute for Law and Behavioral Research. She has also served as Principal Investigator for the UCLA-Sloan Foundation Research Program on Business Organizations; as a member of the Board of Directors of the American Law and Economics Association; as Chair of the American Association of Law Schools Section on Law and Economics; and as Chair of the American Association of Law Schools Section on Business Associations. Professor Stout has also taught at Harvard Law School, NYU Law School, Georgetown University Law School, and the George Washington University National Law Center, and served as a Guest Scholar at the Brookings Institution in Washington, DC. She holds a B.A. *summa cum laude* and a Masters in Public Affairs from Princeton University and a J.D. from the Yale Law School.

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