



**Gary L. Tidwell**

Gary L. Tidwell is Vice President of Investor Education – Military Financial Education Program and International Outreach at FINRA (formerly NASD). He is also serving as Consultant, Education and Training Strategies, with IOSCO (International Organization of Securities Commissions).

From January 2005 until September 2009 he was Vice President of International Education and Training at FINRA. In that capacity, his responsibilities included conceptualizing, designing, developing, and delivering all of the educational programs and products delivered by FINRA International and/or overseeing others in this capacity.

From January 2000 until January 2005, he was Executive Director of the NASD Institute for Professional Development. Mr. Tidwell joined NASD Regulation in July 1998 as Director of Neutral Management in the Office of Dispute Resolution. He was elected Vice President of NASD Regulation in December 1999.

Mr. Tidwell is a member of the adjunct faculty at New York Law School and he also teaches at the ICMA Centre at the University of Reading, UK. Previously he was a tenured Professor of Legal Studies at the College of Charleston (South Carolina).

He has previously served as an adjunct professor at Fordham Law School, George Washington University, and the University of South Carolina. Mr. Tidwell served as a member of the NASD's National Arbitration and Mediation Committee from 1994 to 1997.

His legal career includes service as a Colonel in the Army's Judge Advocate General Corps, the U.S. Securities and Exchange Commission's Division of Enforcement, and Professor of Law and Director of the Law of Armed Conflict Center at the United States Military Academy, West Point.

Mr. Tidwell is the recipient of numerous teaching and research awards relating to business ethics, white-collar crime, insider trading, and professional liability. He has authored two books and 38 manuscripts, including Anatomy of a Fraud, Inside the Finances of the PTL Ministries. He earned BSBA and JD degrees from the University of Arkansas, and an LLM from New York University School of Law.

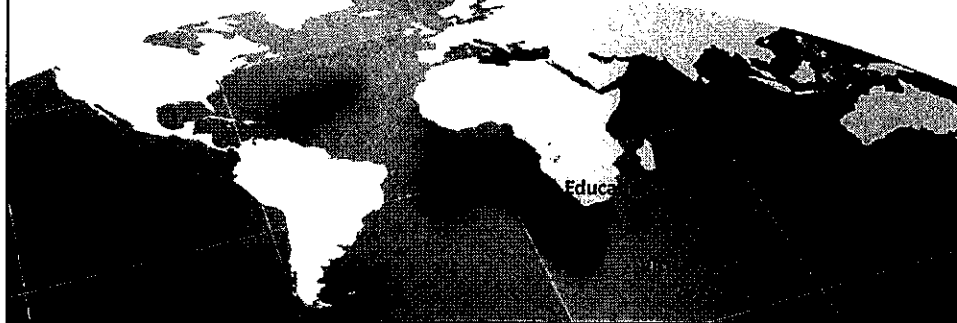
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## What Caused the Financial Crisis and the Regulatory Response to the Crisis

2011 APRC Mobile STP Program  
Kuala Lumpur, Malaysia



## The Way The Market Should Work

- Supply and demand
- Level playing field
- Equal access to information/trading
- Speak the truth in a timely manner




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## Loss as of March 2009

Investor	Company	Investment (Date)	Loss (%)
Various (stock sale)	Lehman Brothers	\$4B (April 2008)	\$4B (100%)
Warburg Pincus	MBIA	\$1B (Dec. 2007)	\$836M (84%)
Citic Securities	Bear Stearns	\$1B (Oct. 2007)	\$925M (93%)
Joseph Lewis	Bear Stearns	\$1.2B (2007)	\$1.1B (91%)
Citadel	E*Trade	\$2.55B (Nov. 2007)	\$2.170B (85%)
Various (FDIC-backed debt sale)	Wachovia	\$6B (Dec. 2008)	\$4.5B (75%)
Govt. of Singapore Investment Corp.	UBS	\$9.75B (Dec. 2007)	\$7.7B (79%)
Bank of America	Countrywide Financial	\$2B (Aug. 2007)	\$1.48B (74%)

*Table 13.1, Bailout Nation, Barry Ritholtz* <sup>3</sup>



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## Loss as of March 2009 Cont.

Investor	Company	Investment (Date)	Loss (%)
Korea Investment Corp./Kuwait Investment Authority/Mizuho Bank	Merril Lynch	\$6.6B (Jan. 2008)	\$2.9B (45%)
Abu Dhabi	Citigroup	\$7.5B (Aug. 2007)	\$6.74B (89%)
China Investment Corp.	Morgan Stanley	\$5B (Dec. 2007)	\$2.6B (52%)
Temasek Holdings	Merril Lynch	\$4.4B (Dec. 2007)	\$1.7B (40%)
Christopher Davis	Merril Lynch	1.2B (Dec. 2007)	\$475M (40%)
Various (stock + debt sale)	Ambac	\$3B (Feb. 2008)	\$2.7B (90%)
Bank of America	Countrywide	\$2.1B (Jan. 2008)	\$626M (30%)

*Table 13.1, Bailout Nation, Barry Ritholtz* <sup>4</sup>



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## Six Broad Principles (True or False)

1. Markets are rational and efficient.
2. Self-interest of investment banks/lenders prevents them from engaging in reckless behavior.
3. Markets (and financial firms) can self-regulate.
4. Deregulation is productive and desirable.
5. Consumers make rational and informed economic decisions.
6. Compensation is properly aligned between shareholders and management.

*Bailout Nation, Barry Ritholtz* <sup>5</sup>




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## The Financial Crisis: What Happened?

### Housing and Paying for the Houses




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THE  
**FINANCIAL  
CRISIS  
INQUIRY REPORT**




Final Report of the National Commission  
on the Causes of the Financial and  
Economic Crisis in the United States

• OFFICIAL GOVERNMENT EDITION •

The Commission concluded that this crisis was avoidable—the result of human actions, inactions, and misjudgments. Warnings were ignored. “The greatest tragedy would be to accept the refrain that no one could have seen this coming and thus nothing could have been done. If we accept this notion, it will happen again.”

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## Observations

- “The sentries were not at their posts.”
- Commission cast regulators as unresponsive and clueless.
  - Ex. S.E.C Chairman Christopher Cox expressed “comfort about the capital cushions” on Wall Street the same week as the collapse of Bear Stearns
- Summer 2007, with housing already past its prime, Federal Reserve chairman Ben Bernanke and Treasury secretary Henry M. Paulson Jr. “offered public assurances that the turmoil in subprime mortgage markets would be contained.”
- Regulators pleaded that their hands were tied – a bogus excuse, according to commission.
- Report by the Financial Crisis Inquiry commission said, “They had ample power in many arenas and they chose not to use it.”
  - Cited S.E.C decision to relax capital requirements for big investment banks as an example.
- S.E.C.’s “poor oversight” of the nation’s 5 biggest investment banks “failed to restrict their risky activities and did not require them to hold adequate capital and liquidity for their activities.”
  - Commission noted all 5 firms took enormous bailouts.
- Commission was unforgiving of S.E.C.’s handling of Lehman Brothers, which collapsed and filed for bankruptcy in 2008.

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## A Failing System

- THE BOOM
  - i. Banks provided home mortgages and sold many of those loans as securities to investment banks like Lehman Brothers and Merrill Lynch.
- THE BUST
  - i. Homeowners stopped paying their mortgages and foreclosures rose, the value of mortgage securities plummeted.

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## A Failing System Cont.

- LOSSES
  - i. Investment banks have written down billions of dollars in assets. They risk owing more than their assets are worth, they must raise capital.
- NOT RAISING ENOUGH CAPITAL
  - i. Many banks have been unable to raise money as quickly as asset values have dropped, leaving them with fewer options, such as bankruptcy or a sale.

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## Why Did It Happen and the Causes of the 2007-2010(?) Financial Crisis:

I. Old System Failed:

- The Fed
- Financial Institutions
- Regulations and Regulators

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## Key Factors that Might Have Led to the Crisis

- Derivatives
- Rating Agencies
- Leverage
- Short Selling
- Federal Reserve
- Regulators
- "Too Big to Fail"
- Corporate Structure
- Non Bank Lenders
- Compensation
- Consumer Protection Issues

*Bailout Nation, Barry Ritholtz* 12




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## Deregulation

- The CFMA removed derivatives and credit default swaps from *any and all state federal regulatory oversight*.
- Prior to the passage of the CFMA, unregulated credit default swaps were under \$100 billion- a sizable, if manageable, amount of derivatives contracts. By 2008, they had grown to over \$50 trillion. To put this in context, that's four times the size of the annual gross domestic product (GDP) of the United States. (*Bailout Nation, pg. 138*)

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## The Mad Scramble for Yield

- In 2000 the total annual issuance of mortgage-backed securities, including CDOs, had risen to more than \$1 trillion. The volume of derivatives-including contracts such as options and swaps grew even faster, so that by the end of 2006 their notional value was just over \$400 trillion. Before the 1980s, these were virtually unknown. (*Bailout Nation, pg 114*)
- In 1990 there were just 610 hedge funds, with \$38.9 billion under management. At the end of 2006 there were 9,462 with \$1.5 trillion under management. (*Bailout Nation, pg 114*)
- Between 1980 and 2007, the volume of GSE-backed mortgage-backed securities grew from less than \$200 billion to more than \$4 trillion. In 1980 only 10 percent of the home mortgage market was securitized; by 2007, 56 percent of it was. (*Bailout Nation, pg 114*)
- According to the Bank of International Settlements (BIS), the total notional amounts outstanding of over-the-counter (OTC) derivative contract-arranged on an ad hoc basis between two parties-as of December 2007 had a gross market value of over \$14.5 trillion. (*Bailout Nation, pg 114*)
- Between December 2005 and December 2007, the notional amounts outstanding for all derivatives increased from \$298 trillion to \$596 trillion. Credit default swaps quadrupled, from \$14 trillion to \$58 trillion. (*Bailout Nation, pg 115*)

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## Credit Rating Agencies

Did Banks Dupe the Rating Agencies?

- Transparency of calculations?
- Hired away people from the credit rating agencies who devised the formula?

And/Or

- Did Raters Ignore Possible Evidence of Unsafe Loans?

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## Corporate Response: A Rush to Risk?



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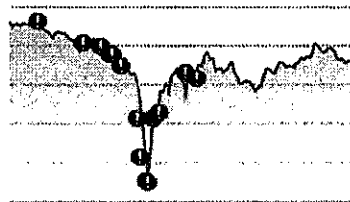
## Flash Trading/Flash Crash or People Versus Machines



*"Letting the Machines Decide," The Wall Street Journal, pg c1, July 14<sup>th</sup>, 2010* <sup>17</sup>

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### Flash Trading/Flash Crash – Dow down 415 points at 2:40 pm and closes out the day down 342 points at 4pm



1. 2 p.m. Protests in Greece turn violent; the euro falls sharply.
2. 2:23 Nasdaq begins issuing alerts about unusual price movements.
3. 2:32 Waddell & Reed starts heavy selling of S&P futures contracts.
4. 2:37 Nasdaq stops routing orders to NYSE's electronic-trading arm.
5. 2:44 Apple Loses more than \$23 a share in the next two minutes.
6. 2:47 Shares of Accenture plunge from about \$40 to one cent.
7. 2:49 The iShares S&P 500 Value Index Fund trades for 11 cents a share.
8. 2:58 Broad-based indexes recover to near their 2:30 levels.

*"Legacy of the 'Flash Crash': Enduring Worries of Repeat," The Wall Street Journal, pg 1, Aug. 6<sup>th</sup>, 2010* <sup>18</sup>




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## Financial Reform Options

- No Reform
- Too Big to Fail
- Let Banks be Banks
- Regulation – “Derivatives”

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## The Debate Continues

- I. Derivatives
- II. Mortgage Securities
- III. Hedge Funds
- IV. “Too Big to Fail, Still a Problem Too Big to Solve”
- V. Fannie & Freddie

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## What We Have Learned From The Crisis

- The current crisis provides a cautionary tale in ethics, risk, and pay.
- What are some lessons business schools and professionals should take from the crisis?

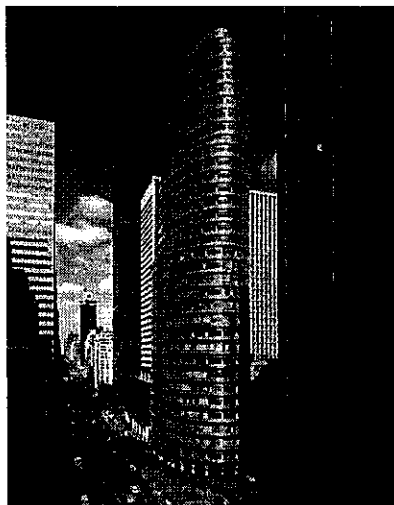
An amplification of ethics; behavioral economics and finance; and an understanding of the interface between business and government.

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## Bernard Madoff



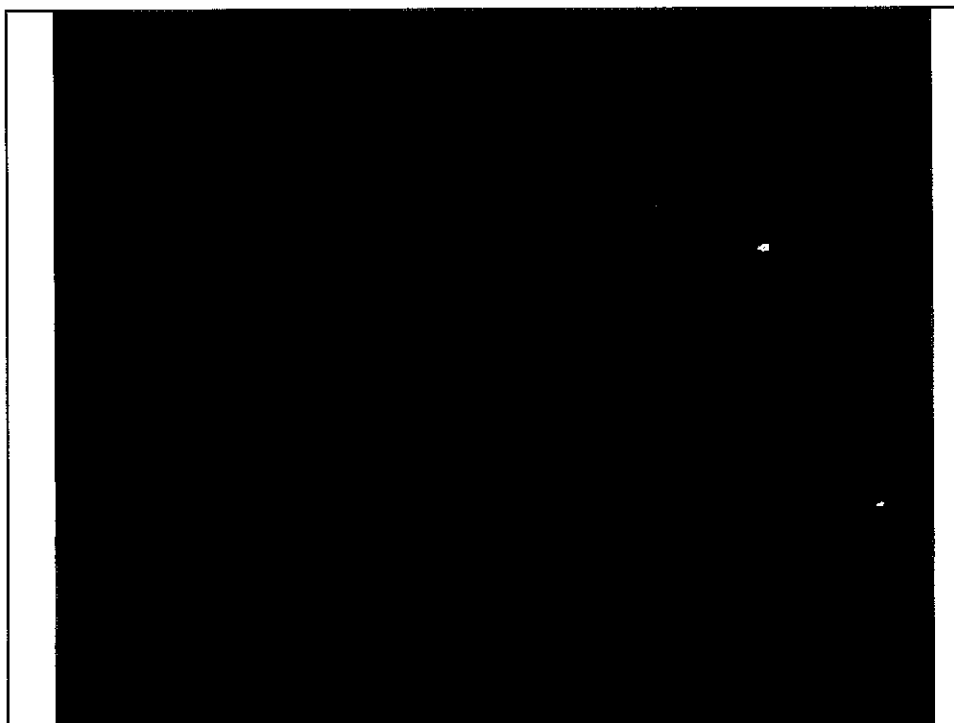
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## “It Coulda Been Worse, Bernie”

- Bernard Madoff
- On June 29, 2010:
  - Sentence of 150 years
  - 71- year-old Madoff would still be looking only the fourth-longest white collar sentence of recent years.
  - For many middle- age convicts that’s a life term.

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## "Madoff's Ghost Still Haunts SEC"

- ▶ SEC Chairman Mary Schapiro
  
- ▶ told Congress during an oversight hearing that 15 of 20 enforcement attorneys and 19 of 36 examination staffers that dealt with the Madoff matter had left the agency


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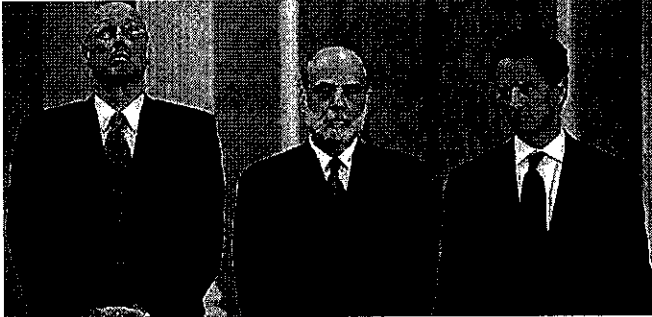
- ▶ Schapiro
  
- ▶ *"These aren't bad people. In some cases they were people who were very junior and not adequately trained or supervised."*
  
- ▶ *"They were pulled from one project to another."*
  
- ▶ The SEC chief also said she has ensured that agency staffers have read letters from Madoff victims to show them how much pain can be prevented when the job is done well.

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## A Financial Crisis With Little Guilt?



“Why in the aftermath of a financial mess that generated hundreds of billions in losses, have no high-profile participants in the disaster been prosecuted?”



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## But Someone is in Prison for What He Had Supposedly Done During the Subprime Bubble: It's Charlie




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**GOLDMAN SACHS**



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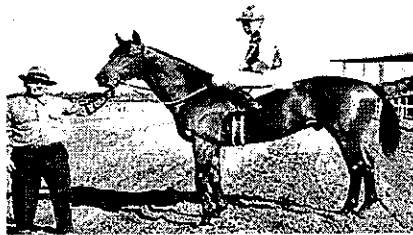
**Goldman: A Tale of Two Horses**

- Horse A
  
- Horse B

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## THE HORSES:

- Horse A- Seabiscuit



- Horse B- Shetlin Pony

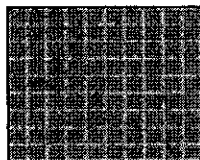


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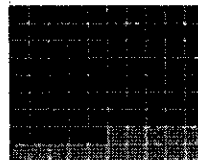
## Goldman and Abacus

### Abacus Meltdown | How the deal turned

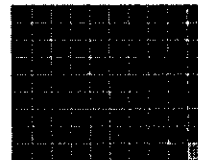
April 26, 2006: 14 losses, Abacus hinges on the performance of 90 mortgage bonds.



By October 24, 2007, 83% of these bonds had experienced ratings downgrades.



By January 29, 2008, 99% of the mortgage bonds had been downgraded.



Source: SEC

By February 2008, the Abacus CDO ranked among the worst, as measured by exposure to downgraded assets.

Deal name	Manager	Underwriter	Percentage of assets downgraded	Asset total balance (millions)
ABACUS 2007-AC1	ACA Management	Goldman Sachs	100%	\$2,000
STATIC RESIDENTIAL CDO 2006-C	None	Deutsche Bank	100	750
ACA ABS 2007-2	ACA Management	UBS	100	750
STATIC RESIDENTIAL CDO 2006-B	None	Deutsche Bank	99	997
TABS 2007-7	Triacca CDO Management	UBS	98	2,275

Notes: For the period April 1, 2007, through Feb. 4, 2008.  
Sources: Wall Street Journal; WSJ research

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## Abacus Deal: As Bad As They Come?

- Both Moody's Investors Service and Standard & Poor's Rating Service placed their triple-A ratings on the Abacus deal.
- The CDO is currently rated near the lowest level possible

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## Goldman: At Issue?

- "Goldman Sachs failed to disclose to investors vital information about the CDO, in particular the role that a major hedge fund played in the portfolio selection process and the fact that the hedge fund had taken a short position against the CDO."



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## Goldman Settles Its Battle With SEC- \$550 Million Deal Ends Showdown That Shook Wall Street

- In one of the largest penalties in Wall Street history, Goldman Sachs Group Inc. agreed to pay \$550 million to settle civil charges that it duped clients by selling mortgage securities that were secretly designed by a hedge-fund firm to cash in on the housing market's collapse.


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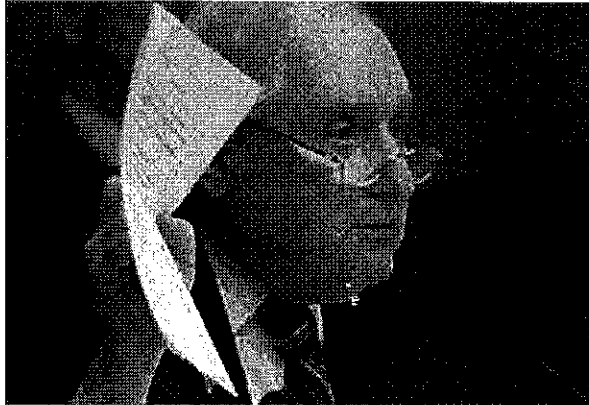
## (CONT.)

- Goldman conceded it made “a mistake” by not disclosing the role of Paulson & Co. to investors for a deal dubbed Abacus 2007 AC1.
- The company wasn't forced to sacrifice any top executives
  - The record-setting penalty is equivalent to just 14 days of profits at Goldman in the first quarter.

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## Goldman and the U.S. Congress



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# Regulator Response

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## Selected Books

- ***Bailout Nation: How Greed and Easy Money Corrupted Wall Street and Shook the World Economy*** by Barry Ritholtz (Wiley, \$25). Explores how the U.S. evolved from a rugged independent nation to a soft Bailout Nation, where financial firms are allowed to self-regulate in good times, but are bailed out by taxpayers in bad times.
- ***The Sellout: How Three Decades of Wall Street Greed and Government Mismanagement Destroyed the Global Financial System*** by Charles Gasparino (HarperBusiness, \$28). Argues that the financial collapse was just the latest in a 30-year pattern of executive excesses, unsustainable leverage, massive hidden losses and unreliable computer models. Gasparino is not optimistic that something similar won't happen again.
- ***The Great Money Binge: Spending Our Way to Socialism*** by George Melloan (Threshold Editions, \$26). Champions the cause of supply-side economics, believing President Obama's adoption of Keynesianism ultimately will result in rising interest rates, higher taxes and disastrous inflation.
- ***The Myth of the Rational Market: A History of Risk, Reward, and Delusion on Wall Street*** by Justin Fox (HarperBusiness, \$28). Attempts to explode once and for all the efficient-market hypothesis, a canon of capitalism. That's the hypothesis that asserts that prices of traded assets reflect all available information, a tough claim to make in the aftermath of the mortgage meltdown.
- ***Last Man Standing: The Ascent of Jamie Dimon and JPMorgan Chase*** by Duff McDonald (Simon & Schuster, \$28). Quits together Dimon anecdotes from first-person sources, resulting in a business bio that's flattering but not fawning. Reveals an able banker who burnishes the reputation of JPMorgan at a time when other Wall Street CEOs watch their companies crumble.
- ***Fool's Gold: How the Bold Dream of a Small Tribe at J.P. Morgan Was Corrupted by Wall Street Greed and Unleashed a Catastrophe*** by Gillian Tett (Free Press, \$26). Digs to the origins of the financial crisis guided by in-depth access to members of the JPMorgan team that developed collateralized debt obligations, revealing how the exotic investment product was conceived on a weekend at the luxurious Boca Raton Hotel in June 1994.
- ***Collateral Damaged: The Marketing of Consumer Debt to America*** by Charles Geisst (Bloomberg Press, \$28). Traces America's credit history and finds it riddled with sleepy regulators, congressional do-badders and slippery financial firms making euphemistic pitches to consumers to drum up business.

## Books Cont.

- ***How Capitalism Will Save Us: Why Free People and Free Markets Are the Best Answer in Today's Economy*** by Steve Forbes and Elizabeth Ames (Crown Business, \$25). A rebuttal to those writing free-market capitalism's obituary. Explains how capitalism really works, arguing that the system is the world's great economic success story despite the financial crisis and the worst recession in decades.
- ***House of Cards: A Tale of Hubris and Wretched Excess on Wall Street*** by William Cohan (Doubleday, \$28). A minute-by-minute account of the last 10 days of Bear Stearns, the 85-year-old investment bank that caved under the weight of a huge position in mortgage-backed securities accumulated without regard to the instability of underlying subprime loans.
- ***This Time is Different: Eight Centuries of Financial Folly*** by Carmen Reinhart and Kenneth Rogoff (Princeton University Press, \$35). A history of financial debacles up to the current crisis, revealing the unending cycle of boom and bust and how politicians and regulators chronically fail to divine recurring signs of bubbles.
- ***The Colossal Failure of Common Sense: The Inside Story of the Collapse of Lehman Brothers*** by Lawrence McDonald (Crown Business, \$27). A Wall Street insider and former Lehman trader reflects on the collapse of the nation's oldest investment bank, a venerable vessel run aground by executives with a reckless addiction to financial leverage and a simplistic grasp of structured finance.
- ***In Fed We Trust: Ben Bernanke's War on the Great Panic*** by David Wessel (Crown Business, \$27). Explains how Bernanke, steeped in the history of miscues by the Federal Reserve during the Great Depression, acted boldly in spearheading the biggest government intervention in more than half a century, effectively making the Fed the fourth branch of government.
- ***The Greatest Trade Ever: The Behind-the-Scenes Story of How John Paulson Defied Wall Street and Made Financial History*** by Gregory Zuckerman (Broadway Books, \$26). Story of how a renegade hedge fund manager outwitted the mortgage-market cognoscenti, betting the market was headed for a major fall, a bet that earned more than \$15 billion for his firm.
- ***Meltdown Iceland: Lessons on the World Financial Crisis from a Small Bankrupt Island*** by Roger Boyes (Bloomsbury USA, \$25). A tale of irrational exuberance and miscalculation by perhaps no more than 30 bankers that wrecked the economy of an island nation of 300,000 people, wiping out all the wealth accumulated the previous decade.



## Books Cont.

- **The End of Wall Street** by Roger Lowenstein, Penguin Press, 368 pages, \$27.95
- **Diary of a Very Bad Year: Confessions of an Anonymous Hedge Fund Manager** (Harper Perennial; 272 pages)
- **The Zeroes: My Misadventures in the Decade Wall Street Went Insane** Randall Lane (Portfolio; 259 pages)
- **The Rise and Fall of Bear Sterns** Alan C. Greenberg (Simon & Schuster; 224 pages)

