Kidder, Peabody & Co.

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In January 1994, Kidder, Peabody named Orlando Joseph Jett, 36, as the recipient of the Chairman's Award, signifying that he was the outstanding employee of the year, in recognition of his performance as head of its government bond desk. 1993 was a good year for Kidder and Jett's best year. To reward Jett for the impressive profits he produced, he received the second largest bonus in the firm: $9 million. Jett said he was proud to be recognized by the firm for his trading performance. In his acceptance speech, he drew an analogy between trading and war.[2]

Joseph Jett

Background

Jett grew up in Wickliffe, Ohio, a small town near Cleveland. After high school, he won a scholarship to MIT,[7] where he earned a bachelor's degree in 1980 and a master's degree in 1982 in chemical engineering.[8] He landed his first job at General Electric's plastics division in Selkirk, New York.

Jett felt stifled by his job. He wanted more responsibility and the opportunity to lead, so he left GE and entered Harvard Business School (HBS) in 1985. While at HBS, he decided to pursue a career in trading. He identified with the students who had worked on Wall Street prior to attending Harvard because of their drive and energy.[10] He obtained his first position in finance as a summer intern at Ford Motor Company working for the group that managed Ford's short-term cash. After receiving his MBA, Jett began his career in trading at Morgan Stanley. He started as a trainee and later became a junior trader.

About two years later he was laid off from Morgan Stanley during a time when the bond market was roiling but stocks were making a comeback from the 1987 market crash. Six months later, he began working at CS First Boston. He was dismissed in early 1991 from CSFB, explaining that the firm discovered he was looking for work at Kidder, Peabody. Former colleagues at First Boston say he was let go because of lackluster performance and for having presented a resume that exaggerated his experience, including his experience as a trader at Morgan Stanley.[14]

Jett Joins Kidder

Kidder hired Jett about April 1991 as a government bond trader (see Appendix I for an explanation of trading) in the fixed income division.[15] It was thought that "as an engineer, he would be adept at quantitative trading techniques."[16] Government bond trading is considered to be one of the most straightforward kinds of securities trading, stressing knowledge of yield curves and mathematics. It was a good place for someone with limited trading experience to start. Jett described the position as his "dream job"[17] and said he worked 12-hour days and then studied at home after hours to learn the job. He was determined to succeed.

At the end of 1991, Jett received a $5,000 bonus (an indication of a poor evaluation by Wall Street standards) along with a warning that if he did not improve his profitability he would be dismissed.

The Turnaround

In 1992, Jett experienced a complete turnaround. Suddenly he was very profitable for the firm and at the end of the year he received a $2 million bonus. Edward Cerullo, Chief of the fixed income division and the number-two executive at the firm, noticed Jett's performance. Jett continued to impress management as he entered the next year. As his monthly profits grew, he was allowed to make larger and larger trades, risking more and more of the firm's capital. Before his arrival, $20 million in annual earnings was the best record for the Government Desk, yet in 1993 Jett's profits ranged from $5 to $10 million per month. Apparently, Jett's supervisors believed that he had invented a new trading technique that had transformed the government bond desk into a powerful money-making asset for the firm.

In March 1993, Jett was promoted to head the Government Desk where he had been a trader for the past two years. He would fill a vacancy created by Melvin R. Mullin, who had been promoted to head up the derivatives trading desk. Mullin, Jett's former boss and the man who had trained Jett, recommended to Cerullo that Jett take his place, citing Jett's outstanding performance as a bond trader.

Cerullo and Michael A. Carpenter, CEO of Kidder, Peabody met early in 1993 to review a list of possible promotions. Cerullo had been watching Jett's profits and slowly increasing the size of the trades Jett was allowed to make. Cerullo championed Jett's promotion because Jett was disciplined and "had a high-energy level, he was very execution-oriented, and he had a drive to succeed."[19] Cerullo and Carpenter decided to promote Jett to head the Government Bond Desk in March of 1993.

Jett, who had joined Kidder only 26 months prior with no prior experience trading government bonds, now had direct responsibility for 32 people and a great deal of authority. Jett's performance and money-making ability continued to impress management, and he was promoted to Managing Director at the end of 1993.

Jett had turned the tide of his unfortunate beginnings on Wall Street. For 1993, Jett's trading activities had generated more than $299 million in profits[20] and accounted for more than one-

quarter of the Fixed income Division's operating profits.[21] This was the performance that led to Jett's being honored with the Chairman's Award and receiving the $9 million bonus.

Kidder, Peabody

Kidder's Acquisition by GE

GE acquired Kidder in 1986 for $600 million as a means of increasing their presence in the then booming financial markets. GE's 1986 Financial Report explains the reason for the acquisition: "Kidder adds value to the Company's financial portfolio in other ways. It gives [GE Capital Corp.] access to a valuable new distribution network in addition to helping create and market new securities. And, by introducing its clients to GECC, it can pave the way for creative financings that combine the talents for both groups."[22] It was expected that Kidder would benefit from the access to GE Capital's "highly sophisticated marketing, systems, and international capabilities."[23] In addition, Kidder was expected to use its Wall Street expertise to find deals for GE Capital and to share its knowledge of Wall Street with GECC.

Kidder reported directly to GE Capital, the huge financial services arm of GE. Having the backing of such a large parent was seen by many Wall Street observers as giving Kidder a major advantage over those competitors without a large industrial parent. Relative to other investment houses that lacked such a sponsorship, Kidder had access to GE Capital's tremendous capital base. Those firms that operated under the traditional partnership, such as Goldman, Sachs, relied heavily upon their partners' capital, which is no match for GE Capital's resources.

Partnerships are operated by their owners. Partners are selected from the traders and investment bankers that work for the firm or are recruited away from other firms. Partners determine the firm's overall investment strategy and consequently the level of risk to which their strategy will expose the firm. Generally, partnerships take a more conservative investment approach because they are, in essence, investing their own money. The culture and compensation system ties the partner's financial gains to the long-term well-being of the firm. Partners generally leave most of their bonuses in the firm's capital account, where it is reinvested to generate more growth for the firm. In other words, it encourages deferring short-term gains (i.e., large cash bonuses) in favor of the long-term rewards of partnership. Employees working for firms like Goldman strive to gain partnership status because of the lucrative payoff they will gain upon retirement, when they cash out of the partnership.

At Kidder, however, the traders were employees. Consequently, their future financial well-being was not so closely tied to the firm's. Since Kidder's traders were not trading with their own money, they were more open to riskier trading strategies because this could mean bigger short-term profits for the firm resulting in bigger annual bonuses for the trader.

In addition, Kidder's management was under intense pressure from GE to produce big profits and to demonstrate rapid growth. As a result, senior management at Kidder chose to adopt a relatively risky investment strategy, leveraging itself significantly more than many of its competitors on Wall Street. Had Kidder been a freestanding partnership, it is less likely that the firm would have chosen such a risky strategy.

The opportunities for synergy and increased revenues that GE anticipated when it acquired Kidder turned out to be less lucrative than expected. Since its acquisition of Kidder, GE had to invest considerable effort and resources into making the firm a serious player on Wall Street. In the late 1980s and early 1990s, GE provided Kidder with approximately $500 million of capital in response to Kidder's business problems. In April 1994, the fixed income market soured and GE again had to infuse Kidder with $200 million in capital funding to save the firm.

When GE acquired Kidder, they expected to gain access to Kidder's "insider" knowledge about Wall Street. Over time however, as GE Capital realized that Kidder did not possess any more knowledge about Wall Street than GE Capital did, the relationship soured. GE Capital employees became disparaging toward Kidder's "stuffed-shirt" behavior increasing the cultural rift. Kidder was expected to bring GE Capital in on big deals. But, rumor had it that GE Capital forced Kidder out of these deals once Kidder initiated them. This, of course, had a negative effect on the morale of Kidder professionals.

General Electric

Under Jack Welch, Chairman and CEO, GE developed a broad diversification strategy that had proven highly successful. Businesses in the GE portfolio had to be number-1 or number-2 in their global market[24] and demonstrate a high growth rate (generally double-digit revenue and profit growth). If a business' performance did not meet expectations, Welch would "fix, close, or sell" the unit.[25] Over the prior 10 years, GE sold off almost two dozen major businesses, which were worth $11 billion and employed tens of thousands of people.[26]

Under Welch's direction, GE was transformed from a rather slow and steady "blue-chip" institution, growing at about the same rate as the U.S. GNP, into a high-powered growth organization that became a Wall Street favorite. By any financial measure, the firm turned in outstanding results. For the 10-year period 1981-1991, GE earnings grew at an annual rate of more than 10% (to $4.4 billion of earnings on revenues of $60 billion), which was 1½ times the GNP's growth rate for the same period.[27]

In order to accomplish this feat, Welch adopted his strategy of diversification and then set about changing the culture of the organization. He diversified into three main types of business: Services (financial, information, and television), Technologies (aerospace, aircraft engines, medical, and plastics), and Manufacturing (appliances, power systems, motors, and transportation systems). He slashed overhead and decentralized the organization--reducing layers of management and pushing decisions down the hierarchy. GE eliminated the "entire second and third echelons of management."[28] This meant that the 14 Strategic Business Units (SBUs) now reported directly to the three most senior people in the organization, which included CEO Jack Welch and Vice Chairmen Edward Hood and Lawrence Bossidy.[29]

This was a sea change for the historically bureaucratic organization of GE. Traditionally, the norm was for employees to push decisions up the hierarchy. Referring most major decisions up the chain of command had been ingrained in the culture long before Welch took over. This "cultural habit" probably had its roots in GE's historical focus on manufacturing, especially for those products operating in rather stable environments, such as dishwashers and lighting.

In order to bring about the cultural shift, Welch emphasized a philosophy of leadership, not management. In other words, he pushed his employees to become more autonomous in the hopes that they would take responsibility for their actions and decisions. This was intended to increase GE's ability to respond to the demands of the many different markets in which it operated. Welch sums up his philosophy:

> The old organization was built on control, but the world has changed. The world is moving at such a pace that control has become a limitation. It slows you down. You've got to balance freedom with some control, but you've got to have more freedom than you've ever dreamed of.[30]

Management Team

For the first three years that GE owned Kidder, they left Kidder executives to run the business. There were troubles with the Kidder unit from the first day that GE completed its acquisition. Siegel, a Kidder trader, was found guilty of insider trading, and, as a result, management and controls at Kidder were seriously questioned. Other problems followed, and in 1989 Welch decided that a manager with strategic and general management skills would be better suited to take on the tremendously difficult task of straightening out Kidder's many problems.

Welch appointed Michael A. Carpenter to the position of CEO of Kidder, Peabody. Carpenter, a personal friend of Welch's, came from GE's Chairman's Office, where he handled strategic issues. Prior to joining GE, Carpenter had worked for many years as a consultant but he had no prior experience on Wall Street. In fact, he remained unlicensed to run a brokerage firm by the SEC from January 1989 through March 1993.[31]

Consistent with GE's growth requirements, Welch wanted to see strong profit growth from Kidder. There was a good deal of resentment among the ranks at Kidder that an "outsider" had been appointed to lead the firm. Carpenter had to work to gain the acceptance of Kidder employees while striving to achieve the growth Welch demanded of Kidder. Carpenter knew he had to find a way to make Kidder a leader in at least one market and identified mortgage-backed securities (MBSs) as the market segment where Kidder would make its mark. He developed a strategy that emphasized aggressive underwriting in MBSs and sought to control costs. Welch supported this strategy and helped finance it through a large standby credit line made available to Kidder by GE.

As one industry expert pointed out, the impact of these decisions had many implications for the way that the firm developed over the next few years. Through the focus on MBSs and on improved profitability in the rest of the fixed income division, Kidder suddenly became very trading oriented. In a certain sense, Carpenter's strategy was spot on, because the fixed income markets were in a bull market for much of the 1980s and early 1990s. There were two weak links in Carpenter's strategy. One was that the infrastructure (systems and controls) needed to support a heavy trading environment, and the other was the need for traders with sufficient skill and experience. As a result, Kidder often promoted less experienced traders into positions of responsibility (relative to their competitors).[32]

When a firm like Kidder underwrites an issue of a given security, they agree to sell an issuer's security to the public. The practice of underwriting requires that the underwriting firm buy any unsold inventory of the security from the issuer. This can expose the firm to substantial risks, particularly if the value of a security is sensitive to changes in market interest rates (e.g., bonds) or other variables.

Under Carpenter, Kidder's overall standing improved from the rank of tenth-largest underwriter of all new debt and equity issues in 1990, to fourth in 1993. This growth was largely driven by Kidder's aggressive underwriting in the MBS sector. In 1989, Kidder underwrote roughly 5% of new MBS issues. This shot up to almost 15% in 1990. By September 1994, Kidder was the number-one MBS underwriter, controlling almost 25% of the market and holding a very large inventory in MBSs.[33] It is noteworthy that none of Kidder's competitors challenged their bid for ownership of the MBS market. Competitors did not see MBSs as an attractive market because of its inherent low liquidity. Some industry observers even take the perspective that Kidder's competitors took advantage of Kidder's strategy and began dumping their MBS inventory on Kidder.[34]

Like many of its competitors, Kidder financed much of its underwriting activities with debt. As of the end of 1993, Kidder was so highly leveraged that every $1 of equity was supporting $93 of assets.[35] Compared to the industry average of $1 equity to $27 assets, they had taken a very high risk position. According to one source, a 3.2% decline in the value of its portfolio could have wiped out Kidder's entire net worth.[36]

Cerullo, who reported to Carpenter, was largely credited with turning Kidder around. It was through his direction of the fixed income division that Kidder became the lead player in MBS underwriting. His division was not only Kidder's most profitable business (in percentage terms), but also the firm's largest contributor to operating profits (in dollar terms). In 1993, Cerullo was responsible for managing $100 billion in assets, $20 billion in daily transactions, $1 billion of earnings, and about 750 people, including traders.[37] Cerullo was given a great deal of latitude in running the division, which he operated out of a separate building from the rest of Kidder.

Over time, Cerullo's responsibilities grew. One former trader explains, "Anytime something new came along, whether a new futures or derivatives product, Ed was given responsibility. Gradually he was just given responsibility for everything [in the fixed income division]."[38] Because his division produced the majority of the firm's profits, Cerullo was, "given something akin to carte blanche to run his own show."[39]

Cerullo relied on a number of reports to keep himself up to date on the activities of his many traders. These reports included inventory reports, Profit & Loss statements, control reports, and risk management reports.[40] In order to strengthen the system of checks and balances in the fixed income division, Cerullo also hired a separate risk manager, financial analyst, and compliance officer just for his division.[41] His risk manager was an accountant named David Bernstein, Manager of Business Development. He was considered to be Cerullo's right-hand man, responsible for risk management as well as trouble shooting.

Traders had a variety of perceptions of Cerullo's management style. Joseph W. Cherner, a former top trader at Kidder said, "Ed is an extremely gifted manager.… Ed is not easily fooled. He's very skeptical, very thorough, very street smart."[42] Another former Kidder trader described Cerullo's style like this: "If [he] thinks someone is doing a good job, he gives them absolute carte blanche. He's a very trusting person."[43]

On the whole, traders summed up the culture under Cerullo as "produce or perish." Traders were expected to produce profits for the firm or be fired. Former fixed income traders were so leery of reporting losses to Cerullo that they would often under-report profits in order to build up a reserve for use in months when they had a loss.[44]

One authority attributed the high pressure culture at Kidder to their practice of principle trading, which means that the firm used its own capital to trade. This practice can be highly profitable, but it is also highly risky. Traders can be described as "superstar gunslingers. They're like baseball players who are free agents--they're trying to maximize their income in the short term. The firms have encouraged this because they have made so much money."[45]

Control at Kidder

For Wall Street firms, issues of compliance and control are serious business. There are a number of important federal laws that have been enacted to insure a stable and orderly market. These laws are enforced through a variety of government regulations and company controls designed to insure compliance (see Appendix II for an explanation of government regulations). Further, without appropriate controls traders could expose firms to disastrous losses.

The Chief Financial Officer (CFO) at Kidder, like that at most of its competitors, had a special management function which included oversight of compliance and controls among its responsibilities. Kidder's CFO Richard O'Donnell commented in April 1994, "I've got great comfort, as the person who signs off on our numbers, knowing that my corporate parent is devoted to total compliance."[46] He went on to explain that GE's financial auditors were "swarming" all over Kidder to insure that their controls were better than their competitors.[47]

Kidder was subject to external audits by GE's corporate auditors every 18 months. Kidder also relied on an automated accounting/control system, as well as internal audits by Kidder accountants. In addition to accounting-based controls, Kidder, like other firms, relied upon management to insure compliance. As Chief of the fixed income division, Cerullo was ultimately responsible for the performance and actions of the traders who worked under him. It was Cerullo's responsibility to understand his traders' practices and trading techniques. Cerullo, as head of the division, set the tone for compliance practices in his division.

The Event

Beginning of the End

Early in 1994, the computer system began having difficulty keeping up with the volume of trades that Jett was making.[48] Specialists were called in to fix the computer system. What the

Information Systems (IS) specialists found was astounding. During Jett's tenure with Kidder, he had entered $1.7 trillion in trades into the Kidder system (this is almost one-half of the total dollar value of Treasury securities currently estimated to be held in private hands).[49] The IS specialists discovered that none of Jett's trade deals were ever consummated. This meant that while no securities had ever changed hands, the profits associated with these allegedly fictitious trades had been accounted for as income on Kidder's books.

Once the computer specialists realized the gravity of the situation, they called in the accountants and senior executives, including Cerullo, to investigate. Cerullo's risk manager, David Bernstein, began an in-depth audit and found a "distortion" totaling $300 million on Jett's trading book.[50] In mid-March 1994, Cerullo notified Carpenter about the situation and asked for dedicated resources to investigate the matter further.

By early April, the findings of Kidder's investigation validated their initial fears and showed that the problem would significantly impact Kidder's profitability for 1992 and 1993. The week of April 11, Carpenter notified Welch that the problem would likely affect Kidder's profitability and would result in a major loss of capital. As the accountants continued to dig, the magnitude of the problem grew. Kidder claims that Jett had created some $350 million[51] in false profits and had hidden approximately $85 million in real losses. Kidder officials notified regulators at the Securities and Exchange Commission (SEC) and the New York Stock Exchange that it expected to report a major loss of capital.

Jett traded government strips, which involves separating the bond's principal and interest components into two separately traded issues. If the demand for bonds is higher than for the strips, as many as 60 interest payments (zero-coupon bonds) could be reconstituted into a traditional coupon-bearing bond (referred to as a "recon"). Since Kidder's computer system was not capable of "making dozens of zero-coupon bonds disappear in a reconstitution and then making a conventional bond materialize,"[52] the exchange was recorded as the sale of the zeros and the purchase of the coupon bond. Kidder's computer system, however, inappropriately allowed "recons" to be settled up to five days in advance.[53] Jett would enter into "forward" contracts, which joined the principal and interest components together at a later date. This enabled Jett to record "profits on the day he entered [the recons] that would vanish by the time the trade was settled."[54] Instead of settling when these forward contracts came due, Jett would roll them over, allegedly leaving the profit on the books.[55] In order to keep the system going, Jett allegedly had to continually increase the value of his portfolio, meaning the system operated much like a pyramid scheme. This could explain the tremendous volume of trades in early 1994.

On Thursday, April 14, Jett was summoned to a meeting of senior Kidder executives to answer questions regarding the matter of his questionable trades. Jett denied that his trading practices created false profits. He explained that in response to the firm's efforts to slash assets, he was using a hedging strategy.[56]

According to Cerullo, Jett acknowledged that his forward recons resulted in false profits. But Jett denied this alleged admission, and it was his refusal to appear for an interview with Gary Lynch, a former SEC enforcement chief hired by Cerullo to investigate, which ultimately led to his dismissal.[58] On the evening of Jett's dismissal, General Electric issued a press release stating that

it would have to reduce its after-tax profits for 1993 by $210 million because of the false trading profits reported by Jett.[59] The firm also froze approximately $8 million of Jett's assets that were held in various accounts at Kidder.[60] Jett maintains that "he was singled out for blame to insulate GE from shareholder lawsuits."[61]

Controls and Jett

GE's last audit of Kidder's books was at the end of 1992. This audit, GE says, concentrated on mortgage derivatives and government options to insure the firm was hedging their risk properly. According to GE, "the Treasuries desk was not involved" in this audit.[62] This might explain why GE did not find Jett's irregular trades, which dated back to early 1992.

Kidder's internal auditors reviewed Jett's trading desk twice in 1993, but according to the Lynch Report (a review of the Jett incident performed for GE by its outside counsel), the auditors were inexperienced, and Jett misrepresented his desk's activities to the auditors.[63]

Former Kidder traders described Kidder's accounting system as unsophisticated.[64] While Kidder's computer software "system appeared to be at the vanguard of Wall Street's high-technology revolution, [in] reality, it was a silicon veneer over a patchwork of archaic computer systems based on software written before Neil Armstrong walked on the moon in 1969."[65] For example, zero-coupon bonds (the type of bond Jett traded) were tracked in the system by price rather than yield. This practice overstated the profits of the securities from the time they are entered into the system. Furthermore, tracking such a security by price does not provide an accurate valuation in a dynamic marketplace. This is because the value (or price) of the bond fluctuates with changes in the market interest rate. In the words of one former Kidder trader, Robert Dickey, "You can make a temporary profit, but it's not real."[66]

Employees had raised questions about Jett's trading practices as far back as 1992. Hugh Bush, a trader who worked alongside Jett raised questions about Jett's sudden profitability with supervisors. He believed Jett was mismarking or misrecording his trading positions. The practice of mismarking is illegal and carries heavy penalties by the SEC for the firm and the trader if discovered. Bush was fired for what Kidder described as an unrelated reason immediately after raising these questions, and Cerullo never investigated Bush's accusations.[67]

In May 1993, a Kidder accountant realized that there was a defect in the system's set-up. Charles Fiumefreddo suggested that the accounting system be changed to correct this flaw. The change Fiumefreddo suggested would have exposed Jett's alleged irregular trading activities. Jett is purported to have opposed this change and it was never implemented.[68]

In late 1993, Brian Finkelstein, another Managing Director at Kidder, questioned how Jett could be so profitable in light of the Government Desk's historical profitability. He spoke with Bernstein, Cerullo's right-hand man, about his concerns. The Lynch Report states, "According to Finkelstein, Bernstein also stated that Cerullo was aware of Jett's trading activities."[69] There is no mention in the Lynch Report as to whether the issue of possible wrongdoing on Jett's part was ever investigated.

It is interesting to note that soon after the Jett scandal erupted in 1994, two other Kidder traders were fired for allegedly hiding losses. In April, Kidder fired Neil Margolin for purportedly hiding $11 million in losses on a bond-derivatives transaction. In June, Peter Bryant was fired for alleged hiding losses totaling $6 million on a number of options trades.[70]

A History of Control Issues--Kidder Management

According to former Kidder traders, Kidder management practices differ from those of other firms. Kidder executives, according to Kidder traders, don't spend much time on the trading floor. This is in sharp contrast to the practices of other firms' managers, who see it as their duty to verify the reports generated by the audit and control functions. Some firms go so far as to plant spies on the trading floor to watch for any irregular or odd trading activity.

One fixed income manager at another firm commented, "It's a general manager's responsibility to know what your trading practices are. [Cerullo] should never have had to rely entirely on secondary sources, including the firm's accounting department. You have to rely on your own direct questioning as a manager, no matter how senior you are."[71] Another manager remarked about Kidder, "The top of the firm didn't understand the business."[72]

One former Kidder trader, Mark Pinto, commented that Cerullo, "didn't care how profits were made."[73] In fact, the Jett scandal was not the first issue of questionable practices in the bond department. In 1985 there was a deal involving the sale of bonds from Kidder to a Texas thrift institution. Kidder allegedly took a 29% profit ($6.3 million) when the maximum profit allowable under regulatory guidelines for this type of trade was 5%. Cerullo was involved in this deal, and Kidder settled the matter by agreeing to pay $3.7 million in 1990 just before the case went to arbitration.

In another instance in 1988, a Kidder trader in Cerullo's division, Ira Saferstein, took advantage of a pricing error made by CS First Boston. The error cost First Boston $1.1 million, according to an investigation by the National Association of Securities Dealers (NASD). After the investigation, NASD fined both Kidder and Cerullo for failing to reverse the trade later. Further, once NASD had released its findings in the matter, Kidder balked at refunding First Boston the $1.1 million.[74]

Perhaps more significant than any of these events were comments made by a former Kidder trader when questioned about his trading activities while working for Cerullo. Walter Mihailovich quit his trading job with Kidder to join a rival firm and left Cerullo with an options position that began to accumulate losses due to market movements. According to former traders, what followed exemplifies the lengths to which Cerullo would go to avoid posting a loss to his books.[75]

Cerullo accused Mihailovich of erroneous record keeping and called in GE's legal counsel and auditors. In the course of a subsequent investigation, Mihailovich explained to the auditors that traders working under Cerullo in the fixed income area were "given latitude in working with the back office to mark their own closing positions."[76] Former traders explained that this practice

gives traders more flexibility to work with different market closings. In addition, it can help traders make the books look better.[77]

Following an internal investigation of the Jett incident, both Kidder and GE "acknowledged intolerable lapses of supervision."[78] Another issue that was raised by the media some time after the Jett scandal erupted was the licensing of senior managers. *Fortune* magazine pointed out that Carpenter was not licensed as a broker-dealer until March 1993, yet he had been running the firm since January of 1989.[79] If a firm or individual fails to register with the SEC (i.e., get licensed) they can be fined up to $50,000 or be suspended from the securities business.

Management's Comments

On a purely technical basis, it was an accounting loophole in Kidder's system that made Jett's alleged trading practices possible. Carpenter commented, "Is this a sloppy firm that doesn't care about risk management and controls? No way. No way. We are very diligent about it." He went on to say, "There is no system in the world that cannot be beaten by somebody that is determined to game it."[80]

Cerullo and Mullin (Jett's first boss at Kidder) both claim that they relied on internal reports to keep tabs on their traders, including Jett. According to the Lynch Report, one of the reasons they did not catch Jett's irregular trading activities was because the Kidder accounting system did not distinguish between realized profits (resulting from the sale of securities) and unrealized profits (resulting from increases in the value of securities in inventory).[81]

Cerullo commented about the Jett affair, "To hang me with the responsibility, singularly or solely, for detecting or not detecting this is unreasonable. This isn't one guy running the department with a lot of spies running around." As regards his responsibilities as a supervisor, Cerullo says that the internal controls he developed and implemented "meet industry standards."[82]

Jett's Comments

Jett and his lawyers have remained steadfast in their position that Jett is innocent. Jett claims that he filed his trades every day, and that his trading positions were monitored regularly by his superiors.[83] He also pointed out that Kidder's management felt sure enough of his trades to report them as profits in their financial statements.[84]

Jett comments, "Kidder has presented no factual evidence, so it became necessary to destroy the character of the person they were accusing. They have done it in spectacular fashion. They are very, very good at that. It is basic crisis management. Put all the blame on one person. It becomes necessary to destroy that person's credibility through the media."[85]

Industry Experts' Comments

David Beim, Professor, Columbia Business School:

> I think that people are sometimes driven to this by the way that Wall Street firms, or at least some Wall Street firms, compensate their people, and I think there's an important lesson to be drawn for managements of Wall Street firms about compensation policy.[86]

Samuel Hayes, Professor of Investment Banking, Harvard:

> I can't believe others didn't know about [Jett's alleged trading activities].[87]

Roy C. Smith, Professor of Finance, NYU, Salomon Center:

> I think [Jett] stumbled upon a way to make money on the firm's computers, and probably thought (at least at first) that the money was real. Lots of people must have known what his trading strategy was, though few figured out how much trading had to be done downstream to keep the game going. It is telling, I think, that $8 million of the $9 million paid to Jett was still in his brokerage account when the dam broke. If he was trying to cheat Kidder, why leave the money where it could be frozen.[88]

The Sale of Kidder, Peabody

Although Kidder, Peabody was able to liquidate Jett's trading portfolio at an $8 million profit (despite expectations of a $25 million loss), the firm experienced large losses on its fixed income trading positions in 1994. Further, Kidder has been "merged out of existence,"[89] with rival PaineWebber Group Inc. taking over selected businesses and GE Capital "warehousing" the left-over assets (primarily MBSs).[90] GE received common and preferred Paine Webber stock, estimated to be worth $670 million, in exchange for Kidder's U.S. brokerage, asset management, investment banking, equity research, international and domestic fixed income, commercial mortgages, and U.S. futures businesses.[91] GE now holds one seat on Paine Webber's board and a 25% stake in the company.[92] This allows GE to maintain a presence on Wall Street without the responsibility of actively managing a Wall Street firm.

Roy C. Smith, Professor of Finance at NYU's Salomon Center points out that while the Jett affair, "was embarrassing and revealed management and control problems,...it was the unrelated losses in MBSs that seriously destabilized the firm leading to its sale."[93] This view was later supported in a *Wall Street Journal* article, "Kidder, Peabody's Most Severe Financial Strain Stemmed From its Huge Portfolio of Mortgage-Backed bonds"--$12 billion at the beginning of 1994[94]--which were hit very hard with the interest rate hikes. This essentially paralyzed the firm by deflating the value of its tremendous MBS portfolio, thereby crippling Kidder's ability to underwrite new MBS business.[95] In September 1994, Kidder's inventory of MBSs were transferred to GE capital, clearing the way for the company to be sold.[96]

As explained earlier, Carpenter's strategy of becoming number-one in MBSs was a highly risky strategy, given the low liquidity and high volatility of these securities. As interest rates rose, Kidder took huge losses on their MBS portfolio, and by the first quarter of 1994, they needed GE to step in with a capital infusion to keep the firm solvent.

Where Are They Now?

Joseph Jett was acquitted of criminal charges in 1996 after being sued by Kidder for $82.8 million in fraud claims. Although the National Association of Securities Dealers rejected Kidder's claims, $5 million of Jett's funds remained frozen while an arbitration panel and/or the courts decided who should be responsible for legal fees. $1 million of Jett's bonuses was awarded to him after a securities arbitration panel ruled that Kidder was not able to prove that he engaged in "fraud, breach of duty and unjust enrichment."[97]

Civil administrative changes were also brought against Jett.[98] On July 22, 1998, after two years of deliberation, Carol Fox Foelak, an administrative law judge at the Securities and Exchange Commission (SEC) decided that Joseph Jett violated the Exchange Act by keeping false books and records as part of a fraudulent scheme that lasted more than two years. He was not found guilty of securities fraud because his actions weren't "taken in connection with the purchase or sale of any security".[99] The judge ruled that Jett had to return $8.2 million in bonuses he received from Kidder Peabody. In addition, he was barred from being associated with any brokerage firm and fined $200,000. Her 54 page ruling depicted him "as a Wall Street scoundrel."[100] She said that he "exploited an anomaly in Kidder's software, in the manner of a pyramid scheme, that credited him on Kidder's books with enormous, but illusory profits. He did this with an intent to defraud.[101] She also rejected his claim that he was directed in his trading by his supervisors, stating that "I find that Kidder's management did not affirmatively approve" what he did.[102] Kenneth E. Warner, Jett's attorney, pointed out that his client was not found guilty on the most serious charge of fraud and that he would appeal the charges on which he was found guilty. The SEC is considering an appeal of the part of the case it lost.

Mr. Jett commented that "We knew going in that the chances were I was going to be found guilty. But [the judge] turned into a contortionist in order to find me guilty…. When you have a 95 percent conviction [rate] . . . that is a system that in itself needs to be changed."[103] Despite Jett's observations, some Wall Street executives indicated surprise at the degree to which the judge did not go along with the SEC's allegations, suggesting a growing trend toward independence of SEC administrative law judges.[104] Jett pointed out that the $3.7 million he earned that the government did not question, over and above the $8.2 million it demanded back, still ranked him as one of the Street's top bond traders.[105]

Currently Jett is writing a book on his career at Kidder and managing money for some friends.[107]

Michael A. Carpenter was forced to resign from his post on June 22, 1994. This was largely due to the loss of confidence that the Jett scandal caused among clients and lenders.

Edward A. Cerullo was forced to resign on July 22, 1994, just one day before the Lynch Report was released. Although the Lynch Report did not find any wrongdoing on Cerullo's part, the

report questioned his supervision. The SEC charged Cerullo with failing to supervise Jett's trading activities. In 1996, Cerullo settled the charge, paid a $50,000 fine, and was suspended from working in the securities industry for one year. He was paid $9 million in severance and deferred compensation by Kidder.[108]

Melvin R. Mullin was forced to resign on August 3, 1994. He settled civil sanctions, paid a $25,000 fine, and was suspended from working in the securities industry for three months.[109]

David Bernstein was demoted for his "incorrect analysis, [which] contributed to the failure to detect Jett's trading abuses,"[110] but was never legally accused of any wrongdoing.

Appendix I

Trading[111]

Some firms, like Kidder, Peabody, are primary dealers. They have the right to buy government bonds directly from the Federal Reserve. In exchange for this privilege, they are required to make a market in government securities. This means they must provide access to government securities for the rest of the market, selling from their own inventory or buying from a seller when they cannot match up market buy and sell orders externally. This insures that the market operates efficiently and fairly for all participants. In exchange, the primary dealers have the opportunity to corner the market on a given issue (i.e., buy up all inventory for an entire issue and become the sole source for that issue), giving them the opportunity to make additional profit on that issue.

Primary dealers utilize traders to carry out the buying and selling of securities. Traders are allocated a certain amount of the firm's capital with which to carry out their trading activity. Traders set the prices at which they are willing to buy or sell a given security. In the process of making these trades they are trying to generate profit for the firm. As traders prove their ability to trade profitably, they are often allowed to take larger positions; that is, they are able to risk more of the firm's capital base. Essentially, traders working for one firm are competing against other traders at other firms.

Traders operate in an extremely fast-paced, high-pressure market environment. This requires an aggressive, highly self-confident personality, combined with an ability to live with high-risk situations. To be successful, traders must be facile with mathematics, have a very strong knowledge base about the securities they trade, and understand how changes in the economy will impact that security.

Traders generally specialize in one type of security. For example, in the case of Kidder's government desk, the traders specialize in government debt instruments. Within this area there are three basic sub-specialties based upon the maturity of the debt instrument--Treasury Bills (maturity of one year or less), Treasury Notes (maturity of one year to 10 years), and Treasury Bonds (maturities longer than 10 years).

The head of a desk, also called a trading manager, sets the strategy for the firm by determining the level of risk their traders may expose the firm to--called a risk position. This is a dynamic process, and managers may change their instructions frequently to insure fit between the firm's strategy and the current market situation. The manager must have an in-depth knowledge of all the different maturities within the security they manage in order to develop a successful strategy for the firm.

Both traders and trading managers are paid a salary plus bonus. Bonuses often exceed the trader's salary. The bonus a trader receives is based on the trader's profitability for the year. The trading managers' bonus is based upon the profitability of their desk for the year. In 1993,

another Kidder trader--Michael Vranos received more than $14 million as a bonus for his trading. Cerullo, the head of the fixed income division received at least $15 million (some estimate it at $20 million) in bonuses for 1993.[112]

Appendix II

Controls--An Industry Perspective

Given the large amount of capital with which traders work and the nature of a reward system that focuses almost exclusively on profitable performance for traders, traders can be faced with great temptation to cheat. Therefore, the issue of controls is very important in managing traders. These controls are designed to insure that traders work with the legal strictures of the highly regulated securities industry and the objectives, policies, rules, and procedures of the firms that employ them.

The Securities Act of 1933 was passed to protect investors by requiring the full disclosure of relevant information relating to the issue of new securities. The Securities and Exchange Act of 1934 was enacted to establish the Securities and Exchange Commission (SEC). The SEC's main purpose was to administer the 1933 Act, by insuring that the relevant facts are disclosed by firms seeking to raise funds in the securities exchanges, Over-the-Counter (OTC) trading, brokers, and dealers (such as Kidder).[113]

The SEC's primary responsibility is to oversee the securities market. The SEC shares its oversight responsibilities with other regulatory agencies, such as the Federal Reserve. The Fed is responsible for the health of the U.S. financial system and enacts regulations to insure an orderly and stable securities market.[114]

Because the securities market is so big, the SEC delegates much of the day-to-day responsibility for oversight of trading to secondary exchanges (e.g., NYSE). In addition, much of the securities industry is self-regulated through professional organizations such as the National Association of Securities Dealers (which oversees OTC trading).[115]

One of the SEC's responsibilities is to make sure that firms such as Kidder insure compliance with regulations through adequate controls on their trading floors. In order to increase pressure on these firms, the SEC has recently been placing greater emphasis on the responsibility of supervisors to insure that traders do not engage in any illegal transactions. In may cases over the last few years, supervisors have been fined or otherwise censured if a subordinate is found guilty of illegal trading activities.

Investment houses take this responsibility very seriously and have devised a number of ways to insure compliance. Most firms rely upon a combination of close supervision by management and computerized systems to track traders' activity and their ensuing profits/losses. Since these methods are often not enough, some firms, such as Goldman, Sachs, have made ethical standards

a part of their cultural norms. Others, like Bear Stearns Co., employ in-house spies on the trading floor to investigate oddly priced or risky trades.[116]

The penalties for being found guilty of illegal trading activities range from fines to being barred from working on Wall Street for a few years to life. The much publicized Milken case is one instance where a trader was barred from trading securities for life. In other instances, traders and/or their supervisors have been fined $5,000 or more.

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