Kidder, Peabody & Co.: Creating Elusive Profits

On April 17, 1994 Kidder, Peabody & Co. announced a $350 million pre-tax charge against earnings resulting from the discovery of false trading profits. That same day, the termination of Joseph Jett’s employment with the company was made public.

This was the final event of a story that began in November 1991, four months after Joseph Jett joined Kidder, Peabody & Co. During this time, Jett allegedly accumulated trading losses of $85 million dollars, while his profit and loss statement showed $264 million in profits. Notwithstanding these losses, his trading performance had been praised by his supervisors and colleagues, and was reflected in the year-end bonuses awarded to him. The financial world was kept wondering what went wrong and how much Joseph Jett was to blame.

Origins

Kidder, Peabody & Co. was organized in 1865 at 40 State Street in Boston, by Henry Kidder, Francis Peabody, and his brother Oliver Peabody. The three partners had been employed at J.E. Thayer & Brother, founded in 1824, and created their partnership when Nathaniel Thayer decided to retire and turn the business over to them. The company grew during the last part of the 19th century and beginning of the 20th century to become the leading banking house in New England and a major player in the U.S. financial market. In 1868, as New York was eclipsing Boston as the nation's investment banking center, an office was opened at 45 Wall Street. Boston remained the main office until the market crash of 1929.

The firm was hit hard by the debacle of 1929. It survived with the help of several investors who valued the goodwill represented by the Kidder, Peabody name and injected the cash needed to rescue the firm. A new partnership was founded in March 1931 taking over the old Kidder, Peabody & Co. name. Based in New York, its partners were Chandler Hovey, Edwin Webster, and Albert

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1Source: "Report of Inquiry Into False Trading Profits at Kidder, Peabody & Co. Incorporated" by the law firm of Davis Polk & Wardwell, New York, dated August 4, 1994. The investigation team was headed by Gary G. Lynch, a former Director of the SEC’s Enforcement Division, and the document is generally referred to as the ‘Lynch report’. Much of the factual information provided is drawn therefrom.

Gordon. The firm survived the difficult thirties and regained its position among the leading investment banking houses by the end of World War II.

By 1985, Kidder, Peabody & Co., with $363 million in capital, was ranked 15th in the industry. Unlike many of its competitors, the firm had funded its growth through accumulated profits which limited its growth opportunities. Competitors were bolstering their capital by issuing shares to the public (e.g., Morgan Stanley), or were being acquired by large corporations (e.g., Salomon Brothers). Finally, in early 1986, 80% of Kidder’s equity was sold to General Electric (GE) for $602 million. In 1990, GE increased its ownership to 100%.

GE Capital Services (GECS), the financial subsidiary of GE to which Kidder, Peabody & Co. reported, was the largest diversified finance company in the United States. Kidder’s new financial strength, combined with its investment bank knowledge, promised to make Kidder “a very powerful institution if they integrate people right”.

During the first years of the combination, the firm was run by Kidder insiders. But in January 1989, Michael A. Carpenter, a GE executive, was named CEO of Kidder, Peabody & Co.

Carpenter, who previously held the number two position at GECS, had managed leveraged-buyout loans and takeover deals. He had no experience in brokerage but he intended to bring GE’s successful management practices to Kidder, driving the investment bank to achieve the number one or number two market position required by GE’s chairman Jack Welch. Carpenter's plan for Kidder was:

‘First, to reestablish the firm's total commitment to integrity ... 'that's numbers 1 to 10'. Second, Kidder was to have a well defined strategy for each business—a GE mandate for all of its businesses. Third, to develop Kidder's people. Fourth, the firm needed to cut overhead, to become 'cost effective.' Fifth was to develop a successful synergy with GE Capital. And sixth was to build a winning culture.'

Carpenter’s strained relationship with the head of GECS, Gary Wendt, (described as "intense and well known animosity") constrained his initial enthusiasm to integrate Kidder into GECS and take advantage of the synergies that were still mostly unrealized. During this period, several key managers left the firm seemingly unhappy with the “get-tough moves” of the parent company. Cost cutting had reduced their bonuses despite an increase in Kidder’s profits. This drop in bonuses was very noticeable in an industry where bonus pay-outs could be several times the basic salary of a successful employee and competing firms were continuously vying for top performers.

The performance of Kidder, Peabody & Co. under GE’s ownership is shown in Exhibit 1.

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3Business Week, May 12, 1986, p. 27.
Organization

With training from MIT and Harvard Business School, Joseph Jett was hired by Kidder, Peabody & Co. in July 1991. At the time he was 33 years old. He had worked previously as a bond trader at Morgan Stanley for two years and at First Boston for eighteen months. In one of them he floundered and was laid off, in the other one he was fired. Jett’s job was to trade the long-end market (maturities of ten years or longer) for STRIPS—a type of zero coupon financial instrument related to U.S. Treasury notes and bonds.

Together with Jett, three other traders covered the various segments of the market for zero coupon government instruments. The traders in the zero coupon desk were supervised by the head of the government desk, Melvin Mullin, who had been in that position since June 1988. Mullin was succeeded, at his own recommendation, by Jett in February 1993 when Mullin was appointed head of the derivatives division. Exhibit 2 presents the relevant organizational structure of Kidder, Peabody & Co.

The government desk grouped together all the traders involved with government-related instruments. It was part of the Fixed Income Division which employed over 700 people, accounted for the majority of Kidder’s earnings, and was responsible for over 90% of Kidder's balance sheet in 1992 and 1993. It employed a large salesforce and had 12 different trading desks each one in charge of a different type of fixed-income instrument: government securities, corporate debt securities, derivative products, municipal securities, and collateralized mortgage obligations.

Edward Cerrullo, a skilled and knowledgeable trader, had headed the Fixed Income Division since 1986. Kidder’s new CEO, Michael Carpenter, had little experience in securities’ trading and relied heavily on Cerrullo’s experience to run the Fixed Income Division. Cerrullo was also a member of Kidder’s Board and of several internal committees. He supervised the management tasks of the various desk heads and the trading performance of those desk heads who were also active traders. Jett, at the time he was promoted to head of the government desk, remained an active trader and, accordingly, was supervised directly by Cerrullo.

Cerrullo was assisted by David Bernstein, manager of business development, and by a risk manager responsible for ensuring that the market risk of the various trading positions was properly hedged. Bernstein came from GE where he had worked for twelve years in different financial analysis positions. He joined Kidder in 1988 as Business Unit Controller (“BUC”) on the Controller’s staff. In September 1991, he moved to the Fixed Income Division as Cerrullo’s “right-hand man” to help Cerrullo manage the division. He was respected for his “intelligence and familiarity with financial and administrative issues.”

Also under Cerrullo’s supervision was the financing or “repo” desk. Its job was to go to the market to execute the trades entered by the traders.

The finance and administration department was headed by Kidder’s Chief Financial Officer, Richard O’Donnell, who reported directly to Carpenter. O’Donnell was responsible for formal control reports and procedures of the company and the internal audit function. The operations department or “back office” was also under the umbrella of O’Donnell and included the government clearance area which processed all transactions at settlement date.

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6This section of the case is based on data from the Lynch report.
7 “Did He or Didn’t He”, on 60 Minutes, aired 2-19-95.
8 Zero coupon instruments have only one cash flow associated with them at the end of their lives.
The Government Trading System

U.S. Treasury notes and bonds are financial instruments with the right to a string of cash flows made up of (1) periodic interest payments and (2) the payment of the principal at the end of their lives. However, this cash flow structure is not convenient for some market participants who need an instrument with the equivalent cash flows but where each payment can be traded separately.

To satisfy these market needs, the Federal Reserve Bank of New York (the "Fed") offers the option of exchanging U.S. Treasury notes and bonds for an equivalent set of zero coupon instruments. In other words, it exchanges a single note or bond for a series of instruments representing its cash flow components. These individual components are called "Separate Trading of Registered Interest and Principal of Securities", or STRIPS.

For example, a semiannual bond maturing in 10 years can be exchanged for 21 zero coupon bonds, 20 of them associated with interest payments and 1 with the principal payment (see Exhibit 3). This process of converting a bond into separate STRIPS is called stripping. The Fed also offers the inverse transaction: a market participant can come with the separate STRIPS of a bond and get the full bond. This process is called reconstitution ("recon"). Simply stated, these exchanges are like going to the bank with a dollar and receiving four quarters in return or giving four quarters and getting a dollar back. The Fed routinely offers this service without charge in the same way that a bank would exchange a dollar for four quarters (see Figure 1).

Kidder traders in the STRIPS market used a proprietary expert computer system, the Government Trader System, to record transactions in this market. Traders only needed to select the trade, specify whether it was a strip or recon and the quantity being traded, and the System updated their inventory position, printed the trade tickets with the transaction’s characteristics, informed the financing desk (repo desk) and clearance personnel. The Government Trader System also allowed the trader to scan market prices to detect arbitrage opportunities. Sometimes the value of a stripped bond would be temporarily higher or lower than the complete bond; in these cases the trader could take advantage of the arbitrage opportunity. Usually, STRIPS desks were not high performers because arbitrage opportunities were small and short-lived; most of the income generated came from the sales commissions to execute these trades.

Kidder's proprietary Government Trader System treated a strip—converting a bond into its separate STRIPS—as selling a bond and purchasing STRIPS. For example, the stripping of the 10 year bond described above would be recorded as 22 transactions: selling the bond would represent one transaction and purchasing the 20 zero coupon instruments associated with the interest payments together with the final principal payment would represent the other 21 transactions. These transactions had no counterparty (i.e., buyer or seller) because the Fed was only exchanging one instrument for an equivalent series of instruments (in the same way that an accounting system would not recognize changing a dollar for four quarters). The Government Trader System, recognizing this fact, recorded these transactions as being with Kidder itself.
To increase flexibility, the Government Trader System allowed traders to commit today to a transaction that would take place at a future date (at a price established today). The trader could choose to settle the transaction the next-day ("default" alternative) or at any future date. This forward capability was used at the request of customers or to take advantage of arbitrage opportunities. For example, if a bond was trading cheaper stripped than reconstituted, the trader could take advantage of this arbitrage opportunity by buying STRIPS today and doing a recon—transforming the STRIPS into a bond—the next day. Because arbitrage opportunities were short-lived and the Fed was ready to exchange at any time, most transactions in the STRIP market were done the same day or the next day. Forward strips or recons beyond one day were unusual.

After each transaction, the inventory position of the trader was updated. For example, when a recon was entered—the obligation to deliver STRIPS to get a bond—the trader’s “short” position in STRIPS—his deficit position—increased because the Government Trader System posted the delivery of STRIPS as a sale. At the same time his “long” position in bonds—his outstanding buying position—went up because the trader had increased his stock of bonds. For forward transactions, the effects upon unsettled inventories were equivalent: a forward strip—deliver a bond and get its separate STRIPS—increased the short position on unsettled inventories of bonds (because a bond was being sold) and increased the long position on unsettled STRIPS (that were being bought).

Inventory positions were valued at market price at the end of each trading day (i.e., they were “marked-to-market”). Any change in value was recognized in the trader’s daily profit and loss statement. For example, if the price of an instrument went up and the trader had a long position in it—i.e., had the instrument on hand or was committed to buy it at a fixed price—then a profit was recorded; similarly if the trader had a short position on the instrument, then he or she incurred in a loss.

Like all financial instruments, zero coupon instruments are valued in the market at the present value of the future cash flow of the instrument. However interest-bearing bonds and notes are valued "ex-interest"—the price quoted in the market does not include the interest accrued since the last payment and, thus, does not fully reflect the present value of the future cash flows. When a bond is traded, the seller receives from the buyer the market price of the bond plus the accrued interest on the bond since the last interest payment which is not included in the price (see Exhibit 4).

This difference in market valuation methods had a special impact on how the Government Trader System accounted for forward settlement transactions. Because strips and recons are "neutral" transactions with no effect on the P&L statement, the System correctly assigned the same value to the bond and its STRIPS at settlement date. The value was the market price of the bond ("ex-interest") plus the accrued interest at settlement date. But at the transaction date, the System valued the STRIPS (which are zero coupon instruments) at their discounted cash flow value (market price), while bonds were valued at their settlement date value. Thus at the transaction date, the System recognized a profit (for a recon) or a loss (for a strip) equal to the difference between the value of the STRIPS at the transaction date and their value at settlement date. This profit or loss disappeared over time to become zero at settlement date (see Figure 2 on the next page).
Trading Strategy

The trading strategy allegedly used by Joseph Jett to generate unrealizable profits was based on the mark-to-market valuation of unsettled positions. According to the Government Trader System, a forward recon to be settled several months into the future produced a sizable profit at the date the transaction was entered. This "unrealizable profit" occurred because of the different valuation methods used by the Government Trading System to value STRIPS and interest-bearing bonds. As discussed above, the unrealized profit was offset over time by small daily losses as the settlement date approached and the computer system updated the value of the STRIP (which was increasing in value as its maturity date drew nearer). But these daily small losses, as well as any other trading losses, could be swamped by the illusory profit generated by entering a new forward recon.

For example, on December 28, 1992 Jett entered a recon of $200 million of 12% bonds maturing in May 2005 to be settled on May 11, 1993. The System showed a profit associated with this transaction of $9.4 million because the long position in bonds (valued at the future settlement date) was $292.9 million while the short position in STRIPS (valued at the transaction date's discounted value) was only $283.5 million.

Many at Kidder believed that, in its strip and recon activities, the Fed behaved as a dumb customer; and where you made money, of course, was on dumb customers. As Jett stated:

"When you do a strip or recon forward, there is both a buy and a sell of a security; ... It was puzzling that there was any P&L effect at all. ... The only reasons [for] P&L consequence is [that the] Fed accept STRIPS at today's yield level for a forward settlement date. ... [David] Bernstein [the department's manager of business development and Cerrullo's right-hand man] explained it was like doing business with an unsophisticated investor like a municipal defeasance. ... We all agreed on that".

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10The Lynch report, p. 34 - 35.
According to Jett, Cerrullo as well as Mullin, his first supervisor, were aware and informed of his trading strategy. Jett described a successful trading day in a meeting with Cerrullo, O'Donnell, (Kidder’s CFO), and general counsel John Liftin:

"At 9:00 a.m. principal trading rich and I can sell 300 million at a profit level.
I enter a strip. Take bond and sell at market. This may put market under pressure.
My buying pressure creates opposite effect. You can do that all day long..."\(^\text{12}\)

Forward recons not only had an effect on the profit and loss statement, but they also altered the balance sheet position of each trader. In Joseph Jett’s case, the unsettled short position in STRIPS due to forward transactions had grown to be significant as well as its counterpart, the unsettled long position in bonds. Since Cerrullo was concerned about minimizing the balance sheet exposure of the firm, traders were asked to control their asset positions. Keeping his positions at reasonable levels was, perhaps, the most challenging aspect of Jett’s trading strategy.

Before September 1993, Kidder’s accounting system gave the same treatment to settled (i.e., securities in hand) and unsettled (open transactions) inventories. It reported the net position that every trader, and the company as a whole, had in every single financial instrument. Long and short positions on the same financial instrument were netted out by the accounting system irrespective of whether the positions were settled or unsettled. To keep his balance sheet exposure down, Jett compensated his large unsettled positions in forward recons with settled positions in the same bonds and STRIPS. For example, on August 27, 1993, Jett’s position in unsettled short STRIPS was $13.2 billion and his unsettled long bond position was $13.4 billion. But, through off-setting settled positions on the same bonds and STRIPS (i.e., inventory on hand) \(^\text{13}\), he was able to keep his net position down to $3.9 billion on STRIPS and $9.8 billion on bonds.\(^\text{14}\)

In September 1993, Kidder’s accounting system was changed. Unsettled positions would now be moved off balance sheet. The past strategy used by Jett to control the size of his balance sheet was no longer possible because settled and unsettled positions were now reported separately and could no longer be netted out. They had to be managed independently. From September 1993 onward, Jett’s trading strategy to manage his inventory of unsettled positions could only be based on other unsettled transactions.

To counteract the inventory effect, every forward recon to be settled several months into the future had to be matched with a forward strip in the same bond for a similar dollar amount. But a forward strip, under the Government Trader System, was associated with an unrealized loss. To minimize this loss, Jett used a shorter settlement date for these unsettled strips. (With a shorter settlement date, the loss associated with the different accounting treatments was lower because the discounted cash flow effects were smaller.) As these strips reached their settlement date, they were replaced by a new forward strip with identical characteristics. For example, in December 1993, Jett’s average remaining days to settlement for forward recons (generating unrealizable profits) was 43 days, while remaining days to settlement for offsetting forward strips (generating unrealizable losses) was 4 days.\(^\text{15}\)

\(^\text{13}\)By “same bonds and STRIPS,” we refer to exactly the same instrument; for example, the 10 years, 8.5% government bond issued August 1991.
\(^\text{14}\)The Lynch report, p. 43.
\(^\text{15}\)The Lynch report, p. 45.
The new trading strategy required the use of both forward recons (to generate unrealizable profits) and forward strips (to keep unsettled inventory down). Because of the snowball effect associated with this profit generating strategy, which required ever larger unsettled forward recon positions, Jett had at times unsettled positions greater than the actual market for the bond he was trading—sometimes as high as 269% of the actual market. As a practical matter, it would have been impossible to settle these positions at settlement date since the clearance personnel would not have been able to purchase the required instruments in the market. They simply did not exist in sufficient quantity. To solve this problem, Jett created next-day settlement transactions on the same instrument to pair-off strips or recons: the clearance personnel received two offsetting transactions that neutralized each other and did not, therefore, require them to go to the market to actually execute the trades. In November 1993, for example, $5 billion of Jett’s strip and recon transactions were settled, but $140 billion were paired off.

The effects of the new trading strategy on forward transaction volume are shown in Exhibit 5 at the end of the case. They also showed up in Jett’s personal trading volume and trading mix:

<table>
<thead>
<tr>
<th></th>
<th>July to December 1991 (6 months)</th>
<th>1992 (12 months)</th>
<th>1993 (12 months)</th>
<th>January to March 1994 (3 months)</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Trading volume</strong></td>
<td>$25 billion</td>
<td>$273 billion</td>
<td>$1,567 billion</td>
<td>$1,762 billion</td>
</tr>
<tr>
<td><strong>Trading profit</strong></td>
<td>-</td>
<td>$32.5 million</td>
<td>$151 million</td>
<td>$81 million</td>
</tr>
<tr>
<td><strong>Trades with counterparties</strong></td>
<td>78%</td>
<td>32%</td>
<td>10%</td>
<td>5%</td>
</tr>
<tr>
<td><strong>Trades (strips/recons) with the Federal Reserve</strong></td>
<td>22%</td>
<td>68%</td>
<td>90%</td>
<td>95%</td>
</tr>
<tr>
<td><strong>Strips</strong></td>
<td>10%</td>
<td>32%</td>
<td>45%</td>
<td>47%</td>
</tr>
<tr>
<td><strong>Recons</strong></td>
<td>12%</td>
<td>36%</td>
<td>45%</td>
<td>48%</td>
</tr>
</tbody>
</table>

Figure 3: Jett’s Personal Trading Volume

The Failure of Internal Controls

Joseph Jett made his first forward recon in November 1991. After several months of poor performance in early 1992, Jett began to show consistent profits. In 1992, his trading profits were $32.5 million, an unheard of record for the STRIPS desk. His bonus was $2 million. In 1993—newly promoted to head of the government desk, but still an actual trader—he generated $151 million in profits, representing 27% of the Fixed Income Division’s profits (up from 6% in 1992). His efforts earned him a $9 million bonus and Kidder’s “Employee-of-the-Year” award. That same year, Cerrullo was awarded a bonus of $12 million. During the first three months of 1994, Jett’s reported profits were $81 million. Exhibit 6 shows Jett’s performance over his tenure at Kidder Peabody.

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16The Lynch report, p. 42.
17The Lynch report, p. 6.
18This section is based largely on data from the Lynch report.
Mullin, Jett’s supervisor until he was promoted, reviewed daily reports on the trading activity of all the government desk traders. These reports illustrated the major contribution that Joseph Jett was making to the division’s profitability. Mullin’s review of Jett’s performance in the first half of 1992, when he recommended a substantial raise for Jett, reads:

"Jett’s performance in 1992 has been outstanding, after taking some time in the second half of 1991 to grow up the learning curve. Profitability in STRIPS at this time is $8.4 million. This profit level substantially exceeds that of 1991, and on an annualized basis far exceeds our best ever performance in STRIPS.

The level of profitability has been consistent with no month under $1 million; profits have come from intelligent trading activity and close attention to detail. Joseph has worked diligently to become one of the best STRIPS traders in the business."19

Mullin did not seem to be knowledgeable of how the unrealizable profits were generated, nor was he aware of the forward recons entered by Jett. Mullin, relying on the computer-generated reports of the Government Trader System, allegedly failed to review information on settlement dates or counterparties that could have guided him in understanding the implications of the trading strategy used by Jett. In October 1992, a review of the government desk done at Cerrullo’s request by outside counsel recommended that Mullin review trade tickets. However, Mullin responded that such a review would be impractical given the volume of trade tickets generated each day. Alternatively, he proposed that he review an exception report. Such a report was never generated.

Cerrullo, Jett’s boss since February 1993, believed that "Jett's level of profitability was consistent with asset growth and was attributable to a combination of market-making and arbitrage opportunities in STRIPS."20 Even when Jett's 1993 profits grew almost five-fold when compared to his 1992 profits, Cerrullo did not go beyond daily P&L reports, risks reports and other Kidder reporting structures to understand where profits—profits that were not generating any cash—were coming from.

Cerrullo said that "he continually monitored Mr. Jett’s performance, but that he had to rely on the firm’s internal audit reports, which gave no hint of irregularities. ...that Kidder’s accounting and auditing systems gave a reassuring picture of Mr. Jett’s trading activity."21 He believed that "given the liquidity and transparent pricing of the government market, as well as the sophistication of the Government Trader System, adequate systematic controls existed and detailed scrutiny of Jett's trading was unnecessary."22 Cerrullo said:

"No numbers I saw ever came close, every single bit of evidence—the inventory reports, the P&L statements, the control reports, the risk management reports—was reinforcing."23

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19From the Lynch report, p. 50.
20From the Lynch report, p. 13.
22From the Lynch report, p. 54.
Reports and Reviews

Kidder, Peabody & Co. had a full accounting and control department to maintain the formal reporting systems and audit the activity of the various desks. This department reviewed all the trading processes, but traders were under no obligation to share their trading strategies with the accounting and control staff. The function of the Business Unit Controller, staffed until September 1991 by Bernstein, was to provide independent accounting and control to the firm. This position was vacant until November 1993 because of lack of a good candidate.

Kidder’s internal audit department reviewed Jett’s transactions in two different audits. The first one, from January to September 1993, focused on trading practices at the zero coupon desk. The other, from August to September 1993, reviewed the settlement practices in the government clearance area. Neither of these two audits uncovered the true nature of the unrealizable profits. The first audit team was made of inexperienced auditors who relied on Jett’s account of his trading strategy without verifying his statements; they deferred to the second audit team to review the settlement process. At the time the second audit team reviewed settlement practices, Jett’s trading had not been identified by clearance personnel as a concern and the audit team did not spend time on it. Jett commented on these audits:

"When a trader is audited, that is the firm’s stamp of approval on everything that the trader does."\(^{24}\)

In May 1993, Charles Fiumefreddo, a member of the Controller’s department, was working on a project sponsored by the Inventory Committee to identify forward settlement transactions that could be moved off-balance sheet. The Inventory Committee, comprised of senior executives including Cerrullo (head of the Fixed Income Division), O'Donnell (Chief Financial Officer), and Carpenter (CEO of Kidder Peabody), had become concerned about Kidder’s balance sheet asset levels. Kidder’s leverage ratio at the end of 1993 was about twice that of its nearest Wall Street rival and the company was making efforts to reduce its balance sheet.\(^{25}\) Generally Accepted Accounting Principles (GAAP) allowed transactions in government securities to be moved off-balance sheet if they were to be settled within one day.

Fiumefreddo identified $1 billion in forward transactions in Jett’s ledger. To help him better identify forward transactions in the Government Trader System, Fiumefreddo contacted the analyst who, together with Mullin, had designed the System. Outraged, “Jett called Fiumefreddo and berated him for independently contacting the analyst.”\(^{26}\) Bernstein, Fiumefreddo and Jett met to discuss the matter. Jett and Bernstein discussed a possible P&L distortion that the System could be introducing into forward transactions, but the conclusion was "that Jett’s forward reconstitution activity did not generate any P&L distortion."\(^{27}\)

Jett’s outburst at Fiumefreddo was not unusual. Jett was harsh and domineering with subordinates, many of whom were afraid of him. Thus, the junior traders who executed his instructions may have been reluctant to voice their concerns. Jett had a well deserved reputation for firing anyone who questioned his trading methods. In addition, he was seen to be held in increasing esteem by senior management, culminating in the receipt of Kidder’s “Employee-of-the-Year” award in January, 1994.\(^{28}\)

\(^{24}\)Newsday, February 19, 1995
\(^{26}\)From the Lynch report, p. 55.
\(^{27}\)From the Lynch report, p. 57.
\(^{28}\)The Lynch report, p. 56 and 66.
In September 1993, a new management report was generated to monitor forward government transactions that had been moved off balance sheet. This report, called KPPS98, was generated weekly, and received by financial accounting and regulatory accounting staff. Ninety percent of all the transactions and 100% of the dollar volume shown in the report came from Jett's ledger, but accountants argued “that we had no reason as accountants to question how STRIPS trading could generate such large forward positions, and that the volume of forwards were disclosed in balance sheet information reviewed each week by the Inventory Committee.”

The financial accounting personnel did, however, inform David Bernstein, Cerrullo’s “right hand man”, in early December 1993 that part of the increase in Kidder's balance sheet exposure was due to Jett's trading. Jett’s trading showed an excess of next-day pair-off transactions (to avoid having large unsettled strips and recons that required actually going to the market). Since next-day pair-off transactions were part of the balance sheet, Bernstein explained to Jett that he "should not enter regular-way pair-offs at months-end when the Fixed Income Division needed to avoid major balance sheet increases".

The repo desk and the government clearance area (back office) were also becoming uneasy about the high number of transactions and the effective cancellation of most of them through pair-offs. Both departments shared their concerns with Bernstein who told them that Jett's trading strategy was legitimate and Cerrullo was aware of it.

Starting January 13, 1994, forward transactions had become so important that the financial accounting personnel disclosed a separate footnote in the weekly balance sheet to inform the Inventory Committee of the size of 'non-regular way' sales (STRIPS). In January 13, 1994 the amount disclosed was $11 billion and one week later it was $25 billion. O'Donnell did not raise any questions regarding the footnote because "the Fixed Income Division remained within its overall inventory limits ... (and) he relied upon Cerrullo's ability to identify anomalous trading events and positions."  

In February 1994, in a routine report to the Market Report Division of the Federal Reserve, the increase in forward positions led to an inquiry by the Fed. When it was found that these transactions had no counter-party, the Fed asked to have them removed from the report to avoid being mislead by the high numbers reported.

During the time that the unrealized profits were generated, two Kidder internal reports showed the actual amount of unrealized profits. These were the Government Credit Exception Report and the Government Security Analysis. The first report was reviewed daily by the credit department. The report showed the strips and recons in two separate accounts, the net of the two accounts being the amount of unrealizable profits. These two accounts were internal accounts (“house accounts”), with no credit limit and the credit personnel never paid attention to them because there was no credit exposure on them.

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29From the Lynch report, p. 62.
30From the Lynch report, p. 63.
31From the Lynch report, p. 64.
Detection

By March 1994, Ed Cerrullo and David Bernstein were surprised by the amazing size of Jett’s profits for January and February. He had generated each month as much profit as in all 1992, when his performance was praised by Mullin. By this time, Jett’s accumulated profits were approximately $260 million: $350 million of unrealizable profits and $85 million of real trading losses. His trading volume had reached $1.76 trillion and his forward positions exceeded $42 billion in recons and $47 billion in strips.

Bernstein began to investigate carefully. He discovered the forward positions in early March. Bernstein got the insight on the origin of Jett’s unrealizable profits through the RACE report. RACE (for "Regulatory Application for Counterparty Exposure") began to be produced in February 1994 by the financial accounting personnel in response to FASB Interpretation 19, which required firms to disclose unrealized P&L effects associated with off-balance sheet instruments. Cerrullo, Bernstein, Jett, and other traders had several meetings to fully understand what was going on. Jett tried several times to explain how his profits were generated, but he failed to convince them of the appropriateness of his trading strategy. His explanations were described as "contradictory and illogical."

Joseph Jett’s employment termination with Kidder Peabody was announced on April 17, 1994—the same day that General Electric made public the $350 million pretax charge against earnings resulting from the false profits.

Who Was to Blame?

Several interpretations have been given to the above described events. In assigning blame, it has been argued that:

"Jett knew that his forward recons were resulting in unrealizable profits and that he intended to mislead Kidder about his true trading performance. ...We conclude that Jett’s conduct over nearly two and one-half year period can only be explained as the product of a deliberate effort to generate false profits. ... no one at Kidder other than Jett knew that hundreds of millions of dollars of false profits were embedded in the massive forward reconstitution position maintained by Jett."

On the other hand, others believed that Jett acted honestly to capitalize on what he saw as legitimate opportunities:

"Jett had been trained at the Massachusetts Institute of Technology and the Harvard Business School to accept information from computer screens and to act on it. He didn’t work in a world of common sense (arbitrage itself, after all, often defies common sense, which is why you need rocket scientists); he worked in cyberspace. If the computer got it wrong, he was going to get it wrong; and if the computer got it wrong in his favor, he would see no reason to ask questions, even when the thing got...

\[32\text{FASB Interpretation 19 required companies to disclose the gross unrealized P&L associated with off-balance sheet instruments (Lynch Report, p. 78).}\]

\[33\text{From the Lynch report, p. 81.}\]

\[34\text{From the Lynch report, p. 7 to 10.}\]
silly. The Jett story, in other words, is not part of the story of panicked or dishonest traders hiding the slip in the desk.”35

Jett’s lawyer, Kenneth Warner, elaborated on this point of view in an open letter to the New York Times on March 7, 1995:

“Joseph Jett and your readers deserve better than your Feb. 28 editorial in which you uncritically adopt Kidder Peabody’s position that Mr. Jett ‘fooled’ the experienced Kidder executives who supervised him.

Government agencies have been investigating this matter for almost a year and no charges, criminal or civil, have yet been files against Mr. Jett. Moreover, two independent, experienced financial experts retained by CBS’s ‘60 Minutes’ to look into the Jett-Kidder controversy concluded during the show’s airing Feb. 19 that Mr. Jett committed no fraud.

When experts who examined the financial records believe Mr. Jett, and when government agencies refrain from filing charges, it is difficult to understand how a responsible newspaper can call Mr. Jett ‘a rogue.’

Mr. Jett acted openly and did nothing wrong. His trades were contemporaneously reported in Kidder’s books and monitored by high Kidder executives. The trades were conducted in compliance with an accounting system established by Kidder long before Mr. Jett’s arrival. Mr. Jett left all his earnings in a Kidder account now frozen by Kidder to prevent him from defending himself.

Moreover, after Kidder discharged Mr. Jett and liquidated his trading-desk portfolio, Kidder realized a profit of approximately $8 million on his positions, far from the ‘reckless bet’ you describe.

Your editorial exemplifies the insidious influence of the propaganda campaign waged against Mr. Jett by Kidder and its parent, General Electric. You have been misled and Mr. Jett has been unfairly pilloried.”36

Following Jett’s dismissal in April 1994, Mullin was fired in August of that same year, and Cerrullo and Carpenter were pressured to resign in July. General Electric decided in November 1994, after reporting a $350 million charge related to Jett’s trading and losses associated with mortgage backed securities, to orderly dispose of Kidder’s assets. Over two thousand Kidder employees would lose their jobs.

Both Cerrullo and Mullins settled SEC charges against them by paying fines ($50,000 and $25,000 respectively) and agreeing to suspensions from activities in the securities industry (one year for Cerrullo and three months for Mullins). Concerning Jett’s supervision, Ed Cerrullo stated:

"Somehow, to single out one supervisor as singularly responsible for a department with 700 or 800 people, $100 billion in assets and $20 billion in daily transactions and earnings of $1 billion is totally unrealistic.”37

As part of the agreement, neither Cerrullo nor Mullins admitted or denied wrongdoing.

In January 1996, Joseph Jett was named by the SEC in an administrative proceeding over his alleged role in the controversy. The jury began deliberations in June 1996 and was not expected to render a decision until early 1997. An article in Business Week proclaimed his innocence:

“In the annals of Wall Street scams, Orlando Joseph Jett holds a special—and contemptible—place. This former Kidder, Peabody & Co. bond trader allegedly masterminded $340 million in phony trades from 1991 to 1994. So badly was Kidder tarnished that its name was dropped when its assets were sold by General Electric Co. to Paine Webber Inc. last year. According to the Securities & Exchange Commission, which is wrapping up administrative proceedings against Jett in New York City, the 38-year old trader was a cunning flimflam artist.

There is only one thing wrong with this picture: There’s an awfully good chance that Joseph Jett is an innocent man.

If that sounds ludicrous, it’s understandable. For two years, Jett has been pilloried by his former employers and the SEC. His accusers say the former trader secretly abused an ‘anomaly’ in Kidder’s trade-accounting system that recorded ‘phantom’ profits from stripping and reconstituting Treasury bonds into their interest and principal components. He manufactured phony profits, they say, under the noses of his bosses—and was so good at it that Kidder proudly named him Man of the Year in early 1994. Even now, says Kidder general counsel John Liftin, ‘there’s no evidence that he has anything resembling a defense.’

But Jett’s defense is substantial. He claims that he was using—not abusing—Kidder’s computer system and was singled out for blame when the accounting system was changed. Evidence produced at his trial makes a persuasive case that he conducted his trades openly—and even disclosed them to Kidder’s internal auditors. And that undermines one of the central tenets of the SEC’s case: that Jett was deceptive.

To prove fraud, the SEC must demonstrate intent. As defined in one U.S. Supreme Court ruling, that’s a ‘mental state embracing intent to deceive, manipulate, or defraud.’ The key word is deceive. But documents introduced at the SEC’s proceedings against Jett seem to favor him on this crucial point.

Jett’s trades were recorded by Jett and other traders in large ledger books, or ‘red books’ that he kept in plain view on his desk. They were available for anyone to peruse during Jett’s frequent absences from the desk. The books undercut the theory that Jett was acting stealthily.”

The Lynch report, commissioned and released by General Electric, asked the critical question:

“The obvious question is how the false profits generated by Jett could have gone unnoticed at Kidder for a period of over two years. We conclude that no one provided knowing assistance to Jett’s trading abuses. Instead, the story of how Jett’s activity remained undetected until near the end of the first quarter of 1994 is primarily one of lax supervision, as well as poor judgments and missed opportunities.

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38Business Week, July 1, 1996, p. 90.
Although we suggest a number of changes in Kidder’s supervisory and control procedures, the door to Jett’s abuses was opened as much by human failings as by inadequate formal systems. In particular, employees throughout the firm appear to have deferred to the success of the Fixed Income Division and been unwilling to ask hard questions about Jett, the division’s rising ‘star’.\(^{39}\)

An additional perspective was provided by the Institutional Investor:

"It's a general manager’s responsibility to know what your trading practices are. He 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."\(^{40}\)

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\(^{39}\)From the Lynch report, p. 10-11.

The figure for 1994 includes a one-time charge of $350 million ($210 million after taxes) related to Jett's trading. Approximately $238 million ($143 million after taxes) of the charge are related to prior periods. In addition to the $551 million loss for 1994 shown in the above chart, GECS recognized an additional net loss provision of $868 million related to the exit costs expected to be incurred in connection with Kidder's liquidation.

Source: From information included in General Electric Capital Services, Inc. and General Electric Financial Services, Inc. 10 K reports.
Exhibit 2  Kidder, Peabody & Co., Organizational Chart

Chairman of the Board
President and CEO

M. Carpenter

Fixed Income
Managing Director

E. Cerrullo

US Government Securities Desk

J. Jett ‘93 - ‘94
M. Mullin ‘88 - ‘93

Business Development
D. Bernstein

Risk Management

Financing (REPO)

Zero-coupon
J. Jett
J. Unger
J. Ossman

10 Other Desks

Operations

Capital Market Clearance

Government Clearance

Controller

Assistant Controller

Revenue Accounting
C. Fiumefreddo

Business Unit Controllers

Credit

Internal Audit

Treasurer

Regulatory Reporting

Source: The Lynch report
Exhibit 3  Transforming an Interest-Bearing Bond into a STRIP

*Cash flow structure of a U.S. Treasury bond.* When a U.S. Treasury bond is purchased, the buyer has the right to the displayed cash flows but cannot trade on them separately unless the bond is stripped. When the bond is stripped, it is transformed into several instruments, one for each of the original cash flows of the bond. In this example, a 10 year bond with semi-annual interest payments is transformed into 21 separate instruments.

![Diagram of cash flow structure of a U.S. Treasury bond and transformation into STRIPs]

- **Interest Bearing Bond = 20 payments**
  - Principal
  - Interest

- **21 Separate zero-coupon bonds**
Exhibit 4  Pricing of Interest-Bearing Bonds and Zero Coupon Bonds (assuming constant market interest rates over time)

Pricing and Market Value of an interest-bearing bond
(Market interest rate = bond rate)

Pricing and Market Value of a zero coupon bond
Exhibit 5  Jett's Reconstitutions and Stripping Total Principal Value Traded 1991-1994

($ billions)

Source: The Lynch Report, p. 46
Exhibit 6  Jett's Performance Cumulative Results 1991-1994

($ millions)

False Profits
$349,678,000

Net Reported
Trading Profits
$264,259,000

Real Trading
Losses
$85,419,000

Jett hired

Source: The Lynch Report, p. 39