

The Perfect Storm: Joseph Jett and Kidder Peabody

"The more any quantitative performance measure is used to determine a group or an individual's rewards and punishments, the more subject it will be to corruption pressures and the more apt it will be to distort and corrupt the action patterns and thoughts of the group or individual it is intended to monitor."

- Darley's Law

There is perhaps no better illustration of the concepts outlined in Darley's Law than the case of Orlando Joseph Jett and Kidder Peabody.

At a go-go time for fixed income desks, Jett was employed to engage in bond trading for Kidder Peabody. Like most traders, he was controlled through an incentive scheme based primarily on trading profits. His plan and how management communicated it to him gave Jett a clear direction to make money from trading only. While the firm may have wanted Jett to care about the Kidder brand image, customer loyalty, or long-term business strategies, he had no incentive to do so. He was simply 'instructed' to make money from daily transactions.

Saul Hansel of the New York Times wrote an excellent narrative of how this case developed ([Joseph Jett: A Scoundrel or a Scapegoat?](#)). When Jett made a "paltry" US\$417,000 for the firm in his first five months, he was rewarded with a bonus of just US\$5,000. This was a signal that his career with the firm was not expected to be long if his profitability was not higher. A former top Kidder executive noted "I think Joe was someone who had a tremendous psychological need to be a star trader." Given the fact that Jett had been dismissed by one Wall Street firm already, the risks

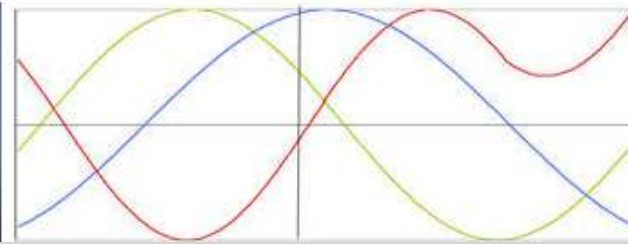
were high that if he lost this job, he might not get a third chance to be such a star.

Things changed quickly for Jett. Over the next several months, he showed accounting profits of US\$28 million on his trades and subsequently received an incentive payment of roughly 8% of those profits. This payout was, in percentage terms, six times that which he received for his earlier "meager" profitability. The shape of the incentive curve was quite steep and probably was starting to look like a call option to Mr. Jett.

It turns out that while Mr. Jett's profits were being reported through a company-approved system, vetted by his boss, that

Joseph Jett and Kidder Peabody

In 1993, Orlando Joseph Jett was accused of engineering an astounding \$339 million in phony profits as a bond trader at Wall Street firm Kidder Peabody. The evidence that he was a "rogue trader", however, is not so clear in this case. Did the company implicitly condone his activities without explicit awareness of their support? Were incentives not framed properly to be aligned with risk management and corporate objectives? At the time of the loss, Kidder was owned by General Electric. Following the case, in 1994, GE sold Kidder "out of disgust".



system was providing inaccurate figures.

It is not clear if Mr. Jett was cheating the system, because it is not clear that he knew of the accounting glitch. Still, when on one trading day, Jett reconstituted US\$200 million of bonds for forward settlement, producing an immediate profit of US\$12 million according to the system; he might be reasonably expected to become suspicious of some problem. Jett said that indeed this was the first time he noticed the big profits to be had from forward reconstitutions, and he sought an explanation from the programmer who helped design the system. By the programmer's own account he responded that the system was supposed to work as Jett saw it working. Moral authority was further extended by this validation.

The same former senior Kidder executive quoted above noted about Mr. Jett's trading, "It was like a lab rat in a cage. He pushed the lever, and food came out. The rat doesn't give much thought to why the food came out."

In his second full year with Kidder, Jett was realizing trading gains of over \$10 million a month for the company. As his boss moved on to another assignment, Jett was named to supervise all government bond trading. At the end of 1993, he was named Kidder's "man of the year" and awarded \$9 million in bonuses.

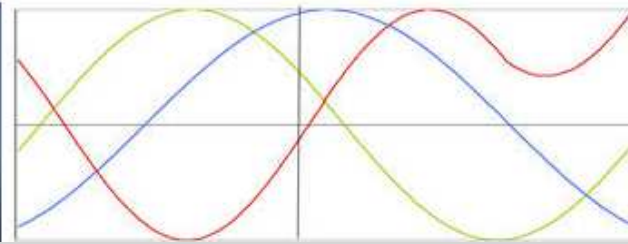
The trap was growing. Since Jett was a star, so too, by inference were those brilliant enough to have hired him. There was a highly perverse incentive created for those who should have been supervising him to ignore or not to dig too deeply into any suspicions that they may have had. The answers to any questions that were asked were not being challenged

Review of Key Points Regarding Control Systems and Authority Influences

- Overly objective systems may increase risk by attracting concentrations of personalities who prefer such to subjective systems
- Correct framing of incentive plans, particularly objective ones, thus becomes even more critical
- Objective systems may not be morally neutral and can stimulate gaming, cheating and the placing of self-interest above corporate interest
- Corporate authority, particularly when expressed through monetary incentives is the most pervasive influence
- Management may exacerbate risks through complacent oversight, brought about by a misunderstanding of how well corporate morals are understood by employees

sufficiently.

One might have expected Kidder's risk management infrastructure to step in. It seems that in this case, risk managers may have been partially culpable in realizing the ultimate result. According to Jett's first boss, long after he had switched jobs and Jett was no longer his responsibility, he casually asked the risk manager in the fixed-income division, how Jett was making money. "[the risk manager] said he has a big bet on the



shape of the yield curve" -- the gap between short-term and long-term interest rates, Jett's former boss said. "We don't do that," he further recalled. "And [the risk manager] said, 'Jett can do anything he wants.'" Our risk manager was likely influenced by the corporate authority that was rewarding Jett and did not want to hurt his own prospects for advancement.

GE, Kidder's parent company had around this time begun to look with dismay at the size of Kidder's portfolio of bonds. Worried about risks, GE ordered Kidder to cut back on its holdings, and it gave the firm three weeks to meet its target. Jett was told to reduce his combined bond holdings from \$22 billion to \$16 billion. It seems that if Jett had reduced his positions in the tainted-accounting trades, he would have incurred a loss and that would have impacted his incentive payments. He instead resorted to a complex series of forward trades that simultaneously preserved his profits and complied with GE's new balance-sheet mandate.

In court records, Jett and Kidder oddly agree that his new approach consisted entirely of paper trades, with the sole purpose of manipulating Kidder's financial statements. "We no longer had a profit motive," Jett said. "The trades became more and more a massive juggling act." In effect, he began to take things underground.

Jett says he was ordered by Kidder to engage in the trading to deceive GE. The SEC contends that Jett desperately sought to keep a fraudulent scheme from being detected by Kidder management. The evidence on the issue is ambiguous, but the alignment with Darley's law is not.

So was Jett just playing the game that Kidder had built for him? Said Jett, "If I am operating under their system to generate profits, with their approval and they turn around and change the rules so the reasons you had for doing this no longer exist -- and, by the way, we are taking all the money back we paid you -- is that fair?"

Hansel concludes his narrative of the Jett case by relaying a story of a professor from New York University named William Starbuck and 500 graduate business students who gathered one evening to hear Jett discuss his case and the point Jett made about the rules of the game. Starbuck reported that the overwhelming majority of students felt that Kidder and GE had implicitly defined a game by setting up their accounting system. In the students' view, Starbuck said, "it is the job of employees to play the game, not to decide whether they are good games or bad games."

The challenge for a firm to remain ductile is neither simple, nor achievable by single-actions. It is a process of ongoing discernment, education, communication and alignment with industry best practices. It is ultimately the responsibility of the Board of Directors to create the environment of ductility and for the risk-takers to make the best use of their opportunity.

About Us

Ductibility is private advisory service. We provide benchmarking research through our Research Circles. We design risk education and risk-awareness-building programs. We review and analyze compensation and incentive structures for alignment with corporate objectives.