SECURITIES AND EXCHANGE COMMISSION
Washington, D.C.

SECURITIES ACT OF 1933
Rel. No.8395 / March 5, 2004

SECURITIES EXCHANGE ACT OF 1934
Rel. No.49366 / March 5, 2004

Admin. Proc. File No. 3-8919

In the Matter of

ORLANDO JOSEPH JETT
61 East Eighth St.
New York, NY 10003

OPINION OF THE COMMISSION

BROKER-DEALER PROCEEDING

Grounds for Remedial Action

Fraud in the Offer and Sale of Securities

Causing, and Aiding and Abetting, Recordkeeping Violations

Former government bond trader and registered representative of former registered broker-dealer recorded enormous illusory profits through anomaly in firm's trading and accounting systems, deceived the firm about his trading performance, and caused, and aided and abetted, recordkeeping violations. Held, it is in the public interest to bar respondent from association with any broker or dealer; to order respondent to cease and desist from committing or causing any violation and committing or causing any future violation of Section 17(a) of the Securities Act of 1933 or Section 10(b) of the Securities Exchange Act of 1934 and Rule 10b-5 thereunder; to cease and desist from causing any violation and any future violation of Section 17(a) of the Exchange Act and Rules 17a-3 and 17a-5 thereunder; to order respondent to disgorge $8,210,000; and to order respondent to pay $200,000 in civil penalties.

APPEARANCES:

Orlando Joseph Jett, pro se.

Carmen J. Lawrence, Kay L. Lackey, Herbert J. Willcox, John J. Graubard, Christian Sandoe, and Henry Klehm III (Of Counsel), for the Division of Enforcement.

Appeal filed: August 11, 1998
Briefing completed: November 2, 1998
Oral argument: February 4, 2004

I. INTRODUCTION

The Division of Enforcement and Orlando Joseph Jett appeal from an administrative law judge's decision. 1/ Jett was a government bond trader, registered representative, Managing Director, and Senior Vice President with a former registered broker-dealer, Kidder, Peabody & Co. ("Kidder" or "the firm"). The law judge found that Jett, with intent to defraud, booked hundreds of millions of dollars in illusory profits through an anomaly in Kidder's trading and accounting systems, thereby deceiving the firm about his trading performance and obtaining large bonuses and other benefits.

However, the law judge found that Jett did not violate Section 17(a) of the Securities Act of 1933, 15 U.S.C. § 77q(a); Section 10(b) of the Securities Exchange Act of 1934, 15 U.S.C. § 78j(b); and Rule 10b-5 thereunder, 17 C.F.R. § 240.10b-5 (1998), because Jett's conduct was not "in the offer or sale," or "in connection with the purchase or sale" of securities within the meaning of those antifraud provisions. The law judge did find that Jett was a cause of, and aided and abetted, recordkeeping violations by Kidder

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1/ Orlando Joseph Jett, Initial Decision Rel. No. 127 (July 21, 1998), 67 SEC Docket 1901. The Order Instituting Proceedings in this matter also named Melvin Mullin, one of Jett's supervisors at Kidder, for failing reasonably to supervise Jett. Mullin settled those charges. He was suspended from associating with a securities firm for three months, suspended from associating in a supervisory capacity with a securities firm for three months immediately following his suspension from association, and was ordered to pay a $25,000 civil penalty. See Orlando Joseph Jett and Melvin Mullin, Securities Exchange Act Rel. No. 37226 (May 20, 1996), 61 SEC Docket 2852. Edward Cerullo, who also supervised Jett, settled with the Commission. He was suspended from associating with a securities firm in a supervisory capacity for twelve months, and ordered to pay a $50,000 civil penalty. See Edward A. Cerullo, Securities Exchange Act Rel. No. 36695 (January 9, 1996), 61 SEC Docket 82. Our findings here with respect to Mullin and Cerullo are made solely for the purposes of this proceeding.

because his illusory profits were reflected in the firm's ledgers and Financial and Operational Combined Uniform Single ("FOCUS") reports, in violation of Exchange Act Section 17(a), 15 U.S.C. § 78q(a); Exchange Act Rule 17a-3(a)(2), 17 C.F.R. § 240.17a-3(a)(2) (1998); and Exchange Act Rule 17a-5, 17 C.F.R. § 240.17a-5 (1998). 2/

Jett was barred from association with a broker or dealer, and ordered to cease and desist from committing or causing any violations of the recordkeeping provisions he was found to have violated. He was also ordered to disgorge $8.21 million (plus prejudgment interest) and to pay a $200,000 civil penalty.

The Division appeals the law judge's decision concerning the antifraud provisions. Jett appeals the law judge's findings of recordkeeping violations and, more generally, contests the findings that he engaged in a scheme to defraud. Jett makes contentions in his defense that, on their face, are quite troubling. Among these are that his supervisors at Kidder condoned his activities and that this proceeding is tainted by racial discrimination.

We have independently reviewed the record, which, as the law judge aptly described it, includes transcripts of 19 days of hearings, at which nearly two dozen witnesses testified, and a "vast number of exhibits." We base our findings on our de novo review, except regarding those findings below not challenged on appeal. 3/

After exhaustively reviewing the evidence and thoroughly examining the parties' arguments, we find that the Division proved Jett willfully violated or aided and abetted and caused the

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2/ Jett was also charged with being a cause of, and aiding and abetting, Kidder's violations of Rule 17a-3(a)(1), 17 C.F.R. § 240.17a-3(a)(1) (1998) (blotters), and Rule 17a-3(a)(7), 17 C.F.R. § 240.17a-3(a)(7) (1998) (memoranda of purchases and sales). The law judge found that Kidder did not violate these two provisions because the firm's blotters and order tickets accurately reflected the exchanges that Jett entered. The Division did not appeal this ruling.

3/ Rule of Practice 451(d), 17 C.F.R. § 201.451(d), permits a member of the Commission who was not present at oral argument to participate in the decision of the proceeding if that member has reviewed the oral argument transcript prior to such participation. Commissioner Campos, who was not present at the oral argument, performed the requisite review.

violations with which he is charged and that Jett's defenses do not withstand scrutiny. We set forth the basis for our decision in detail below.

II. FACTS

After an unsuccessful start at Kidder, Jett's employment was in jeopardy. Jett responded by devising what he calls a "carefully planned trading strategy." The manner in which the strategy worked was complicated, but its purpose was simple. It created the illusion of profitable securities trading. It involved entering an ongoing sequence of carefully formulated instructions into Kidder's computer system to exchange with the U.S. Government the component pieces of U.S. Government bonds for the whole bonds, or vice versa. The strategy exploited an anomaly in the computer system to make it appear that Jett was making enormous profits for the firm. The strategy concealed the failure of Jett's real trading and the costs of the strategy itself. Jett pursued it, with variations, for over two years, until he was fired. It brought him rich rewards at the firm, including promotions and millions of dollars in bonuses. In fact, Jett's "trading strategy" caused the firm a large loss.

A. Jett Has an Unsuccessful Start at Kidder

In July 1991, Jett began working as one of several traders on Kidder's Zero Coupon Trading Desk ("zero coupon" or "STRIPS" desk), after a period of unemployment, at a salary of $75,000. Jett came to Kidder with an impressive academic background, having received undergraduate and graduate degrees in chemical engineering from Massachusetts Institute of Technology by 1984 and a Master of Business Administration degree from Harvard University in 1987. However, his trading career was not impressive. During a three-year period between August 1987 and December 1990, Jett had been employed, and terminated, by Morgan Stanley & Co. and The First Boston Corp., where he had traded collateralized mortgage obligations, including devising trading strategies with the use of computers.

Until Kidder ceased to exist in early 1995, the firm was a registered broker-dealer and a subsidiary of General Electric Co. ("GE"). The zero coupon desk was a unit of Kidder's Government Securities Trading Desk ("government" desk) within the firm's Fixed Income Division. Initially, Jett reported to Melvin Mullin, then the manager of the government desk.

Jett began trading government bonds at Kidder in August 1991. That month, his trading ledger lost money. In each of the next two months, Jett generated profits that Mullin viewed as an insufficient contribution to the STRIPS desk's progress toward its goal of $1 million in monthly profits. In October 1991, Mullin gave Jett a negative performance review, and awarded Jett a "very, very low" bonus of $5,000. Jett understood that Kidder was not happy with his performance for 1991.

B. Jett Devises a Complicated "Trading Strategy" To Create the Appearance of Improved Performance

In response to his review, Jett devised a "trading strategy" to create the appearance of improved performance. It involved entering instructions into Kidder's computer system to exchange securities with the U.S. Government, and exploited an anomaly in the way the computer system, which was designed for real trades, treated such non-trade exchanges.

1. Strips trading

Beginning in 1985, the U.S. Treasury Department ("Treasury") established the Separate Trading of Registered Interest and Principal of Securities ("STRIPS") program. At the request of a participating financial institution ("Primary Dealer"), such as Kidder, the Federal Reserve Bank of New York ("Fed") either converts a coupon-bearing bond into a series of discounted zero coupon securities consisting of the original bond's interest and principal components (known as "stripping") or combines those components (or "strips") into a whole Treasury bond (known as "reconstituting"). 4/

4/ While Kidder was a primary dealer, the Bank of New York actually processed the exchange with the Fed. The Treasury issues securities that are debt obligations on which interest is paid. There are two types of U.S. government securities: 1) coupon securities that provide interest payments periodically (usually every six months) and 2) discount or zero coupon securities that do not provide the owner with periodic interest payments, but which pay the equivalent of the interest at the maturity date as a result of the difference between the purchase price and the face value at maturity.

After a bond is stripped, each interest coupon (known as a "TINT," short for "Treasury Interest" strip) and the principal piece (the "corpus" or "TPRN," short for "Treasury Principal" strip) is identified by a distinct Committee of Uniform Securities Identification Procedures ("CUSIP") number, and the original security is retired. A stripped bond may consist of as many as 61 separate strips (60 TINTs and the corpus)

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Reconstituting and stripping are non-cash exchanges of essentially economically equivalent securities, processed within about a day. Neither the Primary Dealer nor the Fed profits or loses money from the "strip" or "recon" exchange itself. The only money that changes hands is a small processing fee. The Fed merely has a clerical role in processing the conversion. Moreover, the Fed does not accept instructions to strip or recon on a forward basis; stripping and reconning is done promptly upon receiving a Primary Dealer's instruction.

Strips are traded by broker-dealers in the secondary market in order to satisfy customer requests to buy or sell the securities, to profit from market making opportunities, to earn the "carry" from holding the securities in inventory (appreciation in value less the cost of financing), and to take advantage of arbitrage opportunities (for example, where the sum of the component parts of a bond is worth more or less than the whole bond). To capture this arbitrage, a trader would execute the appropriate trades in the market and, if the necessary strips (or bond) were not available in the firm's inventory for delivery to the counterparty at settlement, the trader would submit the bond (or strips) to the Fed to be stripped (or reconstituted). However, because the market for Treasury securities is closely monitored and is one of the most liquid and actively traded markets in the world, strips arbitrage provides limited profit opportunities. Any such opportunity is generally short-lived and traders must act quickly to capture it. 5/

When traded between counterparties in the secondary market, Treasury securities generally settle on the next business day following the transaction ("regular way" settlement). 6/ However, broker-dealers may settle transactions further in the future. When a trade in a zero coupon bond is forward settled, the proper forward

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depending on the length of time before the bond matures.

5/ The Division's expert testified that arbitrage profit opportunities would rarely have exceeded 0.03125% of the face value of the bond. Mullin testified that a trader could not expect to make more than 0.2% profit from strips arbitrage. Even Jett's expert stated that the potential profit from strips arbitrage was between .3% and 1.1% of the bond's principal value, far less than Jett's claims that arbitrage alone could yield a return of 1.64% to 1.98%.

6/ John Downes and Jordon E. Goodman, Dictionary of Finance and Investment Terms 527 (Barron's Financial Guides 4th ed. 1995).

sales price will be higher than the current spot price. The higher forward sales price reflects the interest the seller would earn between the trade date and settlement date. The further forward the settlement date for a zero coupon bond, the higher the forward sales price the buyer must commit on trade date to pay at settlement date.

2. The anomaly in Kidder's computer system

At Kidder, transactions in government securities were entered in the firm's "Government Trader" computerized analytic system ("GT") and recorded in the "G1" ledger. Although a recon or strip was a non-trade exchange of fundamentally equivalent securities with the Fed, GT treated a recon instruction as a sale of strips and the purchase of the whole bond; it treated a strip instruction as the sale of a bond and the purchase of its principal and interest components. Kidder reflected an open recon instruction as a short strips position and a long bond position in its inventory; it reflected an open strip instruction as a long strips position and a short bond position.

As with a real trade, Jett could enter on GT a "trade" date and a "settlement" date for the Fed exchange. For a recon, Kidder's repurchase (or "repo") desk obtained and, on the "settlement" date, delivered to the Fed the component strips and received the reconstituted bond; for a strip, the desk delivered the whole bond to the Fed and received the component strips. 7/

As originally designed, GT allowed a trader to choose four settlement dates for government securities transactions: "cash settlement" (same day settlement as the trade date); "regular way" (next day settlement); "skip day" (two business days forward); and "corporate settlement" (five business days forward). GT defaulted to next day settlement if no choice was made. In November 1992, GT was upgraded to allow a trader to enter any future settlement date.

Again as with real trades, GT automatically recorded "profits" on the "trade" date from forward recons (and "losses" from forward strips). Jett could see the profit and loss ("P&L") impact of a forward recon or strip on the GT screen within 10 to 14 seconds of entering it. The GT screen displayed the total P&L for all transactions (including futures).

7/ When a trade was needed to perform a recon or strip with the Fed, the Kidder trader entered this into GT as a separate transaction.

Three factors influenced the size of the apparent up-front profit from a forward recon (or loss from a forward strip) exchange: the number of days forward between the "trade" date and the "settlement" date, the dollar amount of the bond being stripped or reconned, and the coupon rate for the bond. The larger these numbers were, the larger the profit (or loss).

As there was no real purchase or sale, no price or date set by counterparties, these P&L figures were pure mathematical constructs. In a forward recon, GT assigned to a strip a forward price that equaled the bond price (the price of a strip includes all interest that accrues on the bond) through the "settlement" date. GT constructed the "trade" date prices for strips using the accrued interest through the "settlement" date (not the "trade" date). 8/

GT thus recorded an automatic up-front "trade" date "profit" that essentially equaled this accrued interest. This profit figure did not reflect any of the costs that would have been associated with earning such income if this were a real trade. 9/ GT reversed

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8/ The premise for GT's calculation of forward prices in a strip or recon exchange was the formula: (sum of the value of the strips components (TINTs and corpus)) = (the price of the bond plus interest expected to accrue from the trade date to the settlement date).

GT first calculated the projected price of the bond as it was expected to sell at settlement date by holding the bond's yield constant; it then added the interest expected to accrue up to the settlement date. GT then calculated the theoretical forward price for the TINTs on the settlement date by holding the yield constant. Finally, GT "plugged in" the price of the principal piece calculated by the difference between the bond plus accrued interest and the sum of the TINTs. It calculated an automatic profit equal to the difference between the higher theoretical forward price of the strips and the lower spot price when the exchange instruction was entered into GT.

9/ For example, if Kidder needed to buy the securities for an exchange with the Fed, as part of legitimate trading in the market, Kidder would borrow the money to pay for them, incurring financing costs. Furthermore, if Kidder were to buy the securities in advance of the date of the exchange, and thus hold the securities in inventory, the firm would become exposed to the risk of a decline in their market value in the interim. It cost money to address this risk by hedging the price of the
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the process for a forward strip exchange and recorded an automatic up-front "loss."

This P&L was artificial and imaginary. GT recorded it regardless of whether Kidder held the securities designated for exchange with the Fed; whether Kidder ever bought or borrowed those securities; whether they were ever delivered to the Fed; and whether the exchange was related to any real trade.

Indeed, the exchange need never take place. After entry of a forward recon or strip instruction, but before the exchange "settled," a Kidder trader could "pair off" the recon with a corresponding strip or the strip with a corresponding recon. When a recon and a strip instruction (at the same or different "trade" dates) had been entered for the same bond, same quantity, and same "settlement" date, the "trades" directly offset and showed a neutral trade date position. A pair-off dispensed with any delivery of securities to the Fed, but generated a reported trade loss equal to whatever profit remained on the forward recon (or a trade profit equal to any loss left on the forward strip).

However, as Jett knew, the P&L figures for forward Fed exchanges were ephemeral. Kidder's system would correct, day by day until "settlement" date, for the up-front "profit" recorded from a forward recon (or "loss" from a forward strip). Each day between the "trade" date and the "settlement" date, the "profit" or "loss" would reduce proportionately until on "settlement" date it was gone.

Kidder's accounting system would subtract the current day's market strip price from the prior day's market strip price. This calculation generally resulted in an increasingly large negative number, because the price of a zero coupon strip tends to rise (or accrete) as it matures. As the "settlement" date neared, the zero coupon strip's price approached the theoretical forward price entered on the "trade" date (assuming constant interest rates). This incremental loss is referred to as "negative accretion." It resulted in the reporting of daily trading losses for a forward recon (or profits for a forward strip) that by "settlement" date would tend to add up to the up-front trading profit from the recon (or loss from the strip).

GT generated trade tickets for the exchange. A ticket did not reveal on its face the recorded P&L of the recon or strip exchange. Although each exchange was entered on GT as a single "trade," it

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reconstituted bond at settlement with the sale of bond futures.

entered Kidder's accounting systems as up to 62 separate component "trades" (the purchase or sale of the bond and the individual strips) depending on the number of coupon payments left on the bond. Data about the exchange instruction Jett entered (including price, size, and "trade" and "settlement" dates) appeared in the G1 ledger, and were transferred from GT to Tandem, another firm computer system. For a forward recon, Tandem updated GT's entry-time profit by recording a profit equal to the difference between the strips' higher theoretical forward price and their lower closing price when marked to market at trade date's end. Then the data was fed into the firm's IBM mainframe system. Internal firm reports and databases, firm ledgers, and FOCUS reports were created from the information in Tandem and the IBM system.

3. Jett's "strategy" to exploit the anomaly in Kidder's computer system

Jett took advantage of traits of real trades and the anomaly that GT, except for using a P&L formula for Fed exchanges that ensured the falloff of that P&L over time, treated exchanges as real trades. His "trading strategy" depended on characterizing Fed exchanges as "trades" with a counterparty occurring over an extended period of time. Exploiting the anomaly in GT, Jett made forward recons the "focal point" of his activities at Kidder. 10/

Beginning in late 1991, Jett consistently entered Fed exchanges designed to "settle" as far forward as GT would allow. Jett counteracted the system's corrective feature. He entered enough new forward recons so the aggregate "profits" they generated exceeded the aggregate losses from the automatic falloff of "trade" date profits from previously entered forward recons, and enhanced any net profits or hid any net losses from his real securities and futures trading and net interest. As Jett entered more and larger forward

10/ Jett admits that, well before the end of his employment at Kidder, he knew that, as he puts it, "forward recons had a time value of money embedded in them . . . which meant the profit opportunity of a recon was enhanced by the time horizon at which it was done." Jett repeated this admission at oral argument when he conceded that while working at Kidder he had become aware of the anomaly in GT. Although Jett refers to a "profit opportunity," there could in fact be none from these administrative conversions alone. What Jett describes as a "time value of money" is merely his characterization of the fact that GT automatically calculated an imaginary profit for these forward recons and that these "profits" grew with the time-length of the recons.

recons in a pyramid-like manner, the automatic profits recorded from a forward recon on any given trade date more than offset his losses and financing and hedging costs reflected on that date. 11/

Thus, Jett's "trading strategy" amounted to little more than a pyramid scheme that generated fictitious, paper "trading profits." These profits approximated the gross income that theoretically would be earned from the mere act of holding in inventory from the "trade" date to the "settlement" date the securities that, pursuant to the exchange instructions Jett entered into GT, were to be delivered to the Fed. Jett used these "profits" to mask the level of his real trading profits, which in most months were actually losses, on a sustained, ongoing basis, and thereby portray his failed securities trading as a huge success.

When Jett's colleagues or supervisors at the firm questioned him about his profits, he did not describe the "trading strategy" outlined above. 12/ Instead, Jett gave them a completely different explanation. He typically attributed his profits to three legitimate sources: (1) arbitrage opportunities between the market price of a whole Treasury bond and the price of its component strips; (2) profits from the bid/offer spread on an expanding volume of customer transactions; and (3) arbitrage from basis and yield curve trades (buying and selling Treasury securities of differing maturities and differing interest rates). Even when referring to Fed exchanges, he misused the familiar trading terms "arbitrage" and

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11/ Firm reports did reflect the aggregate costs of financing strips (included in net interest) and the costs of hedging with futures. However, even when Kidder did buy securities for delivery to the Fed pursuant to forward recon instructions, the reported financing and hedging costs for a particular trade date were not necessarily related to the costs of buying the securities corresponding to the forward recons that were entered on that date and that generated an automatic up-front profit. There was likely a lag between the entry of the forward recon and the incurrence of the costs of financing and hedging associated with buying the underlying securities and the futures. Thus, to the extent Kidder purchased or borrowed the underlying securities, the costs reflected in firm reports were primarily the financing and hedging costs associated with previously entered recons (as well as strips and real trading), not the recon entered on that date.

12/ Mullin and Cerullo were sophisticated traders. They would have immediately recognized that a mere administrative exchange of basically the same securities with the Fed had no economic impact and could not generate either a profit or a loss.

"hedging," misleading others about the real source of his huge reported trading "profits."

C. Jett Implements His Strategy Under Mullin, and Begins to Report Large Trading Profits

After Jett implemented his "trading strategy" in late 1991, the apparent profitability of the zero coupon desk began to increase dramatically. The G1 ledger reported a profit (from trading and net interest) of $7.8 million from January through June 1992. The source of Jett's new-found success was a marked increase in Fed exchanges designed to "settle" in up to five business days.

On the strength of his reported "trading" results, Jett gained the confidence of Mullin, the manager of the government desk. In June 1992, Mullin declared Jett to be "one of the best STRIPS traders in the business." Mullin rated Jett's performance as "outstanding," and doubled his salary to $150,000.

From January through October 1992, the G1 ledger recorded approximately $17 million in illusory profits from strip and recon exchanges, which enabled the ledger to show a total profit over the period of more than $25 million.

In November 1992, Jett took advantage of the upgrade of Kidder's computer system, which allowed a trader to enter any future settlement date, to enter exchanges much further forward. The furthest forward recon exchange was entered in November 1992 (203 days forward); the furthest forward strip exchange was entered in May 1993 (155 days).

The profits in the G1 ledger reflected this increased use of forward exchanges: by the end of 1992, recorded profits for the STRIPS desk were $32.5 million, more than five times the profit for 1991. This consisted of $40.4 million in illusory profits from forward Fed exchanges and nearly $8 million in net losses from real trading with real counterparties and interest.

In fact, the volume of Jett's forward recon and strip exchanges had increased so much by late 1992 that James Rizzi, who worked at Kidder's repo desk, began to have difficulty obtaining the pieces for delivery to the Fed. When that desk was unable to obtain the strips or the bond before "settlement," it told a trader to pair off the exchange. In December 1992, the desk tried to reduce the number of pair-offs. It began to keep information about Fed exchanges from the GT trade tickets in a specially designated notebook (the "Red Book"). Rizzi testified that use of the Red Book made it easier for the repo desk to plan to obtain strips. From January to August 1993, pair-offs fluctuated between 9% and 40%.

Jett received an "outstanding" evaluation at the end of 1992, and was promoted to Senior Vice President. He was awarded a $2.1 million bonus. Again, Mullin told colleagues that Jett "has become one of the top STRIPS traders in the industry."

D. Jett Continues To Pursue His Strategy Under Cerullo, and Continues To Reap the Rewards

In February 1993, Mullin was transferred to another trading area at the firm and Jett was promoted to Mullin's former position as Managing Director of the government desk. There, Jett reported directly to Edward Cerullo. In addition to Jett and the other zero coupon traders, Cerullo supervised over 700 employees in the billion-dollar Fixed Income Division.

Forward recon and strip exchanges continued to increase throughout 1993, as did profits in the G1 ledger. 13/ By April 1993, the ledger reported nearly $44 million in profits for the year-to-date, surpassing its total reported profits for 1992. By the end of the second quarter of 1993, the ledger recorded over $66.7 million in year-to-date profits. This comprised approximately $58.5 million of illusory profits from forward Fed exchanges, and approximately $8.2 million in profits from real trades with real counterparties, plus interest on settled inventory positions.

From December 1991 to August 1993, 8% to 46% of the Fed exchanges entered into GT were paired off. Moreover, by the end of July 1993, Jett had entered so many recon instructions involving a particular strip that the open instructions provided for the delivery to the Fed of more of that strip than existed.

Jett often exceeded his inventory position limits and Cerullo approved limits for Jett that were higher than Kidder guidelines for other traders. Cerullo also approved large futures positions for Jett, which were necessary for Jett's purported trading strategy.

E. Jett Adapts His Strategy to Kidder's Balance Sheet Reduction Effort, and Records More Large Profits

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13/ During 1992, the dollar value of recons and strips in the G1 ledger was double the dollar value of actual trading with real counterparties. In 1993, this ratio rose to 9 times real trading, and by the first quarter of 1994, recons and strips were 21 times actual trading.

Jett adapted his "trading strategy" to changed circumstances at Kidder in September 1993. Around August 1993, Kidder became interested in obtaining an unsecured line of credit from a syndicate of banks. To do this, Kidder management decided to make the firm's financial condition appear stronger by reducing the amount of inventory included as assets on the firm's balance sheet by the end of the third quarter of 1993. 14/

It appears that Kidder wanted to reduce its reported assets to appear either more profitable (by increasing its ratio of profits to assets) or less leveraged. The firm's Inventory Committee (of which Cerullo and other senior management officials were members) agreed that certain transactions (including forward trades) could be used to reduce the balance sheet if they were "legitimate transactions," if there were no improper "parking of securities," and if the trades were treated in accordance with Generally Accepted Accounting Principles ("GAAP").

Beginning in September 1993, Kidder's balance sheet reflected only "settled inventory," i.e., all settled positions and all positions entered to settle the next day (what Jett defines as "securities owned, or securities sold and delivered with the use of a borrowed security"). It did not reflect "trade date inventory," which included both settled and unsettled positions. Thus, forward transactions were recorded off balance sheet; transactions that had settled or were pending for next-day settlement as of a reporting date would appear on the balance sheet.

In early September 1993, Cerullo directed a plan to reduce the Fixed Income Division's balance sheet inventory by $26.2 billion by month's end. The plan included reducing strips inventory by approximately $5 billion by moving assets off the balance sheet through the use of "trades with forward settlements" and reducing the amount of outstanding repos. David Bernstein, Manager of Business Development for the Fixed Income Division, was assigned to implement this plan. Bernstein had no experience as a trader, but Cerullo delegated substantial responsibility to him concerning general matters in the Division.

14/ By mid-1993, Jett's inventory positions represented 21.5% of the Fixed Income Division's assets, 19.5% of Kidder's overall assets, and 6.8% of GE's assets. To the extent that these positions reflected recon and strip instructions, and Kidder did not own the underlying securities that were to be exchanged with the Fed, the positions were imaginary.

Bernstein told Jett in September 1993 to reduce his asset positions in the G1 ledger for the third and fourth quarters of 1993 and first quarter of 1994 to meet certain targets. Bernstein asserts that he did not tell Jett how to reduce the balance sheet; Jett disputes this. Bernstein testified that he assumed that Jett would use a "legitimate methodology." Kidder received its bank financing around the end of March 1994.

Jett entered the balance sheet reduction period with a "settlement date" (or balance sheet) inventory that was long in strips and short in bonds. Prior to September 1993, before Kidder created the separate category of "settlement date" inventory, Jett's open forward recon instructions -- each of which represented a short strips position and a long bond position -- netted with settled long strips positions and short bond positions in his inventory that corresponded to the recons. This reduced his settled long strips position and short bond position. As of September 1993, this netting occurred only in the "trade date" inventory, not in the balance sheet inventory.

Jett claims that, from September 1993 through March 1994, his recon and strip activity was no longer designed to generate trading profits, but only to manage his inventory positions in a "revenue neutral" way until he could return to his original strategy; or at least that it was done "primarily" to meet "balance sheet objectives." In fact, during this period, Jett continued to use recons to generate illusory trading profits.

As Jett describes it, he began the process of reducing his settled inventory in mid-September 1993. First, he removed strips from his inventory by converting them into whole bonds through "massive" next-day settling recons. This reduced his settled long strips position and short bond position.

Next, Jett systematically entered a series of strip and recon instructions with no intention of allowing the vast majority of the exchanges to occur. He says he entered forward strips that "would settle in or around the first week of October," beyond the quarter-end date, so that his original long strips position would be reestablished "off balance sheet" on the forward date. Then, before these large strip exchanges could "settle," Jett says he "paired off" "most" of them with recons, and "rolled forward" those positions by entering more forward strip exchanges. 15/ This

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15/ James Rizzi confirmed that, prior to September 1993, Jett maintained strips in inventory. However, Rizzi's testimony (continued...)

essentially delayed "settlement" of "a large portion of the strips" so that the balance sheet increased gradually during the intra-quarter period rather than causing a balance sheet "spike." 16/

Finally, Jett states that he developed the idea that for each "balance-sheet-related" forward strips exchange he entered, he would enter on the same day "a smaller-sized recon transaction further forward," typically a "90 day recon." Jett's purpose, he says, was to "offset" or "neutralize" the reported up-front trading loss from each forward strip exchange -- "a large loss unrelated to his trading strategy" -- with a reported up-front trading profit from each forward recon. Jett makes no pretense that he bought and held the strips associated with these recons; the recons were purely a device to manipulate reported P&L.

The Division presented evidence that Jett continued to use forward recons to generate large illusory trading profits during this period. The Division's evidence shows that Jett engaged in a pattern of entering a long-dated recon, followed by a shorter-dated strip exchange of the same bond and same amount. The strip served to temporarily cancel out the positions created by the recon in Jett's trade date inventory but not much of the fictitious profits

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15/(...continued)
about the high level of Kidder's requests to Bank of New York during the summer of 1993 to borrow securities indicates that the dollar value of Jett's real strips positions was not commensurate with the dollar value of Jett's open recon instructions. Rizzi also testified that, beginning in September 1993, Jett's inventory generally conformed to Jett's description of his activities during the balance sheet reduction period, i.e., his long strips positions were reconned to bonds, and the original strips positions were reestablished by means of a forward strip exchange. After September 1993, most exchanges in the G1 ledger were paired off, unless Jett told Rizzi otherwise.

16/ Due to mistakes in the timing of pair-offs, some fluctuations did occur. Kidder's balance sheet and asset fluctuations were discussed at meetings of the firm's Inventory Committee. Cerullo, a Committee member, testified that he believed Jett was using forward-settling trades to reduce the balance sheet. According to Cerullo, the use of forward exchanges with the Fed for that purpose was never brought to his attention and was not discussed at Inventory Committee meetings or at any other time. He said paperwork prepared for the meetings did not alert him to the role of forward exchanges because data about them was "buried in a two inch thick packet of documents and numbers."

generated by the recon. This would be followed by a succession of shorter-dated strip and next-day settling recon exchanges.

Contrary to Jett's claim that he entered forward recons merely to "neutralize" losses from forward strip exchanges, the evidence shows that his forward recons resulted in large, illusory profits on Kidder's books and records. His use of exchange instructions during this period let him continue to generate large enough fictitious trading profits to minimize or offset his reported trading losses (from real trades and from previously entered forward exchanges), until the balance sheet effort would end and he could resume his original plan unimpeded. Jett could report a large illusory trading "profit" in the short term from the strips and recons, even assuming he perfectly matched the up-front reported trading loss from each strip with the up-front reported trading profit from the smaller, longer "offsetting" recon, and even assuming those were the only forward recons he entered during the period. 17/

The dollar value of new forward recon and strip instructions at Kidder rose from $50 billion in August 1993 to $664 billion in March 1994. Unsettled recons and strips increased from $38 billion at the end of August 1993 to $112 billion at the end of February 1994. In this period, 92% to 97% of the forward recon and strip exchanges were paired off, making it unnecessary to obtain strips or bonds for delivery to the Fed. In fact, settlement would not have been possible: for one kind of 11.75% bond during this period, the number of recon instructions entered in the G1 ledger and open at the same time would have required the purchase of more strips than existed worldwide, and the number of strip instructions would have required the purchase of more bonds than existed.

17/ Under Jett's own description of his recon and strip activity, the "offsetting" forward recons counteracted a key feature of forward strips -- the up-front trading loss reported when a forward strip is entered (on the "trade" date). With the up-front loss from the forward strip "offset" by the up-front profit from the forward recon, Jett was left to enjoy the incremental reported trading profits that a forward strip generates each day after the "trade" date and until its "settlement" date (which add up to the up-front losses). These "profits," reported over the short life of the strip, would far exceed the incremental trading "losses" reported each day over that same period by the far longer-term "offsetting" recon. Indeed, it would take months after the "settlement" date of each strip exchange before the sum of the losses thrown off day by day by the corresponding recon would finally catch up with the profits generated by the strip.

The forward exchange activity during this period had a tremendous P&L impact. The G1 ledger reported total profits of about $142.1 million between September 1993 and March 1994. This number reflected approximately $193.2 million in net imaginary "profits" from recon and strip exchanges minus a net loss of approximately $51.1 million from real trading and interest.

In 1993, the effect of Jett's recon and strip exchanges on the firm's P&L was huge. By year's end, profits for the STRIPS desk were $150.7 million, nearly five times the profits in 1992. The desk's profits derived from approximately $198.2 million in illusory profits from unsettled recon and strip exchanges minus a net loss of approximately $47.5 million from real securities and futures trading in the market and from net interest on settled positions. The STRIPS desk's profits accounted for approximately 27% of the entire profits of the Fixed Income Division, a division of 700 employees and twelve separate trading desks.

In recognition of Jett's reported highly successful results, he was awarded a $9.3 million bonus in 1993 and was named Kidder's 1993 "Man of the Year."

F. Recon and Strip Instructions and Illusory Profits Increased Dramatically Over Jett's Tenure at Kidder and Disguised the Failure of Jett's Actual Trading

During Jett's employment at Kidder, new Fed exchanges entered each month at the firm grew from about $2 billion in December 1991 to $664 billion by March 1994. The net reported profit for the G1 ledger between July 1991 and March 29, 1994 was over $264 million. This included nearly $338.7 million in illusory profits associated with unsettled recon and strip exchanges entered on GT.

Without these "profits," the ledger actually suffered a net loss of $74.7 million in real securities and futures trading and net interest. Indeed, the reported trading and interest revenue from these exchanges was so great that the G1 ledger constituted between 16% and 31% of the total revenue for the Fixed Income Division between late 1992 and March 1994.

As Jett implemented his "trading strategy" from November 1991 into March 1994, greater losses from his real trading (and from previously entered forward recons) invariably coincided with greater volume and average size of his forward exchanges. 18/ In this way,

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18/ Jeffrey Bornstein, the GE Internal Audit Manager who supervised
(continued...)

Jett was able to mask losses from his real trading and from his open recon instructions. When Jett's real trading was profitable, he entered fewer new forward recons and did not offset all of the losses from his open recon instructions.

G. Jett's Facade of Profitability Collapses, Revealing $75 Million in Losses Instead of $264 Million in Profits

By early March 1994, Bernstein noticed that reported profitability in strips trading had increased significantly in January and February 1994, in step with the huge increase in the "pair off roll forward" transactions. At about the same time, Cerullo asked Bernstein to investigate Jett's trading because he was concerned that Jett's tremendous profits in January and February 1994 might be due to taking unacceptable risks.

Bernstein's initial research showed that there were very large unsettled forward strip and recon positions; he wondered whether Kidder would be able to settle these positions and whether there was a link between them and the tremendous recorded P&L. Bernstein gave preliminary findings of his investigation, which included these concerns, to Cerullo. Cerullo maintains that it was not until this communication from Bernstein that he learned about Jett's large volume of forward Fed exchanges.

Bernstein and Cerullo met with Jett during the second week of March to determine the reasons for the forward recons and strips. According to Bernstein, Jett claimed that he rolled the exchanges forward because the arbitrage profit (the difference between the value of the strips and the whole bond) still existed when the "settlement" date arrived so Jett "would perpetuate the position by rolling it forward." Jett also told them that he executed "pair off roll forward" exchanges to obviate the necessity of obtaining the securities. According to Bernstein, Jett did not assert at that time any connection between his use of forward exchanges and the balance sheet reduction effort. Some offsetting forward recon and strip exchanges were eliminated at this time over Jett's objections.

Bernstein testified that, after further investigation, he concluded that there was an automatic up-front profit effect from

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18/(...continued)
the reconstruction of Jett's trading and recon/strip activity at Kidder, testified that there was a strong inverse correlation of -.87 between Jett's actual profits and his fictitious profits (with 0 representing no correlation and 1 or -1 representing a perfect direct or inverse correlation).

entering a forward recon exchange into GT and an automatic up-front loss from entering a forward strip exchange. He determined at that point that there was more than $300 million in "profits" from the forward exchanges with the Fed and so informed Cerullo. He also spoke with Jett near the end of March, telling him of Cerullo's concern with these "profits" and gave Jett a report summarizing his analysis of Jett's trading.

At about this time, Jett told Cerullo that he entered forward recons with the Fed for three reasons. First, he deferred exchanges to give the back office sufficient time to obtain the underlying strips. As a general matter, however, the repo desk did not have difficulty obtaining the strips, and when it did, it told the trader to "pair off" the exchange. Second, Jett claimed that he was directed by Bernstein to roll trades forward in order to reduce the balance sheet; Bernstein denied this to Cerullo. Third, Jett stated that he entered forward recons to recoup losses that he incurred from the balance sheet reduction effort. Cerullo apparently realized from this last explanation that Jett understood that merely entering a forward recon resulted in an automatic up-front profit.

Jett and senior Kidder management then had several meetings. In a March 29, 1994 meeting with Richard O'Donnell (Kidder's Chief Financial Officer or "CFO"), Bernstein, Charles Fiumefreddo (an accounting manager), and others, Jett claimed that he initiated his "pair off roll forward" approach at the end of the third quarter 1993 as part of the balance sheet reduction process. But Bernstein claimed that he did not understand how the forward exchanges he was reviewing were related to that effort. Jett also asserted that Bernstein and Fiumefreddo had approved the accounting treatment for forward strips and recons in May-June 1993 and had set a 90-day forward limit on these trades (in fact, no recons were entered in the G1 ledger more than 95 days forward after May 17, 1993). Bernstein denied this. Jett did not dispute Bernstein's conclusions, articulated at the meeting, about the P&L distortion of Jett's forward exchanges.

In late March 1994, Cerullo directed Jett to settle or pair off his forward Fed exchanges to remove the positions from the firm's records. When the forward exchanges were removed from the G1 ledger through pair-offs, large losses were generated (as Bernstein had predicted). Cerullo was "devastated" when he learned that eliminating the forward positions with the Fed resulted in a shortfall of over $300 million. He concluded that Jett's trading performance was an accounting illusion with no economic substance.

As part of the ongoing inquiry into Jett's trading, CFO O'Donnell met with Jett on April 1, 1994. Jett claimed then (and now) that he "hedged" the forward recons by buying the underlying strips, which "locked in" the up-front profit, that Bernstein and Fiumefreddo approved of the accounting treatment for forward recons in 1993, and that he was directed to enter forward Fed exchanges to reduce the balance sheet. Jett also asserted that the "trades" with the Fed were "real" in the sense that actual securities were bought and sold in the market. He tried to allay concerns about Kidder having to take a write-off by noting that the firm would not have to make a large cash payment to the Fed when his positions were collapsed. Jett acknowledged that he only "presumed" that Cerullo knew his trading approach and admitted that he did not discuss his precise trading strategy with Cerullo. Jett could not explain which trades hedged which other trades in his "trading strategy."

On April 11, 1994, Jett sent three memoranda to Cerullo. He conceded that a "naked" or "unhedged" forward recon (without the purchase of the underlying strips) would generate ephemeral profits. But he claimed that no negative accretion resulted from a forward recon "hedged" with the purchase of strips. He also claimed that he hedged the reconstituted bond (to be received from the forward recon) with the sale of futures contracts. In the memoranda, Jett minimized the potentially significant costs of financing the strips and of hedging with futures contracts.

On April 14, 1994, at another meeting with O'Donnell, Cerullo, and in-house counsel, Jett again conceded that a "naked" forward recon "trade" would generate ephemeral profits, but argued that there was no negative accretion if the underlying strips were purchased, in which case the only issue would be the cost of financing the strips. He again asserted that Bernstein and Fiumefreddo approved the accounting treatment for forward exchanges in 1993. He also admitted that he intentionally entered forward recons to record "profits" to offset reported losses that he incurred when Bernstein directed him to reduce the balance sheet by entering forward strips. Jett claimed that he did not consider forward recon or strip exchanges with the Fed to be any different from "real" counterparty trading. Jett did not claim that Cerullo knew his trading strategy.

Kidder fired Jett on April 17, 1994. GE, Kidder's parent company, took a one-time $210 million after-tax charge ($350 million before taxes) in the first quarter of 1994 against its net earnings because of what it alleged to be fictitious unrealized profits recorded by Jett.

III. ANTIFRAUD VIOLATIONS

The Division alleges that Jett committed securities fraud. The Division argues that Jett generated non-existent, unrealized (and unrealizable) profits by exploiting an anomaly in Kidder's computer and accounting systems and entering new forward recons into GT in a pyramid-like fashion that concealed losses from real trading and from previously entered forward recons. At the same time, the Division contends, Jett claimed to his colleagues and supervisors at Kidder that he generated his profits from legitimate trading strategies. Thus, Kidder was deceived about Jett's use of forward recons to generate "false" profits.

Jett contends that he engaged in a legitimate strips "trading strategy" that created real, if "advanced," profits essentially equal to the unaccrued interest on the bond through the "settlement" date. Jett claims that information about his forward exchanges was disclosed to others at Kidder by him or in firm reports. He argues that, because "his sophisticated supervisors believed" his strategy was legitimate, it was not a fraud; because others knew about it, there was no deception; and because he believed it was legitimate and that others knew about it, he had no fraudulent intent.

A. <u>Jett's "Trading Strategy" Was a Scheme To Defraud</u>

We find that Jett employed his forward recon and strip "trading strategy," with some variation, at Kidder beginning in November 1991 and ending in March 1994, to record illusory profits. As such, Jett's strategy was a "device, scheme, or artifice to defraud" within the meaning of Securities Act Section 17(a). It was also a "deceptive device or contrivance" under Exchange Act Section 10(b), and constituted a "device, scheme, or artifice to defraud" under Exchange Act Rule 10b-5.

When all is said and done about the particulars of the STRIP program, Jett's recon and strip instructions, and the interplay of those instructions with Kidder's internal systems and with his real trading, the simple fact is that his "trading strategy" was a means of deceiving the brokerage firm that employed him about the profitability of his securities trading. Jett orchestrated the deception through a sequence of exchange instructions that he formulated and entered into Kidder's computer system and through his false and misleading explanations of the source of his "profits."

Specifically, Jett recorded in Kidder's books a series of "forward" exchanges with the Fed that might or might not occur. Although merely a series of administrative conversions without economic substance that did not, in themselves, generate either a real profit or a real loss, they nonetheless would appear to be real purchases and sales to Kidder's computer system and would cause it to report a large, sustained trading profit.

We agree with the Division that Jett used instructions for forward Fed exchanges to generate fictitious trading profits, and entered new exchanges "in a pattern and frequency which preserved the appearance of existing false profits, concealed actual trading losses, and created the false appearance of incremental increases in profitability." When asked about the source of his record profits, Jett attributed them to legitimate trading activities, or described Fed exchanges in a confusing manner using trading terminology.

By means of his strategy, Jett invented or greatly inflated the reported trading profits that Kidder used to determine his salary, his bonuses, his promotions, the amount of capital he was permitted to commit on the firm's behalf, and his standing at the firm. Jett took full credit for these profits, and reaped the rewards. Having failed to succeed based on his actual trading performance, Jett was suddenly a success story. Like a pyramid scheme, Jett's "strategy" accelerated and escalated, demanding more and more effort to sustain it and perhaps reaching levels beyond anything even Jett initially contemplated. Jett's scheme worked like a charm until Kidder learned that his paper profits grossly distorted economic reality by showing profits of over $264 million when, in fact, there were losses of $74.7 million.

1. <u>Jett's strategy created illusory profits</u>

Contrary to Jett's contentions, the profits reported on GT from his forward recons and strips were not an accurate measure of the profits, if any, from his activities. At times, Jett does not even seem to contest that he booked hundreds of millions of dollars of "profits" that should never have been reflected on Kidder's books and that inevitably would have to be written off.

Jett seeks refuge in Kidder's computer system and in semantic characterizations of exchanges with the Fed as real trades. Jett asserts that he was simply using Kidder's computer system, like any other trader of government securities at the firm. Kidder's system, he says, treated exchanges with the Fed as real counterparty trades. He defends GT's feature of recording up-front profits on forward recons by saying that Kidder was entitled to use whatever system it wished "for its internal calculation of P&L for trades," and GT's feature was "a legitimate internal accounting system that does not meet the criteria of GAAP." In his view, "Kidder management elected not to follow GAAP procedure in their treatment of profit." He argues that during the balance sheet reduction period he was simply following orders to reduce his balance sheet inventory.

However, exchanges with the Fed are not real revenue-generating trades. To a point, GT facilitated their treatment as real trades by allowing Jett to enter a "trade" date and "settlement" date and reporting an up-front trading profit or loss when each was entered. But Kidder's system corrected for that treatment by the formula it used to calculate the reported "trade" date profit for a forward recon (or loss from a forward strip) and by whittling that P&L down, day by day, with incremental reported trading losses (or profits for a strip), until the P&L disappeared on "settlement" date.

Jett counteracted that feature by flooding GT with more, bigger, and longer recons, so the up-front "profits" from new recons would exceed the "losses" thrown off by previously entered recons. Jett's own description of his activities during the balance sheet reduction period shows that Jett, in effect, suppressed the reported up-front "loss" from a forward strip by entering a smaller, far-forward recon and then enjoyed the "profits" thrown off by the strip. Kidder could hardly have intended this gaming of its system. Unlike any random trader who happened to "use[] the machine," Jett pursued a purposeful strategy that deceived the firm on a grand scale. 19/

During the course of his fraud, Jett attributed his profits to a combination of traditional strategies, such as arbitrage opportunities, increased market making activities, and speculation on the movement of interest rates ("playing the yield curve"). When this was revealed to be untrue, Jett argued that he had devised a "novel" three-part "arbitrage" trading strategy, to which, as a "rational trader," he committed increasing resources. However, the results of Jett's purported three-part trading strategy would bear no resemblance to the up-front profits he was generating and perpetuating in Kidder's profit reports.

Jett described his "novel" three-part "arbitrage" trading strategy as: (1) a forward recon; (2) the purchase of a collection of strips to "hedge" the forward recon; and (3) the sale of bond futures to hedge the price of the reconstituted bond at "settlement." He asserts that, by acquiring the securities that would be delivered on the "settlement" date to the Fed, he both

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19/ Jett claims that there were legitimate business or operational reasons to use a longer "settlement" date for his forward exchanges, such as to accommodate customers or to provide enough time to obtain the strips for delivery to the Fed. In fact, the repo desk generally had little difficulty obtaining strips within two business days, and Jett did not pursue his forward recon and strip strategy at the instance of customers.

covered the "short" strips position and "locked in" the profit recognized on the "trade" date. The increase in value of the newly acquired strips supposedly would offset the "losses" through negative accretion of the "short" position. As a result, according to Jett, the "profits" recorded on GT from forward recons were "accelerated," not "false." 20/

In fact, Jett's three-part strategy was actually a two-part strategy, because, as discussed above, no real profits could come from a recon itself. As for the remaining two parts of the strategy, the record is clear that the profit potential from a long strip combined with the sale of a bond future was limited.

As explained by the Division's expert, Dr. Richard Klotz, the significant costs of financing the underlying strips and hedging the strips or bond by selling bond futures would essentially offset the positive accretion from buying and holding strips. Accretion of the strips' prices and the losses from selling bond futures are both determined by the difference between long term and short term interest rates. Because long term interest rates tend to be higher than short term rates, the positive accretion on a long strips position generally will exceed the cost of financing. But hedging incurs the additional cost of taking an offsetting position in equivalent or similar

20/ In addition to dressing up his exchanges with the Fed in the language of real trades, Jett also draws a false analogy between exchanges and municipal defeasance trades. In the latter, a municipality makes forward-settling purchases of strips whose maturity dates match the payment schedule of municipal debts in order to pay off (defease) those debts. In 1993, dealers could profit by purchasing strips cheaper than they sold the strips forward (at current yield) to the municipalities; because these were forward trades, there was an attendant cost of carry. Unlike forward recons, however, municipal defeasances were real forward-settling trades with real counterparties.

securities to balance potential losses in the market value of the hedged securities. 21/

Dr. Klotz noted that Jett's strategy (as outlined in Jett's April 1994 memoranda to Cerullo) failed to show any costs from the sale of futures contracts and minimized the effects of the costs of financing strips on Jett's P&L. 22/ The income hypothesized by Jett -- derived from owning the underlying strips for the entire period of a forward recon and corresponding to the recorded up-front "profit" from the recon -- would be virtually eliminated by the offsetting costs of financing the strips and hedging the settled inventory. 23/

21/ Before the law judge, Jett dismissed Dr. Klotz's testimony on hedging costs as "irrelevant" because Cerullo, "an experienced futures trader," "knew Mr. Jett used futures" for hedging purposes and did not "criticize[] the practice." The issue is not whether selling futures contracts as a hedging device for long bond positions can serve a legitimate function in trading with others in the market. The point is that Jett's strip and recon instructions were not market trading. Moreover, hedging generally will cost traders money because a futures contract's price will tend to rise toward expiration in the usual situation in which short-term rates are lower than long-term rates. In that case, the futures seller loses the amount by which the futures contract increases in price. Jett's assertion on appeal that "[f]utures contracts are beyond the regulatory authority of the SEC" evades the issue. Recognition of the part futures contracts play in a securities fraud scheme does not constitute regulation of such contracts.

22/ Not even Jett's expert, Ernest Ten Eyck, thought that the profit from Jett's "three-part strategy" could have been as high as Jett claimed.

23/ Moreover, Jett's three-part strategy depended on generating profits from buying and holding securities. Jett concedes that Kidder would have "strongly discounted" or disregarded interest earned on his settled inventory (what he apparently terms "financing profits") in assessing his trading performance and determining his bonuses. Kidder hired Jett to trade government securities, not to make "the focal point" of his activities buying securities with borrowed money and holding them in inventory for extended periods of time. Not surprisingly, Jett only articulated his three-part strategy to his supervisors under intense scrutiny in his final days at the firm.

The record confirms Dr. Klotz's analysis. The vast majority of the time, Jett's real trading produced results far worse than his reported trading profit (which included illusory profits from instructions for forward Fed exchanges). There was a strong inverse correlation between Jett's results from real securities and futures trading and net interest, on the one hand, and the illusory trading profits he generated by entering forward Fed exchanges into GT, on the other. Clearly, the imaginary profits generated by his exchange instructions masked his actual, disappointing results.

Accordingly, we find that Jett used his forward strip and recon "trading strategy" to record illusory profits. 24/

24/ We reject Jett's submission of two exhibits attached to his reply brief on appeal: the transcript of one day of Jett's testimony in the NASD arbitration proceeding between Kidder and Jett, and a chart purportedly derived from Kidder's FI-10 reports. Jett claims the chart shows that "on August 25th 1993 [he] could have liquidated his entire trading position with no profits or loss impact." The exhibits were not admitted into evidence before the law judge, and the Division opposes their admission now. Jett did not file a motion for leave to adduce additional evidence under our Rule of Practice 452, nor does he explain the exhibits' materiality or demonstrate any grounds for his failure to introduce them before, as the Rule requires. Moreover, to admit a portion of a transcript from another proceeding without knowing its context -- and without an opportunity for cross-examination by the Division -- would not meaningfully aid our review. Finally, Jett has provided no foundation for the numbers in the chart. For the same reasons, we have also not accepted into the record a visual aid reflecting hypothetical trades distributed by Jett at oral argument.

2. Jett deceived Kidder about his performance as a securities trader and the source of his "profits"

We find that Jett's purported trading strategy deceived Kidder about the profitability of his securities trading. Jett created and implemented a scheme that exploited an anomaly in Kidder's computer system. The scheme generated "profits" on the firm's books that transformed Jett's failed securities trading into an apparent success. As a result, Kidder doubled Jett's salary, promoted him, and paid him multi-million-dollar bonuses. These "profits" misrepresented Kidder's financial condition on firm books, records, and regulatory filings, and would have to be written off, at firm expense. When inventory constraints during the balance sheet reduction effort impinged on his scheme, Jett himself claims he adapted it by developing and implementing the idea of "offsetting" recons, which allowed him to continue to book illusory profits. This was a scheme devised and orchestrated by Jett for his benefit.

Jett argues that he disclosed the facts about his "trading strategy" to Mullin, Cerullo, some of their subordinates, such as Bernstein, and an internal auditor, that they could have learned the facts from various firm documents or reports, and that they benefitted from the profits Jett booked. 25/ Mullin, Cerullo, Bernstein, and the auditor testified that they did not know about Jett's scheme. The Division argues that Jett's representations to others constituted more deception and that the documents and reports did not alert others to the nature and source of Jett's "profits."

The law judge found the Division's witnesses to be more credible than Jett's contrary claims. Specifically, the judge found that neither Jett's supervisors nor the firm understood the source of Jett's "profits." Further, the judge found that "Jett knew that Kidder had not approved and did not know the source of his profits."

Based on our own de novo review, we find that Jett deceived the firm. In making this finding, we by no means suggest that others at Kidder are without blame with respect to Jett's activities. As noted at the outset of this opinion, the Commission found in separate settled orders imposing sanctions that Jett's supervisors, Mullin and Cerullo, failed reasonably to supervise Jett with a view

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25/ Mullin and Cerullo received bonuses based, in part, on Jett's "profitability." In fact, Cerullo received a bonus of $11.4 million in 1992 and $15.4 million in 1993. The severance payment Kidder made to Cerullo upon his July 1994 resignation was reduced to offset compensation he received based on Jett's activities.

to preventing his securities law violations. Nor do we suggest that Kidder, which had ceased to exist by the time of those sanctions, acted in an exemplary fashion. Rather, our finding concerns Jett's own culpability and is that Jett defrauded the firm.

Like the law judge, we think that on these facts it is highly implausible that numerous Kidder personnel fully understood Jett's strategy, as he asserts, but let hundreds of millions of dollars in imaginary profits build up and continue to grow over time until, inevitably, they were revealed, with predictably negative consequences for Kidder's (and its parent GE's) balance sheet. Moreover, we have exhaustively examined the record and the Division's and Jett's conflicting claims regarding what Jett told others, what his statements meant, what various documents or data conveyed, and what the others at the firm understood. 26/ We give

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26/ As relevant to this dispute, Jett and the Division cite, among other things: conversations between Jett and Mullin and Cerullo; Bernstein's May-June 1993 inquiries of Jett, certain documents prepared then, and their December 1993-January 1994 conversations about the balance sheet reduction effort; meetings of Kidder's Inventory Committee during that effort; an August 1993 through January 1994 internal audit of the Zero Coupon Desk; a late 1993 conversation between Jett and the Fixed Income Division's risk manager; Jett's December 1993 conversation with a Kidder accountant; Jett's January 1994 speech before Kidder's management counsel as 1993 "Man of the Year"; and regulatory reports to the Fed and Fed inquiries during the period June 1993 through February 1994.

Jett places great weight on two sets of materials that are unreliable or of especially limited probative value. First, Jett cites numerous entries in what he claims is a computerized diary of his activities at Kidder after March 1993. Some entries are undated, and some have entry dates that are obviously inaccurate. Most of the entries Jett cites do not appear in another version of the diary, left at Kidder after Jett's departure; nor do they meet the criteria Jett claims he used for excluding information from the other version, i.e., they are not of a personal or offensive nature. The law judge admitted both diary versions into evidence, but gave no evidentiary weight to entries in either version "insofar as they support [Jett's] version of disputed facts." We agree.

Second, Jett cites certain notes of interviews with Kidder employees conducted by Kidder's outside counsel during Kidder's

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considerable weight to the law judge's credibility determinations, which are based on hearing the witnesses' testimonies and observing their demeanor. 27/

The evidence shows that Jett claimed to others that his huge profits derived from various forms of legitimate trading, including "making [the] bid/offer spread," "making markets for customers," increasing "the volume of customer business," trading in the long (30-year) bond, basis and yield curve trading, and strip/recon "arbitrage." Jett even asserted that "every which way in which the [yield] curve could move, we're on the right side of the spread relations." Jett never mentioned that GT recorded profits automatically on the trade date when he entered a forward recon, or otherwise identified the so-called "time-related" component of his purported arbitrage trading strategy. Nor did Jett ever, until the investigation of his activities in late March 1994, adequately explain his "three-part strategy."

Jett also attempted to hide his scheme from detection by mischaracterizing his recon/strip activity as arbitrage. Legitimate arbitrage trading involving similar or related financial instruments takes advantage of price disparities between them. However, when Jett used the term, he was not referring to the (legitimate and generally modest) difference between the value of the sum of strips and the whole bond bought and sold simultaneously. Instead, he misapplied the term to claim that he was capturing the gains recorded from the forward nature of the recon, the so-called "time-related element." Jett insisted at the hearing that "forward recons are strip recon arbitrage" and claimed it was "general knowledge" that his arbitrage trading included forward recons. This is not a customary use of the term "arbitrage." Exchanges with the Fed were not economic events from which profits or losses could be achieved. The evidence indicates that Jett's colleagues at Kidder did not understand Jett's unusual use of the term.

26/(...continued)
investigation into Jett's activities. Some notes Jett cites were not entered into evidence. We have considered those that were, but have limited their probative value based upon the degree of hearsay, the clarity of the statements, whether the statements are contradicted or corroborated by other evidence, and whether the declarant was available to testify. See Charles D. Tom, 50 S.E.C. 1142, 1145 (1992).

27/ See, e.g., Universal Camera Corp. v. NLRB, 340 U.S. 474, 494-96 (1951); Russo Securities, Inc., 53 S.E.C. 271, 275-276 n.7 (1997).

Jett consistently misstated the nature of his purported trading strategy when he claimed that the purchase of the underlying strips "hedged" his forward recons. "Hedging" is the practice of executing offsetting trades that minimize the investment risk of a particular financial instrument or obligation. Kidder incurred no financial obligation by entering a forward recon, since the Fed did not enter into forward agreements to recon or strip a bond. Thus, buying the underlying strips did not "hedge" an existing obligation or position. Rather, Jett's strategy used forward recons as an accounting ploy to record as "profits" on the "trade" date an amount equal to the anticipated accrued interest or price accretion that would be achieved by actually owning a set of strips.

Jett led Mullin to believe that Jett's increased profits were due to expanding customer business and growth in strip/recon arbitrage trading. Cerullo believed a steep increase in profits was not unusual in fixed income trading. He testified that Jett told him that Jett's profits derived primarily from "market making" in the long (30-year) bond and strips, building up a distribution network and increasing Kidder's customer business, and exploiting price differences among strips, the whole bond, and futures. Hearing what sounded like a commercially viable and sustainable trading strategy, and not suspecting fraud, Cerullo, like Mullin before him, accepted what Jett told him. 28/

Furthermore, contrary to Jett's claims, the nature of his "profits" was not readily apparent from firm reports. Various firm reports and documents contained detailed information that identified a forward recon and from which the P&L impact could have been derived. The Red Books were accessible and showed the existence of forward exchanges with unusual settlement dates that were booked weeks forward. However, anyone reviewing the documents that contained the most detail about forward exchanges with the Fed would have needed to know the internal account numbers used by Kidder to designate these forward exchanges to understand that the entries did not reflect real trades. Moreover, those who presumably understood

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28/ At various times, Cerullo assigned internal staff to inquire into Jett's activities. However, these reviews focused not on whether Jett's reported profits were real, but instead on other matters, such as whether Jett was assuming excessive risks to achieve his results. Proper supervisory vigilance in the face of red flags, like Jett's extraordinary reported profits, requires not only assigning people to ask questions, but carefully considering what are the right questions to ask, and carefully analyzing whether the answers provided are supported by the facts.

the significance of the account numbers (such as his supervisors) rarely reviewed these detailed documents. Finally, because there were as many as 61 separate components to a stripped bond, calculation of the P&L impact would have been very cumbersome.

The evidence shows that Kidder personnel responsible for what Jett was doing (namely, Mullin and Cerullo) did not pay attention to the details of his activities, and the person who did pay some attention (Bernstein) did not have the trading expertise to be able to understand what Jett was doing. 29/ None of them understood the P&L impact of the forward exchanges or that forward recons were entered to post a "profit" to offset purported "losses" caused by rolling positions forward.

Accordingly, we find that Jett deceived Kidder about the profitability of his securities trading.

B. Jett Acted With Scienter

We find that Jett acted with scienter. Scienter for purposes of the antifraud provisions is "a mental state embracing intent to deceive, manipulate, or defraud." 30/ This includes recklessness, defined as "an 'extreme departure from the standards of ordinary care, . . . which presents a danger of misleading buyers or sellers that is either known to the defendant or is so obvious that the actor must have been aware of it.'" 31/ Jett was at least reckless in not knowing that the phenomenal trading profits that he recorded, and for which he was richly rewarded, were illusory.

Jett knew that, in order to stay employed, he had to make up for his initial lackluster trading performance. He knew that his performance was evaluated based on recorded trading profits.

Jett acknowledged at the hearing that he knew that a forward recon or strip was a non-negotiated exchange with the Fed of essentially equivalent securities. His post-hearing brief makes clear that he knew that "the strips can be converted into the bond by a recon at any time." Jett was aware of the anomaly in GT that allowed him to enter a Fed exchange as a purchase and sale of

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29/ Indeed, Bernstein had to conduct an in-depth investigation in March 1994 before he understood the source of Jett's reported profits.

30/ Ernst & Ernst v. Hochfelder, 425 U.S. 185, 193 n.12 (1976).

31/ SEC v. Steadman, 967 F.2d 636, 641-42 (D.C. Cir. 1992).

securities, with a "trade" and "settlement" date, taking place over an extended period of time, and to generate a "trade" date "profit" or "loss" from the exchange. Jett also knew that this reported profit or loss was ephemeral. Kidder's system adjusted it downward day by day until it disappeared. Jett must have known that he was generating huge illusory profits that were of no legitimate or lasting economic value to the firm.

Jett discovered how to manipulate reported P&L from his forward exchanges by increasing the size, coupon rate, and length of time until "settlement"; he could see the resulting profit impact on GT almost immediately. Jett admits that during the balance sheet reduction period he systematically entered forward recons that he had no intention of completing, solely to manipulate recorded P&L. During that period, Jett entered so many forward exchange instructions into GT that the volume of component strips of a particular bond to be reconstituted or of bonds to be stripped exceeded the world-wide availability of the securities. The evidence shows that Jett consciously used his forward recon scheme to mask the failure of his real trading and the losses generated by previously entered forward exchanges.

Furthermore, no trader with Jett's experience and asserted "extensive knowledge of the market" could have believed that profits of the size he was generating could result from a virtually no-risk "trading strategy" sustained over such a long period. In fact, Jett admitted that he knew that the strips market was very liquid and competitive and that it afforded limited opportunity for profits.

Jett argues that his activities at Kidder were inconsistent with an intent to commit fraud. He points out, for example, that he kept his compensation in a personal account at Kidder, opposed the auditors' recommendation that individual passwords be assigned to limit access to GT, and gave full access to his desk and traders during the internal audit.

Based on our review of all of the evidence, we disagree. Jett knew that there was no permanent record on GT that showed the P&L impact of individual forward exchanges or that segregated his positions between true counterparty trading and recon and strip exchanges with the Fed. No firm report clearly indicated the profit or loss impact of his forward exchanges.

Moreover, Jett consistently attributed his trading profits to a combination of legitimate trading strategies, including customer and arbitrage trading, and misused common trading terms, such as "arbitrage" and "hedging." In conversations with Kidder employees, he discussed Fed exchanges as though they were no different than real counterparty trading. Jett hedged with futures contracts, allowing him to tell a Kidder accountant that "every which way the [yield] curve could move, we're on the right side of the spread relations" and to deflect concerns at the firm about risk exposure from his activities. In this way, Jett was able to confound and deceive non-traders, in particular, who inquired about his activities and who failed to question the legitimacy of the strategy and profits of a senior (and well-regarded) trader.

Even if, contrary to the record, Jett's supervisors and co-workers knew about his fraud on the firm -- indeed even if they ordered him to commit it -- that would not relieve Jett of responsibility for what he knew or was reckless in not knowing and for what he did. Jett took advantage of an unintended loophole in Kidder's computer and accounting systems to gain ongoing employment, promotions, raises, and large bonuses. These benefits were based on reported trading profits that he had to know were false. There is ample evidence that Jett acted with scienter.

C. Jett's Fraud Involved the Purchase and Sale of Securities Under the Antifraud Provisions

Jett's scheme to defraud was "in the offer or sale of" securities under Securities Act Section 17(a) and "in connection with the purchase or sale of" securities under Exchange Act Section 10(b) and Rule 10b-5 thereunder. Jett engaged in real counterparty trading, and, when that was unsuccessful, he entered non-trade exchanges with the Fed into Kidder's computer system to create the illusion of real trading profits, which caused Kidder to buy securities to effectuate the exchanges. His fraud thus involved actual and purported purchases and sales within the meaning of the antifraud provisions of the federal securities laws.

Fraudulent schemes such as Jett's are a matter of serious concern to the federal securities laws. In United States v. Naftalin, 32/ the Supreme Court laid to rest any doubt that schemes directed against broker-dealers can constitute securities fraud. Although "[p]revention of frauds against investors was surely a key part of [the 1933 Act], so was the effort to 'achieve a high standard of business ethics . . . in every facet of the securities industry.'" 33/ The Court explained that "[t]he welfare of investors and financial intermediaries are inextricably linked --

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32/ 441 U.S. 768 (1979).

33/ Id. at 775 (quoting SEC v. Capital Gains Research Bureau, 375 U.S. 180, 186-87 (1963)).

frauds perpetrated against either business or investors can redound to the detriment of the other and to the economy as a whole." 34/

Specifically, "[l]osses suffered by brokers increase their cost of doing business, and in the long run investors pay at least a part of this cost through higher brokerage fees." 35/ The fraud can harm owners or investors of the broker-dealer, or customers making investments through the firm, by deceiving them about its true financial condition. If the losses are large enough, they can cause the entire firm to fail. The fraud can also affect the market supply of, and demand for, securities that are involved.

When "fraudulent practices" and the "purchase or sale" of securities are "not independent events" but instead "coincide," they are sufficiently related to give rise to liability for securities fraud. 36/ Jett's fraud coincided with "purchases or sales" in at least four ways. 37/

First, Jett caused Kidder to purchase securities to effectuate his exchanges with the Fed. When Jett entered a forward recon or strip instruction into GT -- the same activity that generated his automatic up-front profits or losses -- Kidder's repo desk bought the strips or bonds necessary to conduct the exchange with the Fed

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34/ Id. at 776; see A. T. Brod & Co. v. Perlow, 375 F.2d 393, 396-397 (2d Cir. 1967).

35/ Naftalin, 441 U.S. at 776.

36/ SEC v. Zandford, 535 U.S. 813, 820, 822 (2002).

37/ Although we decide this case based upon the standard set forth in Zandford, we do not read Zandford to establish a single standard for determining when the "in connection with" requirement is satisfied. For example, the requirement is also satisfied when a misrepresentation is made "in a manner reasonably calculated to influence the investing public." SEC v. Texas Gulf Sulphur Co., 401 F.2d 833, 862 (2d Cir. 1968)(en banc), cert. denied sub nom. Coates v. SEC, 394 U.S. 976 (1969); accord McGann v. Ernst & Young, 102 F.3d 390, 392-96 (9th Cir. 1996), cert. denied, 520 U.S. 1181 (1997); Britt v. Cyril Bath Co., 417 F.2d 433, 435-36 (6th Cir. 1969). As the Supreme Court stated in Zandford, the pertinent statutory terms "'must be read flexibly, not technically and restrictively.'" 535 U.S. at 821 (quoting with approval Superintendent of Insurance v. Bankers Life & Casualty Co., 404 U.S. 6, 12 (1971)).

(unless the firm owned or borrowed the securities or the trader paired off the exchange). In fact, Jett describes these purchases as an "integral" and "important" "part of his trading strategy." Other than blaming the balance sheet reduction effort for his conduct during his last six months at Kidder, these purchases have been Jett's key claim to legitimacy for his deliberate, ongoing manipulation of Kidder's reports of his trading profits.

Thus, Kidder's decision to purchase or "invest" in strips or bonds (at least in these instances) stemmed directly from the activity that constituted the fraud. Deception that induces securities trading, or influences an investment decision, may satisfy the "in connection with" requirement, even where there is no deception about the securities themselves. 38/

Second, Jett's scheme allowed Jett to make further securities purchases and sales for Kidder, at ever-increased capital limits. Deception about the performance or status of a securities professional that persuades an investor to invest through that person may be sufficiently related to the purchase or sale of securities to give rise to liability for securities fraud. 39/ The

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38/ See Zandford, 535 U.S. at 820 ("neither the SEC nor this Court has ever held that there must be a misrepresentation about the value of a particular security in order to run afoul of the Act"). Any suggestion to the contrary in Chemical Bank v. Arthur Andersen & Co., 726 F.2d 930, 943-945 (2d Cir.), cert. denied, 469 U.S. 884 (1984), is overruled by Zandford. Zandford post-dates the law judge's decision, which relied heavily on Chemical Bank to conclude erroneously that Jett's fraud was not securities fraud.

39/ See Marbury Management, Inc. v. Kohn, 629 F.2d 705, 707-710 & n.3 (2d Cir.) (misrepresentation by trainee that he was experienced stockbroker and "portfolio management specialist" was "in connection with" because misstatements of his status induced subsequent purchase and retention of securities), cert. denied, 449 U.S. 1011 (1980); Competitive Associates, Inc. v. Laventhol, Krekstein, Horwath & Horwath, 516 F.2d 811, 815 (2d Cir. 1975)(allegations that accounting firm misrepresented the performance of an investment fund's investment adviser to influence investors to invest through the adviser was "in connection with" the purchase or sale of a security); SEC v. Hasho, 784 F. Supp. 1059, 1077 (S.D.N.Y. 1992) ("[i]n order to induce customers to . . . open brokerage accounts . . . [defendants] made misleading statements regarding their past

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same is true when the deception is aimed at the securities professional's employer. Here, Jett's fraud deceived Kidder into believing that Jett was a phenomenal securities trader, and exposed the firm to great risk of loss by putting so much of its resources at his disposal. Jett is liable on that basis as well.

Third, Jett generated fictitious trading profits to enhance the inadequate results of his actual securities trading. Kidder hired Jett to trade government securities in the market and compensated him based on his performance as a securities trader. Jett's results from real securities trading fell far short of what he needed to survive and succeed at Kidder. His scheme generated the fictitious profits necessary to make up the difference. Thus, Jett's fraud was inextricably tied to his contemporaneous securities trading.

In essence, Jett's fraud is akin to garden-variety securities fraud cases in which a broker-dealer or investment adviser engages in unsuccessful securities trades for a client and then hides the losses or inflates the profits by sending out false account statements. Jett's fraud -- which involved entering instructions for Fed exchanges into Kidder's computer system to generate false reports of his trading profits -- differs only in the identity of the victim and the complexity of the method.

Fourth, even if Jett had engaged in no real securities trading, he deceived Kidder into believing that the "profits" recorded as a result of his instructions for forward exchanges with the Fed came from real securities trading. Jett made Fed exchanges function for purposes of Kidder profit reports as real purchases and sales capable of generating a sustained trading profit. Kidder naturally believed that these reported _trading_ profits derived from _trading_, not Fed exchanges, and were real, not illusory. When asked by others, Jett attributed these profits to legitimate trading strategies; or, as his last resort, to his "three-part strategy," which cannot explain them.

When a person portrays activities as securities purchases and sales that, in fact, are no such thing, that conduct can, and here does, constitute securities fraud. As the Supreme Court made clear

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39/(...continued)
performance as registered representatives and made baseless and unjustified predictions that their investment recommendations would produce future customer profits").

in Zandford, 40/ "a broker who accepts payment for securities that he never intends to deliver" -- and thus engages in a transaction that is a total sham -- commits securities fraud. Courts have had no difficulty finding securities fraud violations when a person purports to sell an interest as a

40/ 535 U.S. at 819.

security that, in fact, is no such thing. 41/ Here, the connection between the purported securities trades and the fraud could not be more direct because the fraud goes to the very question of whether any purchase or sale even existed. Jett is liable for deceiving Kidder into believing that his reported trading profits derived from real securities trading. Accordingly, we find that Jett willfully violated Securities Act Section 17(a), 15 U.S.C. § 77q(a), and Exchange Act Section 10(b), 15 U.S.C. § 78j(b), and Rule 10b-5 thereunder, 17 C.F.R. § 240.10b-5.

IV. BOOKS AND RECORDS VIOLATIONS

Because the fictitious profits generated by Jett's forward exchanges were reflected in the firm's books and records, the law judge found that Jett willfully aided and abetted, and caused, violations of Exchange Act Section 17(a), 15 U.S.C. § 78q(a)(1); Rule 17a-3(a)(2), 17 C.F.R. § 240.17a-3(a)(2) (1998); and Rule 17a-5, 17 C.F.R. § 240.17a-5 (1998).

Section 17(a)(1) requires, *inter alia*, that brokerage firms create and maintain such records and reports of its operations as the Commission, by rule, prescribes as necessary and appropriate in the public interest and for the protection of investors. Rule 17a-3(a)(2) requires firms to "make and keep current . . . ledgers (or other records) reflecting all assets and liabilities, income and expense and capital accounts." Rule 17a-5(a)(2)(ii) requires broker-dealers who clear transactions or carry customer accounts to file quarterly Part II of Form X-17A-5 (known as "Financial and Operational Combined Uniform Single" or "FOCUS" reports). The obligation to make and keep records current embodies the requirement that such records be accurate. 42/

41/ *See*, *e.g.*, *United States v. Schlei*, 122 F.3d 944, 972-73 (11th Cir.) (fraud involving "counterfeit, forged, and nonexistent securities" actionable under securities laws), *rehearing denied*, 132 F.3d 1462 (11th Cir. 1997), *cert. denied*, 523 U.S. 1077 (1998); *SEC v. Lauer*, 52 F.3d 667, 670 (7th Cir. 1995) (scheme to invest in nonexistent prime bank instruments); *First Nat'l Bank v. Estate of Russell*, 657 F.2d 668, 673 n.16 (5th Cir. 1981) (broker-dealer induced counterparty to enter into repo trade involving U.S. Treasury Notes where firm never acquired or delivered the securities at issue).

42/ *See*, *e.g.*, *Sinclair v. SEC*, 444 F.2d 399, 401 (2d Cir. 1971); *U.S. v. Sloan*, 389 F. Supp. 526, 528 (S.D.N.Y. 1975); *James F. Novak*, 47 S.E.C. 892, 897 (1983).

Books and records are the "the basic source documents and transaction records of a broker-dealer." 43/ We have stressed that recordkeeping requirements serve as "a keystone of surveillance of brokers and dealers by our staff and by the security industry's self-regulatory bodies." 44/ Scienter is not required to violate Exchange Act Section 17(a)(1) and the rules thereunder. 45/

We find that Kidder violated Rule 17a-3(a)(2) and Rule 17a-5(a)(2)(ii). Jett's instructions to recon bonds generated a "trade" date "profit" based on the theoretical forward prices for the strips. This automatic gain from forward recons was equal to the anticipated interest on the bond through the "settlement" date. The amount, however, might never be realized and did not account for the significant costs of financing and hedging. The data about these forward exchanges (including "trade" price and size and "trade" and "settlement" dates) in the G1 ledger was included in internal firm reports and databases, firm ledgers, and FOCUS reports.

Kidder violated Rule 17a-3(a)(2) because the firm's ledgers and other records that recorded its income and P&L from the first quarter of 1992 through the first quarter of 1994 (such as the PPR-2, the Fixed Income Daily, and trial balances and related income statements) reflected Jett's nonexistent profits from his forward exchanges. Kidder also violated Rule 17a-5(a)(2)(ii) because the income, revenue, and expense data from firm reports that included the nonexistent P&L impact of Jett's forward exchanges were used to compile the firm's Statement of Income(Loss) contained in its FOCUS reports for each quarter-end filing from March 1992 to March 1994.

Jett is charged with aiding and abetting these violations. The elements of aiding and abetting liability are: (1) a primary violation by another party; (2) a general awareness by the aider and abettor that his role is part of an overall activity that is

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43/ Statement Regarding the Maintenance of Current Books and Records by Brokers Dealers, Exchange Act Rel. No. 10756, 1974 SEC Lexis 3290 (April 26, 1974).

44/ Edward J. Mawod & Co., 46 S.E.C. 865, 873 n.39 (1977), aff'd, 591 F.2d 588 (10th Cir. 1979). See also SEC v. Drexel Burnham Lambert Inc., 837 F. Supp. 587, 610 (S.D.N.Y. 1993), aff'd sub nom., SEC v. Posner, 16 F.3d 520 (2d Cir. 1994), cert. denied, 513 U.S. 1077 (1995).

45/ Drexel Burnham, 837 F. Supp. at 610 (citing Stead v. SEC, 444 F.2d 713, 716-17 (10th Cir. 1971), cert. denied, 404 U.S. 1059 (1972)).

improper; and (3) substantial assistance by the aider and abettor in the violative conduct. 46/

We have already found a primary violation by Kidder. The third element is clearly met here. Kidder's recordkeeping violation resulted from Jett's massive forward exchange instructions. By entering them, Jett substantially assisted Kidder's violation.

The second element is also met. Jett does not contest the P&L impact of his forward exchanges with the Fed or that this P&L effect was reflected on Kidder's books and records. Jett knew that the P&L impact of his forward exchanges was reflected in the firm's books and records, and, as we found above, he must have known that such "profits" were the result of improper activity and not real trading.

Accordingly, we conclude that Jett willfully aided and abetted the firm's violations of Section 17(a)(1) of the Exchange Act and Rules 17a-3 and 17a-5 thereunder. 47/ For the same reasons, we find that Jett caused Kidder's violation within the meaning of Exchange Act Section 21C, 15 U.S.C. § 78u-3. 48/

V. GENERAL OBJECTIONS TO THE PROCEEDING

Jett raises a number of procedural and fairness objections to this action. We discuss only some of them here, but have carefully considered them all and concluded they are meritless.

46/ Russo Securities, Inc., 53 S.E.C. AT 278-79 & nn.16-18; see Graham v. SEC, 222 F.3d 994, 1000 (D.C. Cir. 2000); Investors Research Corp. v. SEC, 628 F.2d 168, 178 (D.C. Cir.), cert. denied, 449 U.S. 919 (1980); Decker v. SEC, 631 F.2d 1380, 1387-88 & nn.12,13,16 (10th Cir. 1980).

47/ See Wonsover v. SEC, 205 F.3d 408, 414-15 (D.C. Cir. 2000)(rejecting notion that "willfulness" requires actor to be aware that he is violating securities laws).

48/ This provision authorizes the Commission to issue orders requiring persons to cease and desist from causing violations of the Exchange Act where those persons "knew or should have known" that their acts or omissions would contribute to such violations. The "knew or should have known" language only requires a showing of negligence. See KPMG, LLP v. SEC, 289 F.3d 109, 120 (D.C. Cir. 2002). However, since we find that, at a minimum, Jett acted recklessly, his conduct was more than sufficient for purposes of Exchange Act Section 21C.

Jett argues that we should defer, in deciding this case, to the outcome of a criminal investigation into Jett's activities by the United States Attorney's Office and of a National Association of Securities Dealers arbitration action between Kidder and Jett. Jett claims that the United States Attorney's Office found "no wrongdoing" and that he was "exonerated" in the NASD proceeding by two of the three arbitrators on an experienced "blue-ribbon panel." 49/ In his reply brief, Jett makes the related argument that he did not present "the more technical aspects" of his case here, because he felt the law judge "lacked the mental firepower to comprehend" those details, and that his "trading strategy" was better presented in the arbitration.

We decide this action based solely on the record before us. The United States Attorney's Office's decision not to prosecute Jett after interviewing him cannot be construed as finding Jett "innocent" of wrongdoing. Prosecutors face different litigation considerations in deciding whether to file criminal charges as compared to instituting a civil proceeding, such as the higher burden of proof. 50/ In the separate arbitration case, there were no formal findings. Any ruling or award in the arbitration based upon different parties, testimony, evidence, and claims is irrelevant to our decision. 51/

49/ In Joseph Jett v. Kidder Peabody & Co., Inc., No. 94-1696 (NASD Regulation, Inc., Jan. 28, 1998), the arbitration panel denied Jett's claims for payment of the approximately $2.9 million deferred portion of his $11.4 million in bonuses. The panel also denied all claims for interest and punitive damages. Two members of the panel denied "[a]ll claims asserted by Kidder against Jett seeking a monetary award"; the third arbitrator "dissents in this determination and would have awarded Kidder Peabody an award of sixty million ($60,000,000) dollars." The arbitration award also directed that "the balance of Mr. Jett's [personal] account at Kidder -- after the reimbursement to Kidder of attorneys' fees advanced -- be distributed to Mr. Jett, subject to any liens thereon."

50/ Rabon v. Great Southwest Fire Ins. Co., 818 F.2d 306, 309 (4th Cir. 1987). See also Heckler v. Chaney, 470 U.S. 821, 831-32 (1985)(agency's decision whether to prosecute or enforce is generally within its absolute discretion).

51/ See, e.g., Perpetual Securities, Inc. v. Tang, 290 F.3d 132, 139 (2d Cir. 2002).

Jett had a full opportunity and obligation to present all relevant evidence before the law judge. Jett was represented by several competent attorneys before, during, and after the hearing. Jett and his counsel gave every appearance of zealously advocating his cause, and Jett specifies no shortcomings on any of their parts. Jett is correct that Fiumefreddo and Kidder's assistant controller, GT's designer, and several strips traders did not testify. However, Jett could subpoena witnesses and compel their testimony pursuant to our Rule 232, 17 C.F.R. § 201.232 (1998). Jett does not dispute that he obtained before the hearing deposition transcripts of uncalled witnesses who were deposed, the Division's interview notes, and the notes of interviews between uncalled witnesses and Kidder attorneys. Jett testified at length. His counsel presented expert testimony, called three former Kidder employees to testify on his behalf, and extensively cross-examined Division witnesses.

Jett asserts that he was discriminated against at the hearing, by the Division in its investigation, by the Commission in its institution of these proceedings, and by Kidder during his employment there, because he is African-American. We agree with Jett that such discrimination, if it had occurred, would be repugnant and intolerable. But Jett has not shown that it did occur. The law judge's decision makes clear that she "examined the record for, and did not find, evidence of discriminatory treatment in the firm's dealings with him that would bear on its approval or knowledge of the forward recon strategy." We have conducted an exhaustive de novo review of the record, and find no evidence that this proceeding was tainted by racial animus. The discrimination claims Jett makes in this proceeding are vague and unsubstantiated. His appeal briefs simply equate disagreements about the evidence in this case, or about inferences drawn from it, with "bias" and "prejudice." That Jett vigorously asserts his innocence, and insists he has unassailable grounds for doing so, does not change the fact that we have carefully considered all of the evidence and arguments, found him liable on the merits, and painstakingly set forth the basis for our decision. 52/

52/ In deciding this case, we have applied the preponderance of the evidence standard that the Supreme Court has held is the proper evidentiary standard for a disciplinary proceeding before the Commission. Steadman v. SEC, 450 U.S. 91, 95-96, 101-03 (1981). See also Herman & MacLean v. Huddleston, 459 U.S. 375, 387-91 (1983) (private action under Exchange Act requires preponderance of the evidence standard); SEC v. C.M. Joiner Leasing Corp., 320 U.S. 344, 355 (1943) (preponderance of the evidence sufficient for Commission to establish fraud under

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VI. SANCTIONS

Based upon findings that Jett willfully aided and abetted and caused violations of the recordkeeping provisions only, the law judge imposed a cease-and-desist order; a bar from associating with any broker or dealer; $8.21 million in disgorgement, plus prejudgment interest; and $200,000 in third-tier civil money penalties. She deemed the sanctions fair, even in the absence of an antifraud violation, because Jett's "violative actions involved dishonesty and fraudulent intent."

Jett objects to the imposition of any sanctions for basically the same reasons as he opposes liability. The Division contends that the sanctions imposed by the law judge for the books and records violation were reasonable in light of the egregious and recurrent conduct by Jett, and that "[i]f the Commission finds that Jett also violated the antifraud provisions, the Commission should impose additional sanctions appropriate to such a finding."

Under Exchange Act Section 15(b)(6), 15 U.S.C. § 78o(b)(6), the Commission may impose sanctions on a person who is associated with a broker-dealer where the sanction "is in the public interest" and such person has "willfully" violated, or "willfully" aided and abetted the violation of, the federal securities laws. Sanctions are imposed to protect the public interest, including investors and the securities marketplace. 53/

In determining the sanctions to impose under Section 15(b)(6), we consider a number of factors, including the egregiousness of the respondent's actions; the isolated or recurrent nature of the infraction; the degree of scienter involved; the sincerity of the respondent's assurances against future violations; the respondent's recognition of the wrongful nature of the conduct; and the

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52/(...continued)
Securities Act Section 17(a)). Jett's argument that the standard is clear and convincing evidence is incorrect.

53/ Jacob Wonsover, Securities Exchange Act Rel. No. 41123 (March 1, 1999), 69 SEC Docket 694, 716, petition denied, 205 F.3d 408 (D.C. Cir. 2000); Richard D. Earl, 48 S.E.C. 334, 335-36 (1985), aff'd, 798 F.2d 472 (9th Cir. 1986).

likelihood that the respondent's occupation will present opportunities for future violations. 54/

Applying these factors to this case, we find that the sanctions imposed by the law judge are reasonable and in the public interest. This is particularly true in light of the fact that we, unlike the law judge, find that Jett violated the antifraud provisions. As we discussed earlier, frauds such as Jett's can potentially inflict serious harm on individual firms, on investors, and on the market. Jett engaged in egregious, deceitful conduct on a large scale for over two years. He profited handsomely from his misconduct, including collecting millions of dollars in unjust bonuses.

Jett's scheme caused Kidder to record on its books and records, and incorporate into regulatory filings, hundreds of millions of dollars of non-existent profits from November 1991 into March 1994. This inflicted on Kidder's public-company parent a $350 million pre-tax charge against net earnings in 1994. Jett knew the P&L impact of his "carefully planned" forward exchanges with the Fed and knew (or was reckless in not knowing) that they deceived the firm about his trading performance. There is little assurance that Jett would not engage in future violations. He has never acknowledged that he acted improperly at Kidder and has shown no remorse for his actions. He has expressed interest in resuming a career in trading government securities, which would provide him with ample opportunities to commit future violations.

We have also considered countervailing factors. Jett had no previous violations or disciplinary record. The conduct at issue occurred some time ago. Neither the firm nor the specialized computer system involved any longer exists. The record does not indicate any harm to customers or counterparties.

In the final analysis, we conclude that it is in the public interest to order that Jett cease and desist from his violative conduct, be barred from associating with a broker or dealer, disgorge his ill-gotten bonuses, and pay a civil money penalty. These sanctions are necessary and appropriate to protect the public and to hold Jett accountable for his serious misconduct. We discuss the amount of disgorgement and penalty separately.

54/ See Steadman v. SEC, 603 F.2d 1126, 1140 (5th Cir. 1979), aff'd on other grounds, 450 U.S. 91 (1981); Martin Kaiden, Exchange Act Rel. No. 34-41629 (July 20, 1999), 70 SEC Docket 439, 454.

Disgorgement. Securities Act Section 8A(e), 15 U.S.C. § 77h-1(e), and Exchange Act Section 21C(e), 15 U.S.C. § 78u-3(e), authorize disgorgement, including reasonable interest, in any Commission cease-and-desist proceeding. Exchange Act Section 21B(e), 15 U.S.C. § 78u-2(e), permits disgorgement, including reasonable interest, in Commission proceedings imposing civil penalties. Disgorgement is an equitable remedy whose purpose is to: (1) prevent a wrongdoer from profiting from his illegal conduct by requiring him to surrender the amount by which he was unjustly enriched and (2) deter others from similar misconduct. 55/ It is not a punitive measure.

Kidder awarded Jett a total of $11.4 million in bonuses for 1992 and 1993 based on the apparent profitability of his trading. Jett received $8.21 million of this (he directly received $5.5 million; Kidder withheld the rest of the $8.21 million as taxes). The remainder of the $11.4 million was withheld as deferred compensation and was not paid to Jett after he was fired. Although Jett insists that he was "underpaid" in 1992, his net recorded profits from November 1991 through March 1994 derived entirely from booking in excess of $300 million in unrealized profits; his securities and futures trading and net interest on settled positions resulted in a loss of nearly $75 million. Therefore, we find it is appropriate to require Jett to disgorge the $8.21 million that constituted his ill-gotten gains. 56/

Civil Penalties. Exchange Act Section 21B(b)(3), 15 U.S.C. § 78u-2(b)(3), authorizes the imposition of civil money penalties. It authorizes third-tier civil penalties of up to $100,000 "for each act or omission" constituting the violation that involves fraud, deceit, manipulation, or deliberate or reckless disregard of a regulatory requirement, results in a substantial pecuniary gain to the respondent or the significant risk of substantial losses to

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55/ See Terence Michael Coxon, Securities Exchange Act Rel. No. 48385 (August 21, 2003), 80 SEC Docket 3288, 3314-15.

56/ Except in the most unique and compelling circumstances, prejudgment interest should be awarded on disgorgement, among other things, in order to deny a wrongdoer the equivalent of an interest free loan from the wrongdoer's victims. Coxon, 80 SEC Docket at 3318. Under the circumstances of this case, we exercise our equitable discretion to decline to order prejudgment interest.

other persons, and "is in the public interest." 57/ Section 21B(c), 15 U.S.C. § 78u-2(c), lists six factors to consider in determining whether to impose civil penalties: (1) whether the conduct involved fraud, deceit, manipulation, or deliberate or reckless disregard of a regulatory requirement; (2) the harm to others; (3) the degree of unjust enrichment less any restitution to victims; (4) whether the respondent was previously found by the Commission to have violated the federal securities laws; (5) the need for deterrence; and (6) "such other matters as justice may require."

The law judge imposed a third-tier civil penalty of $200,000 based on "two courses of action": (1) Jett's forward recons through 1992, which resulted in one of his bonuses; and (2) his 1993 and 1994 forward recons, "which were bolder and far more profitable to him." She rejected a greater penalty because, in her view, there was no securities fraud violation, it would be unreasonable to assess a civil penalty on each of thousands of forward recons, and mitigating factors counseled against it.

57/ This amount is applicable to violations that occurred before December 9, 1996. See Adjustment to Civil Monetary Penalty Amounts, 61 Fed. Reg. 57773 (Nov. 8, 1996)(codified at 17 C.F.R. § 201.1001 (1998)).

On balance, we find that a third-tier civil penalty of $200,000, in addition to disgorgement, is appropriate for the purpose of deterrence and because Jett's conduct involved deceit that succeeded in obtaining substantial pecuniary gain.

An appropriate order will issue. 58/

By the Commission (Commissioners GOLDSCHMID, ATKINS, and CAMPOS); Chairman DONALDSON and Commissioner GLASSMAN not participating.

Jonathan G. Katz
Secretary

58/ We have considered all of the arguments advanced by the parties. We reject or accept them to the extent that they are inconsistent or in accord with the views expressed in this opinion.

UNITED STATES OF AMERICA
before the
SECURITIES AND EXCHANGE COMMISSION

SECURITIES ACT OF 1933
Rel. No.8395 / March 5, 2004

SECURITIES EXCHANGE ACT OF 1934
Rel. No.49366 / March 5, 2004

Admin. Proc. File No. 3-8919

In the Matter of

ORLANDO JOSEPH JETT
61 East Eighth St.
New York, NY 10003

ORDER IMPOSING REMEDIAL SANCTIONS

On the basis of the Commission's opinion issued this day, it is:

ORDERED that Orlando Joseph Jett cease and desist from committing or causing any violations, or future violations, of Section 17(a) of the Securities Act of 1933 and Section 10(b) of the Securities Exchange Act of 1934 and Rule 10b-5 thereunder; and it is further

ORDERED that Orlando Joseph Jett cease and desist from causing any violations, or future violations, of Section 17(a) of the Securities Exchange Act of 1934 and Rule 17a-3 and Rule 17a-5 thereunder; and it is further

ORDERED that Orlando Joseph Jett be, and he hereby is, barred from association with any broker, dealer, member of a national securities exchange, or member of a registered securities association; and it is further

ORDERED that Orlando Joseph Jett disgorge the amount of $8.21 million; and it is further

ORDERED that Orlando Joseph Jett pay a civil money penalty in the amount of $200,000.

Jett's payment of disgorgement and the civil money penalty shall be: (i) made by United States postal money order, certified check, bank cashier's check, or bank money order made payable to the Securities and Exchange Commission, (ii) delivered by hand or courier to the Office of Financial Management, Securities and Exchange Commission, Operations Center, 6432 General Green Way, Stop 0-3, Alexandria, Virginia 22312, within thirty days of the date of this order; and (iii) submitted under cover letter which identifies Jett as the respondent in this proceeding and gives the file number of this proceeding. A copy of the cover letter and check shall be sent to Edwin H. Nordlinger, Deputy Regional Director, Northeast Regional Office, Division of Enforcement, Securities and Exchange Commission, The Woolworth Building, 233 Broadway, New York, New York 10279.

By the Commission.

Jonathan G. Katz
Secretary