

NEW YORK STOCK EXCHANGE, INC.

EXCHANGE HEARING PANEL DECISION 05-108

September 29, 2005

LEHMAN BROTHERS INC.
MEMBER ORGANIZATION

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Violated Exchange Rule 342 by failing to have reasonable policies and procedures in place to supervise manner in which trades relating to facilitation contracts for purchase of stock at prices derived from closing price were submitted and by failing to have adequate controls to evaluate and scrutinize risks associated with trades at close when they could be disruptive or cause excess market volatility; violated Exchange Rule 401 by failing to adhere to the principles of good business practice by engaging in several transactions for sale of stock at or near close of trading – Consent to censure, \$500,000 fine and undertaking to conduct internal review to identify additional procedures and systems of follow-up reasonably designed to prevent recurrence of instant violations.

Appearances:

For the Division of Enforcement
Linda Riefberg, Esq.
Kenneth Bozza, Esq.

For the Respondent
Robert M. Romano, Esq.
Gary Rosen, Esq.
Bonnie Altro, Esq.

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A Hearing Panel of the New York Stock Exchange, Inc. (“Exchange”) met to consider a Stipulation of Facts and Consent to Penalty entered into between the Exchange’s Division of Enforcement (“Enforcement”) and Lehman Brothers Inc. (“Respondent Firm”). Without admitting or denying guilt, Respondent Firm consented to a finding by the Hearing Panel that it:

- I. Violated Exchange Rule 342 by:
 - A. Failing to have reasonable policies and procedures in place to supervise the manner in which trades relating to facilitation contracts for the purchase of stock at prices derived from the closing price were submitted, particularly where there was an economic incentive to impact the closing price; and
 - B. Failing to have adequate controls to evaluate and scrutinize the risks associated with trades relating to such facilitation contracts to prevent such trades from occurring at the close when they could be disruptive or cause excess market volatility; and

- II. Violated Exchange Rule 401 by failing to adhere to the principles of good business practice by engaging in several transactions for the sale of stock at or near the close of trading which were disruptive and caused excess market volatility without having adequate polices, procedures and controls in place to monitor such transactions.

For the sole purpose of settling this disciplinary proceeding, Enforcement and Respondent Firm stipulate to certain facts, the substance of which follows:

Background and Jurisdiction

1. Respondent Firm is a member organization of the Exchange and a subsidiary of Lehman Brothers Holdings Inc., a publicly traded financial services company with principal executive offices in New York City. Respondent Firm is a full-service investment bank providing equity and fixed income sales, trading and research, investment banking, private equity, and private client services to its customers.
2. An investigation was commenced by the Exchange's Division of Market Surveillance into certain transactions effected by Respondent Firm in the stock of XYZ at or near the close of trading on December 11, 2002.
3. By letter dated August 20, 2003, Enforcement notified Respondent Firm that it was conducting a formal investigation.

Overview

4. Pursuant to irrevocable facilitation contracts Respondent Firm entered into with certain of its customers to purchase blocks of XYZ at a 0.33 to 2 cent premium over the stock's closing price on December 11, 2002, Respondent Firm effected several transactions for the sale of 2,050,191 shares of XYZ stock at or near the close of trading on that date which were disruptive and caused excess market volatility. Respondent Firm's final transaction in XYZ for the day was a sale of 1.6 million shares, i.e., approximately 78% of its position. Respondent Firm asked for a bid on this block as the closing bell was ringing. These circumstances did not provide an opportunity for contra side interest to develop and react to its order, and should have alerted Respondent Firm that the price of XYZ could decline. As a result, this transaction had the effect of causing the price in XYZ to close down from \$59.61 to \$59.00 and Respondent Firm's customers potentially received a lower price on the facilitation contracts. Further, because Respondent Firm sold approximately 22% of its position minutes earlier at prices higher than the closing price, Respondent Firm also realized a profit by its conduct.
5. In violation of Exchange Rule 342, Respondent Firm failed to have reasonable policies and procedures in place to supervise the manner in which such trades were submitted, particularly where there was an economic incentive for Respondent Firm to impact the closing price. Respondent Firm also failed to have adequate controls to evaluate and scrutinize the risks associated with such trading and to prevent such trades from

occurring at the close when they could be disruptive or cause excess market volatility. As such, Respondent Firm also failed to adhere to the principles of good business practices with respect to the trades at issue in violation of Exchange Rule 401.

Trading in XYZ

6. Respondent Firm's trading in XYZ on December 11, 2002 was effected pursuant to a proprietary trading strategy to facilitate customers' sales of XYZ stock in connection with XYZ's "migration" from Standard and Poor's MidCap 400 Index (the "S&P 400") to Standard and Poor's 500 Index (the "S&P 500").¹ To attract order flow resulting from the migration, Respondent Firm entered into irrevocable facilitation contracts with certain of its customers tracking the S&P 400 index. Respondent Firm agreed to purchase blocks of XYZ from such customers at a 0.33 to 2 cent premium over the stock's closing price on December 11, 2002.
7. On December 11, 2002, Respondent Firm's Derivatives Department sales force solicited orders from customers, and by approximately 2:00 p.m., Respondent Firm contracted to purchase 2,050,191 shares of XYZ (the "block") from 13 customers pursuant to the contracts. To satisfy these purchase contracts, Respondent Firm's trading strategy contemplated that Respondent Firm would sell an equal amount of XYZ shares in the market that day.
8. Instead of entering orders to sell XYZ stock at 2:00 p.m., and instead of entering any orders as market-on-close ("MOC") orders, Respondent Firm did not transmit any orders to the floor until eight minutes before the close. Thus, at 3:52 p.m., a Firm trader transmitted to Respondent Firm's booth on the floor a "Not Held" market order to sell 1.6 million shares, which represented 78% of the block, and an instruction was given to the clerk working in the booth to hold the order pending further instructions. Thereafter, between 3:53 p.m. and 3:57 p.m., Respondent Firm transmitted separate sell orders totaling 450,191 shares of XYZ stock to the floor, which constituted the remaining 22% of the block. These orders were executed between 3:55 p.m. and 3:59 p.m. at an average price of \$59.61.
9. At approximately 3:59:24 p.m., a Respondent Firm trader called the clerk in the booth and told him to release the 1.6 million-share sell order to Respondent Firm's floor broker. The floor broker received the order on his handheld device and, as the closing bell was ringing, asked the specialist in XYZ for a bid.
10. Immediately prior to Respondent Firm asking for a bid for its 1.6 million share order, the quote in XYZ was 59.60 – 59.61 and the XYZ specialist had announced to the crowd that he anticipated the closing price of the stock to be between \$59.50 and \$60 per share.

¹ The migration was announced publicly after the close of trading on Wednesday, December 4, 2002, giving institutions and fund managers five trading days to transact for their portfolios prior to the migration date.

11. As a result of Respondent Firm's 1.6 million share sell order, the XYZ specialist dropped the quoted bid from \$59.60 to \$57 and, in an effort to accommodate Respondent Firm, the specialist purchased the 1.6 million shares for the specialist's dealer account and contacted known buyers to generate buy interest for a crossing session transaction. Through this process, the XYZ specialist was able to attract sufficient buy interest for a crossing session transaction and priced the closing transaction to include Lehman's 1.6 million-share sell order which was executed at \$59, which was \$.61 lower than the prior sale.
12. Because Respondent Firm previously sold 450,191 shares of XYZ at an average price of \$59.61, although it sold the remaining 1.6 million shares for only \$59, the average price per share of the entire block of 2,050,191 shares was approximately \$59.13. As such, Respondent Firm was able to sell the entire block for approximately \$121,235,885. Thus, at the closing price of \$59, Respondent Firm purchased the block pursuant to the customer facilitation agreements at total cost of \$120,988,226. Consequently, Respondent Firm made a profit of approximately \$247,659 on the contracts.

Violative Conduct by Respondent Firm

13. In connection with the conduct described above, Respondent Firm failed to have reasonable policies and procedures in place to supervise the manner in which trades relating to facilitation contracts such as those involving XYZ for the purchase of stock at prices derived from the closing price were submitted, particularly where there was an economic incentive to impact the closing price. Respondent Firm also failed to have adequate controls to evaluate and scrutinize the risks associated with such trading and to prevent such trades from occurring at the close when they could be disruptive or cause excess market volatility.
14. Exchange Information Memo 95-28 addresses situations in which a firm positions itself to facilitate customer orders and leaves a portion of its own position to be executed at or near the close. As noted therein, such situations would be considered conduct inconsistent with just and equitable principles of trade if the remaining position can be reasonably expected to impact the closing price. Further, such trading strategies may, in certain situations, also be determined to be manipulative trading. Pursuant to that Information Memo, firms are required to establish and maintain procedures reasonably designed to review facilitation activities for compliance with Exchange rules and federal securities laws.²

² While not published at the time of the events herein, Information Memo 04-63, which cites to Information Memo 95-28, reminds firms of the following: "[W]here a firm has committed to purchase from (sell to) a customer an order at a price that is derived from the closing price . . . , reserving a significant position of its hedging or covering transaction to be executed near the close, it must operate with substantial care. If the transaction is completed in a manner that does not effectively place the firm at market risk or provide an opportunity for contra side interest to develop or react to the activity, it would raise manipulative concerns and would operate as conduct inconsistent with just and equitable principles of trade."

15. In the instant matter, Respondent Firm chose not to enter any of its orders as MOC orders. Although Respondent Firm may have had an expectation, based upon its research, that there would be migration-based buy interest of approximately 2.8 million shares appearing at or near the close on December 11, 2002 to mitigate the impact of the block's execution on the price of XYZ, no such buying interest materialized.
16. Accordingly, the manner in which Respondent Firm handled the 1.6 million-share order was disruptive and caused excess market volatility and Respondent Firm failed to fully consider the consequences of its actions in permitting the trading at the close. In particular, Respondent Firm failed to take into account what could occur should the expected buy interest not materialize at or near the close.
17. In addition, by asking for a bid for its 1.6 million shares of XYZ as the closing bell was ringing and not providing an opportunity for contra side interest to develop and react to its order, Respondent Firm knew or should have known that the price of XYZ could decline, thereby resulting in a profit to Respondent Firm and a potentially lower price paid to its customers. In fact, after announcing to the crowd what he anticipated the closing price of the stock to be, the XYZ specialist was thereafter caused to lower the quoted bid for the stock because of the timing of this order.
18. By choosing not to enter MOC orders, and by selling 450,191 shares of XYZ at an average price of \$0.61 higher than the closing price, the decline in the price of XYZ caused by selling 1.6 million shares at the close allowed Respondent Firm to profit by more than \$247,000 after it satisfied the customer facilitation contracts.
19. Because these facilitation contracts entered into by Respondent Firm were tied into the closing price, there should have been heightened scrutiny of the manner in which the orders were handled, which should have included, at a minimum, policies, procedures and controls for the review of its trading strategy. By lacking policies and procedures addressing this situation and by not conducting such a review, which should have taken place well before the close, Respondent Firm violated Exchange Rule 342 and the concepts contained in Information Memo 95-28.
20. By engaging in the aforementioned transactions without adequate policies, procedures and controls, Respondent Firm also failed to adhere to the principles of good business practice.

Other

21. Respondent Firm has informed the Exchange that as it relates to the matter covered in this Stipulation, it currently does not engage in principal transactions involving stock migrations or index additions.

DECISION

Since at least 1995, firms have been on notice that trading at or near the close of the trading day must be done with caution where such trading can be expected to affect a given stock's price

considerably. See N.Y.S.E. Information Mem. 95-28 (stating that trades done after 3:40 p.m. “generally... would be considered ‘near the close’”). There is no question that the trading in this case was near the close and that it caused significant volatility. It is also clear that such volatility should have been expected by Respondent Firm. The Hearing Panel found Respondent Firm guilty as set forth above by unanimous vote.

PENALTY

The Hearing Panel has taken into account the following factors in considering the appropriateness of the penalty in this case: the seriousness of the offense, the corresponding harm to the trading public, and the potential gain to Respondent Firm for disobeying the rules. See McCarthy v. SEC, 406 F.3d 179, 190 (2d Cir. 2005). Other factors considered were the disciplinary history of Respondent Firm and its motivation for its action.

The violative conduct in this case was significant because it caused disruption to the closing price, which is critical to the trading public’s evaluation of the movement in a security’s price and, therefore, to the integrity of the market.

The degree of harm to the trading public can be quantified, to a degree, by the size, in dollar terms, of the violative trades and the relative volatility that resulted from those trades. In other cases involving improper conduct that similarly led to market volatility, respondent firms have consented to fines ranging from \$275,000, see In re Spear, Leeds & Kellogg Specialists LLC, Decision 99-68 (N.Y.S.E. Hearing Panel June 17, 1999) (failure to disseminate timely market information adequately), to \$625,000, see In re Merrill Lynch, Pierce, Fenner & Smith Inc., Decision 04-30 (N.Y.S.E. Hearing Panel Mar. 8, 2004) (failure to implement appropriate procedures for dealing with dissemination of changes in pending research report ratings or earnings estimates). See also In re CS First Boston Corp., Decision 95-98 (N.Y.S.E. Hearing Panel July 18, 1995) (respondent consented to \$450,000 fine where employee had entered and then canceled \$1.5 billion in inappropriate market-on-close purchase orders). Amounts consented to in the past must, however, be considered in light of their relative age in order to ensure consistency and fairness.

Any profit that a respondent has made as a result of his or its violative conduct must also be taken into account in evaluating the appropriateness of a penalty, although the dollar amount is not itself determinative of the amount of a fine. In this case, Respondent Firm generated a profit of just over \$247,000.

In addition, Respondent Firm has been the subject of numerous disciplinary proceedings in the past, including several which, like the present case, involve a failure to supervise under Exchange Rule 342. See, e.g., In re Lehman Bros., Inc., Decision 03-66 (N.Y.S.E. Hearing Panel Apr. 22, 2003); In re Lehman Bros., Inc., Decision 03-157 (N.Y.S.E. Hearing Panel Aug. 6, 2003); In re Lehman Bros., Inc., Decision 00-165 (N.Y.S.E. Hearing Panel Sept. 28, 2000). Such prior failures justify a harsher penalty in a subsequent case.

Finally, the Hearing Panel considers a respondent’s motivation in the circumstances of a particular case. Here, Respondent Firm does not appear to have intended to harm its customers. Rather, its stated motivation was to manage the risk of such customers, who needed to sell a

security in the often volatile circumstance of a stock migrating from one index to another within a short period of time. Nevertheless, Respondent Firm acknowledged the need to devise specific precautionary measures for dealing with large sales at or near the close of the day, particularly in situations, such as this one, where volatility is to be expected. Therefore, allowing an internal review—as opposed to requiring Respondent Firm to hire an outside consultant—is appropriate in this case. See In re Shearson Lehman Bros. Inc., Decision 92-84 (N.Y.S.E. Hearing Panel May 21, 1992) (\$500,000 fine and undertaking to complete internal review, to be conducted by firm’s audit committee); cf. In re CS First Boston Corp., Decision 95-98 (N.Y.S.E. Hearing Panel July 18, 1995) (undertaking to retain outside consultant to conduct review and prepare report making recommendations for additional systems and procedures “reasonably designed to ensure compliance with federal securities laws and Exchange Rules”); In re Spear, Leeds & Kellogg, L.P., Decision 03-108 (N.Y.S.E. Hearing Panel June 9, 2003) (firm that aided and abetted wrongful trading by direct access customer consented to \$450,000 fine and undertaking to retain independent consultant to prepare report recommending additional systems and procedures).

In view of the above findings, the Hearing Panel, by unanimous vote, imposed the penalty consented to by Respondent Firm of: a censure; a fine in the amount of \$500,000; and a requirement to comply with the following undertaking:

- A. Respondent Firm will cause its Office of General Counsel to perform a review to identify the procedures and systems of follow-up and review the Respondent Firm has in place or has adopted which are reasonably designed to prevent recurrence of the foregoing violations, including those involving stock index migrations and additions and facilitation contracts generally that derive their price from the close, to ensure compliance with applicable Exchange rules and federal securities laws, to evaluate whether further enhancements or improvements to such procedures and systems are appropriate, to make any appropriate recommendations for additional procedures and systems, if necessary, and to prepare a written report (the “Report”); and
- B. Respondent Firm’s Office of General Counsel shall prepare the Report, within 120 days from the date this decision becomes final, addressing the aforementioned review, and Respondent Firm shall adopt and implement any recommendations resulting from the Office of General Counsel’s review to prevent the recurrence of the violations described herein and provide a copy of the Report to the Exchange and Respondent Firm’s Global Head of Equities.

For the Hearing Panel

Peggy Kuo – Chief Hearing Officer
Panelists:
John S. French
Laurence A. Shadek