N E W Y O R K S T O C K E X C H A N G E L L C

<u>NYSE HEARING PANEL DECISION 06-53</u> **April 18, 2006**
LEHMAN BROTHERS INC.
MEMBER ORGANIZATION

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Violated NYSE Rule 421 by submitting inaccurate reports of short positions in securities listed on the NYSE; violated NYSE Rule 342 by failing to establish and maintain appropriate systems and procedures for reasonable supervision and control of areas responsible for complying with NYSE short-interest reporting requirements and failing to establish a separate system of follow-up and review to comply with, or detect and prevent violations of, NYSE short-interest reporting requirements – Consent to censure and $400,000 fine.

Appearances:

For the Division of Enforcement
Linda S. Riefberg, Esq.
Myles L. Orosco, Esq.
Tracy Timbers, Esq.
Marianne Paoli, Esq.

For Respondent Firm
Robert C. Mendelson, Esq.
Thomas D. Shpetner, Esq.

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

I. Violated NYSE Rule 421 in that Respondent Firm submitted inaccurate reports of short positions in securities listed on the NYSE.

II. Violated NYSE Rule 342 in that Respondent Firm failed to establish and maintain appropriate systems and procedures for the reasonable supervision and control of areas responsible for complying with NYSE short-interest reporting requirements and failed to establish a separate system of follow-up and review to comply with, or detect and prevent violations of, NYSE short-interest reporting requirements.

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. The Firm, a member organization and a direct subsidiary of Lehman Brothers Holdings Inc., is a Delaware corporation and a registered broker dealer.

2. The Firm's principal offices are located in New York, New York and it maintains approximately 52 branch offices throughout the United States and worldwide. The Firm provides the full range of services offered by a multi-purpose investment bank, including equity and fixed income sales, trading and research, investment banking, private equity and private client sales.

3. In May 2004, after twice being contacted by the NYSE's Division of Member Firm Regulation ("MFR") regarding the Firm's April 2004 report of short interest in the stock XYZ, the Firm informed MFR that it had inaccurately reported to the NYSE short interest of 26,089,923 shares of the stock XYZ, when the correct figure was 625,360 shares.

4. This investigation was opened on June 4, 2004, on the basis of findings contained in a referral from MFR. By letter dated June 15, 2004, which the Firm received, the NYSE notified the Firm that it was formally investigating the findings set forth in the MFR referral, as well as the Firm's supervision of these matters.

Summary of Violative Conduct

5. In April 2004, the Firm inaccurately reported to the NYSE short interest of 26,089,923 shares of the stock XYZ when the correct figure was 625,360 shares. The Firm reported and verified the erroneous XYZ short interest amount in a short interest report that is filed monthly with the NYSE. The investigation disclosed that a Firm employee caused the XYZ reporting error by incorrectly designating the number of XYZ shares into the wrong short and long account types in connection with the unwinding of a swap transaction. The employee transposed the numbers, entering 12,838,810 into the Type 2 account and -12,838,810 into the Type 5 account, thereby increasing the short position to 25,464,563 shares, rather than netting it to zero.

6. During the investigation, the Firm reported to the NYSE additional errors in its systems and procedures for determining its short interest. Due to these errors, the Firm made erroneous filings monthly to the NYSE for approximately three and a half years, between January 2001 and May 2004. The reporting errors stemmed from: (i) the Firm's failure to update and add new accounts to the Firm's system used to adjust

* Hearing Panel Note: The facts, allegations, and conclusions contained in paragraphs 1 to 45 are taken from the executed Stipulation of Facts and Consent to Penalty between Enforcement and Respondent Firm. No changes have been made to the stipulated paragraphs by the Hearing Panel, except that certain names have been deleted to protect the privacy of non-parties.

and correct short positions; (ii) a programming error in that same computer system, and; (iii) the Firm's inclusion of certain syndicate accounts in its reporting. The Firm's short interest reporting errors materially impacted the NYSE's overall short interest reporting with respect to certain securities during this time period.

7. The Firm failed to exercise reasonable supervision over its short interest reporting activities. The Firm did not have written procedures in place for the review and verification of the short interest reports filed with the NYSE. Moreover, the Firm failed to have adequate supervisory systems or procedures in place to monitor, review, and perform follow-up reviews regarding its compliance with applicable short interest reporting requirements.

<u>Short Interest Reporting Requirements</u>

8. NYSE Rule 421 requires, in part, that member organizations shall submit to the NYSE monthly reports of short positions ("short interest reports") in securities that are listed on the NYSE. Short interest reports must include customer and proprietary accounts. However, NYSE Rule 421 directs the exclusion of syndicate accounts in a member organization's computation of its short interest position that it reports to the NYSE.[1]

9. Pursuant to NYSE Rule 421, the Firm, at all relevant times made monthly reports of its short positions in listed securities to the NYSE. The NYSE in turn relied on the accuracy of the short interest figures reported by the Firm in compiling its own calculations of overall short interest in NYSE-listed securities.

<u>Short Interest Reporting Error in XYZ</u>

10. During the period in which the Firm inaccurately reported short interest, the Firm relied on an automated system to comply with its short interest reporting requirements with the NYSE. The Firm's short interest reports were generated by the Firm's Technology Department and filed electronically with the NYSE, without review for errors.

11. In April 2004, the Firm reported to the NYSE short interest of 26,089,923 shares in XYZ. The NYSE Short Interest Symbol Comparison Report for the month of April 2004 for XYZ reflected that the Firm's short position from the prior month was 388,694 shares. The Firm's April 2004 report reflected an increase of 25,701,229 shares in XYZ.

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[1] NYSE Rule 421 requires the reporting of "short" positions resulting from "short" sales as defined in Section 3(b) of the Securities Exchange Act of 1934 ("Exchange Act") and Rule 3b-3 thereunder, but excludes positions resulting from sales by, amongst others, any member of a syndicate or group participating in the distribution of a security as specified in Section 10(a) of the Exchange Act and Rule 10a –1(e)(10) thereunder.

12. In instances where there has been a significant change from the prior month in the short position of a given security, the NYSE asks the firm to verify the accuracy of the current short position number.

13. In response to a request from the NYSE, the Firm's staff faxed a confirmation letter verifying the accuracy of the April 2004 XYZ short interest position. This information was given to the NYSE without any supervisory review of the letter by the Firm. Relying on the Firm's confirmation, the NYSE published its short interest numbers in XYZ for April 2004 using the inaccurate short interest number provided by the Firm, causing the NYSE's published short interest position in XYZ to be inaccurate by 62%.

14. The immediate cause of the XYZ reporting error was the incorrect designation by a Firm employee of XYZ shares into the wrong short and long account types, which resulted in doubling the short position to approximately 25.4 million shares.

15. The underlying cause of the XYZ reporting error was the Firm's failure to update its systems for determining its short interest position. Although a macro existed to review a main table of accounts and make any necessary adjustments to short positions and long positions, the Firm failed to update and add new accounts to the main table of accounts that the macro reviewed, thereby requiring the manual entry. The Firm's failure to update the table of accounts reviewed by the macro is also the source of additional short interest reporting errors during this time period, as is set forth more fully below.

16. The Firm discovered the error in May 2004, after twice being contacted by MFR regarding the Firm's April 2004 XYZ short interest position.

17. The Firm failed to have procedures in place to ensure the accuracy of its short interest reports prior to their filing with the NYSE.

18. The Firm also failed to have written procedures in place for the post-filing verification and confirmation process of its short interest reports filed with the NYSE. Moreover, the Firm provided conflicting verbal guidelines for this process that resulted in a lack of supervisory review.

19. The significant fluctuation in the April 2004 XYZ short interest position should have triggered heightened vigilance and inquiry by the Firm of the short interest reported in XYZ, but did not due to the lack of internal controls and clear policies and procedures for the Firm's short interest reporting and verification process.

Inaccuracies in Short Interest Reporting

20. As a result of the NYSE's inquiries into the Firm's April 2004 XYZ short interest reporting, the Firm conducted an internal operational review of this problem and

discovered that it had been reporting short interest inaccurately for three and a half years. The Firm also uncovered additional failures that are set forth below.

21. During the period in which the Firm inaccurately reported short interest, the inaccuracies were substantial with respect to certain NYSE-listed stocks. The Firm both under-reported short interest with respect to certain NYSE-listed stocks and over-reported it with regard to other NYSE-listed stocks. The Firm's misreporting involved substantial discrepancies in the total short interest for prominent or widely-held listed securities.

22. For example, in January 2002, the Firm erroneously reported short interest of 141,735 shares of ABC, when it should have reported no short interest for this stock. Based on the Firm's erroneous report, the NYSE in turn reported that overall short interest in ABC was 160,055 shares. Thus, the Firm's inaccurate report of its ABC, short position by 141,735 shares caused the NYSE report of total short interest in ABC, for that month to be inaccurate by 89%.

23. Additional errors by the Firm caused the NYSE to misreport by 71% the October 2003 short interest in DEF and by 82% the January 2004 short interest in GHI.

24. On average, the change in reported short interest shares was approximately 4,227,698 shares per month (representing numerous securities) with some of the larger changes (not including the XYZ misreporting) being 1.21 million shares under-reported for the stock JKL, in September 2003 and 7.79 million shares over-reported for the stock MNO, in June 2002.

25. During the period from January 2001 through April 2004, the Firm's inaccurate reports of short interest in individual securities affected the NYSE's calculation of short interest to the following extent:

- **In more than 4,000 instances**, inaccurate reporting by the Firm caused the NYSE's report of short interest in a particular security in a particular month to be inaccurate.

- **In April 2004**, the Firm reported to the NYSE short interest of 26,089,923 shares in XYZ when the correct figure was 625,360 shares. This caused the NYSE's published short interest position in XYZ to be inaccurate by 62%.

- **In 3 instances**, inaccurate reporting by the Firm caused the NYSE short interest report for a given security in a particular month to be inaccurate by 100% or more.

- **In 20 instances**, excluding the April 2004 XYZ reporting error, inaccurate reporting by the Firm caused the NYSE short interest report for a given security in a particular month to be inaccurate by 50% to 99%

- **In 8 instances**, inaccurate reporting by the Firm caused the NYSE short interest report for a given security in a particular month to be inaccurate by 25% to 49%

- **In 20 instances**, inaccurate reporting by the Firm caused the NYSE short interest report for a given security in a particular month to be inaccurate by 10% to 24%

- **In 29 instances**, inaccurate reporting by the Firm caused the NYSE short interest report for a given security in a particular month to be inaccurate by 5% to 9%

26. The NYSE packages the short interest reported by member firms and makes this available in a monthly Short Interest Report (now available on the nyse.com web-site in the News Releases section). The NYSE makes available to the marketplace the total short interest in each individual stock and warrant traded on the NYSE. The NYSE also packages and sells, on a subscription basis, additional information on short interest in NYSE-listed securities. Via the NYSE's nysedata.com web-site, purchasers can subscribe to the NYSE Short Interest File.

27. The NYSE's report of short interest is released each month to such media outlets as Dow Jones, the *Wall Street Journal*, *New York Times*, New York *Daily News*, and Bloomberg services.

28. As described above, the Firm's inaccuracies in reporting individual securities positions significantly affected the accuracy of the NYSE's published short interest data with respect to certain securities in certain months, and therefore the data on short interest available to the market place.

Errors in Process and Procedures

29. The inaccurate reports filed by the Firm from January 2001 through August 2004 stemmed from three problems, set forth in greater detail below.

Programming Error

30. In 2000, the Firm built and began using a macro in its computer system to address the costs of carrying positions on its equity derivative trading books. The Firm designed the macro to review accounts within the system and then pass journal entries to net down long positions in Type 2 and short positions in Type 5 within an account. The resulting data was fed into the Firm's mainframe system, which was ultimately utilized in generating the Firm's short interest reports.

31. However, the Firm incorrectly programmed the macro to run on T+1 for adjustments, which the macro computed as the "trade date" or "T" for posting on T +3.

32. This programming error resulted in the macro posting on T+4 to the trade date, rather than the correct day of T+3. Consequently, the Firm's postings were always one day behind, and its monthly report of short interest was potentially incorrect for every

NYSE-listed security reflected on the Firm's short interest report during the relevant period.

Failure to Update the Table of Accounts

33. The table of accounts reviewed by the macro, described above, needed to be maintained and updated. Initially, when the macro was built, new accounts were added. However, the Firm had no process in place to update the table of accounts and employees who operated the macro were unaware of the need to update the table of accounts.

34. Because of its lack of procedures, the Firm failed to report short interest in some NYSE- listed stocks and/or incorrectly reported short interest in other NYSE-listed stocks during the relevant period. The Firm took steps upon becoming aware of the failure to update the table of accounts, to add the accounts to the table of accounts.

Inclusion of Syndicate Accounts in Short Interest Computation

35. NYSE Rule 421 directs the exclusion of syndicate accounts in a firm's computation of its short interest position that it reports to the NYSE.

36. On January 21, 2005, the Firm reported to Enforcement that for a period of three and a half years, certain syndicate accounts had been erroneously included in some of the Firm's short interest reports.

37. The Firm failed to update the list of syndicate accounts that was reviewed to identify any syndicate accounts that needed removal from the short interest report. The Firm also failed to have written procedures in place for verification of syndicate short positions or for verification of syndicate account ranges. Therefore, certain syndicate accounts were incorrectly included in the Firm's short interest calculations.

38. This caused the Firm to file a number of inaccurate short interest reports during the relevant time period due to the inclusion of syndicate short positions.

Supervision Failures Related to Short Interest Reporting

39. Pursuant to NYSE Rule 342, member firms and organizations are required to provide for appropriate supervisory control of every area of business activity and compliance with securities laws and regulations, including a system of follow-up and review to comply with NYSE Rules and federal securities laws.

40. As set forth above, the Firm failed to establish and maintain appropriate systems and procedures to comply with its short interest reporting obligations to the NYSE. The Firm failed to consistently maintain and update systems that were ultimately used in generating its short interest reports.

41. The Firm failed to establish and maintain appropriate procedures and systems for the supervision and control of areas responsible for complying with NYSE short interest reporting requirements.

42. The Firm failed to implement internal controls designed to capture errors in its systems that were utilized to generate its short interest reports.

43. The Firm had inadequate procedures in place regarding the review and verification of its short interest reporting and failed to properly instruct the responsible employees as to the steps needed to ensure accurate reporting.

44. The Firm failed to establish a separate system of follow-up and review to comply with, or detect and prevent violations of, NYSE short interest reporting requirements.

45. The Firm has represented to Enforcement that it has implemented new procedures to pre-test short interest data before reporting, and that it has revised the verification process. The Firm has also represented that it has addressed the macro, first by revising it and implementing procedures to ensure that relevant data tables were updated, and then by creating a mainframe module to replace the functionality of the macro. The Firm also implemented procedures to ensure that the table of syndicate accounts used in reporting short interest is regularly updated.

DECISION

The Hearing Panel, in accepting the Stipulation of Facts and Consent to Penalty, found Respondent Firm guilty as set forth above by unanimous vote.

PENALTY

In view of the above findings, the Hearing Panel, by unanimous vote, imposed the penalty consented to by Respondent Firm of a censure and a fine of $400,000.

For the Hearing Panel

Peggy Kuo - Chief Hearing Officer
Panelists:
John Cirrito
John P. O'Brien