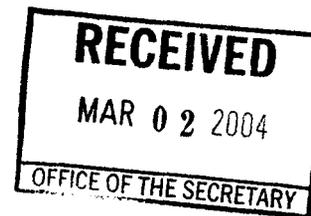


LEHMAN BROTHERS

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MARLISA VINCIGUERRA
MANAGING DIRECTOR & COUNSEL

March 1, 2004



Mr. Jonathan G. Katz
Secretary
U.S. Securities and Exchange Commission
450 Fifth Street, N.W.
Washington, D.C. 20549-0609

RE: Short Sales (File No. S7-23-03)

Lehman Brothers Inc. ("Lehman Brothers") welcomes the opportunity to comment on the proposal by the Securities and Exchange Commission ("Commission") to revise the rules governing short sales of equity securities.¹ Founded in 1853, Lehman Brothers is a registered broker-dealer that serves the financial needs of corporations, governments and municipalities, institutional clients, and high net-worth individuals worldwide.²

Lehman Brothers strongly agrees that reconsideration of the current regulatory framework for short sale regulation is appropriate at this time. It is our view that short sale restrictions not only have outlived any usefulness they may have once had, but also operate to impede market efficiency. In considering the Commission's proposal we believe that a phased or incremental approach to changing current short sale regulation would be prudent. In particular, we recommend that the Commission go forward with the proposed pilot program that would exclude certain liquid stocks from all short sale price regulation, but otherwise keep the existing regulatory framework intact during the duration of the pilot program. Doing so would allow the Commission to gather the data necessary to assess the impact of short sale price regulation on the efficient functioning of U.S. securities markets and the protection of investors. Indeed, we believe that the

¹ Proposed new Regulation SHO under the Securities Exchange Act of 1934 ("Exchange Act") would, among other things, replace current Exchange Act Rules 3b-3, 10a-1 and 10a-2. See Exchange Act Release No. 48,709 (Oct. 29, 2003), 68 Fed. Reg. 62,972 (Nov. 6, 2003) ("Proposing Release").

² In addition to its comments in this letter, Lehman Brothers also supports the comments submitted to the Commission by the Securities Industry Association, in which Lehman Brothers is a member.

data from the pilot will support the argument for less rather than more regulation of short sales and will demonstrate the benefits of short selling to the market.³

To the extent the Commission proceeds with implementing changes to short sale regulation in the form of a new uniform bid test prior to the conclusion of the pilot program, Lehman Brothers urges the implementation of certain additional changes to proposed Regulation SHO. First, we believe the market maker exception currently available under NASD Rule 3350 should be retained. Second, Lehman Brothers requests that the Commission apply the existing Rule 10a-1 tick test—and any short sale price regulation going forward—only to short sales executed during market hours.⁴ Finally, we urge the Commission to include in Regulation SHO a general exception for short sales effected in connection with *bona fide* hedging activity. These suggestions are addressed in more detail below.

The Proposed Pilot Program

The Commission proposes implementation of a pilot program that would temporarily suspend the operation of the Regulation SHO bid test for certain liquid securities. The Commission has previously recognized that highly liquid securities are less susceptible to manipulation and abuse than other securities.⁵ The purpose of the pilot would be “to enable [the Commission] to study the effects of relatively unrestricted short selling on, among other things, market volatility, price efficiency and liquidity.”⁶ Lehman Brothers agrees with the Commission that a pilot program would be a useful vehicle for obtaining hard data that could be used to evaluate whether short sale regulation is necessary.⁷ We also believe that the pilot program would be more effective

³ Other regulators have reached reasoned conclusions that short sale price regulations are not necessary for the efficient and fair functioning of the markets they oversee. For example, the Financial Services Authority (“FSA”) in the United Kingdom has taken the view that potential abuses can be adequately addressed through its general framework of trading rules, including consumer suitability, prudential safeguards, orderly markets, fair trading practices, and efficient settlement. *See* Financial Services Authority, Discussion Paper 17, Short Selling, at 15 (Oct. 2002).

⁴ The Commission states in the Proposing Release that it interprets the tick test to apply to all trades in listed securities, regardless of when they occur. Proposing Release at 62,997.

⁵ *See* Exchange Act Release No. 42,037 (Oct. 20, 1999), 64 Fed. Reg. 57,996 (Oct. 28, 1999) (“Concept Release”).

⁶ Proposing Release at 62,983. On this point, we note that the Commission previously proposed a pilot program that would have temporarily suspended the tick test for certain securities, but the pilot was never implemented. *See* Exchange Act Release Nos. 13,091 (Dec. 21, 1976) (proposing the original pilot) and 17,347 (Nov. 28, 1980) (withdrawing the proposal).

if it were designed to examine the impact on a variety of securities (not just the most actively traded) and if the pilot were conducted while maintaining existing short sale regulation price tests for stocks not selected to participate in the pilot.

We do not think the uniform bid test as proposed under Regulation SHO is an improvement over existing short sale regulation. Short sellers provide liquidity benefits to the market and requiring short sales to be executed one penny above the bid unreasonably burdens sellers engaging in legitimate trading strategies. Implementation of the uniform bid test would also require significant changes by market participants to their systems and compliance procedures. These changes would be costly for market participants. In addition, the updates needed to implement the proposed bid test may be unnecessary if additional changes to short sale regulation are adopted by the Commission in response to the data gathered and analyzed from the pilot program. Thus, we believe that the benefits of the proposed pilot can best be achieved without implementing a new bid test that would impose considerable and potentially unnecessary costs on market participants.

Apart from the unnecessary costs that would be imposed by changing the price test before completion of the pilot, we urge the Commission to consider that any data obtained under a pilot in such an environment would be more difficult for the Commission to evaluate—*i.e.*, there would be additional variables to identify when analyzing the results. By retaining the tick test and the NASD bid test for the duration of the pilot, the exception of liquid securities from short sale price regulation would be the only regulatory change reflected in this wide range of data collected. If the Regulation SHO bid test were adopted before implementing the pilot, systems changes necessary to comply with the new bid test would create additional noise in the market and may further color the data the Commission receives during the pilot.⁸

Hours of Price Regulation

Lehman Brothers believes short sale price regulation should apply only during normal trading hours for U.S. markets. Limiting the hours of current and future short sale price regulation to normal trading hours in the U.S. would combat abusive short sale strategies without expanding the scope of such regulation beyond the hours in which it is truly necessary.

⁷ The pilot “would ... allow [the Commission] to obtain empirical data to assess whether short sale regulation should be removed, in part or in whole, for actively traded securities.” *Id.*

⁸ In addition, a pilot implemented using the tick test and the NASD bid test would be an effective vehicle for testing the disparate impact of short sale regulation on listed and Nasdaq securities because the pilot group, whether it is chosen from the Russell 1000 or otherwise, would likely include both listed and Nasdaq securities. Lehman Brothers notes that the NASD bid test could be frozen for any Nasdaq securities selected for the pilot by the Commission pursuant to its authority to suspend self-regulatory organization rules under Section 19(c) of the Exchange Act.

After hours sales are not prone to the manipulative strategies that short sale regulation is designed to prevent. For example, bear raids rely on the reaction of investors to indications of declining prices. It is difficult, however, to send such signals in the after hours market, which is known for its lack of liquidity.⁹ The experience of the OTC market with the NASD bid test, which has not applied after 4:00 p.m. since it was first implemented in 1994,¹⁰ demonstrates the lack of opportunity for bear raids after hours. Lehman Brothers is not aware of any post-1994 Commission enforcement actions for abusive short sale activities effected in after hours trading.

The Commission has long recognized the difficulties of applying the current Rule 10a-1 tick test to after hours transactions. The Concept Release explains that “[i]f the Consolidated Tape does not operate after the close of regular trading hours, short sales can only be executed at a price above the closing price on the Consolidated Tape for the security (or, at the closing price if that price were an uptick) ... [which] could greatly limit the ability to execute short sales in after hours trading.”¹¹ We believe applying any short sale regulation after market hours unreasonably restricts legitimate trading and impedes the price discovery process. When negative news is released after 4:00 pm, the after hours trading of all buyers and sellers, including short sellers, facilitates the price movement of the stock toward equilibrium at the market open.

On a related note, Lehman Brothers urges the Commission to consider another undesirable consequence of applying U.S. short sale price regulations after markets close in the United States—namely, market participants may choose to conduct post-market closing short sales with trading operations outside the United States. If the Commission were to make it clear that U.S. short sale regulation—both the current tick test and, if adopted, the Regulation SHO bid test—does not apply after 4:00 p.m., there would be less incentive to effect after hours short sales with foreign trading desks outside the United States.¹²

⁹ Participants in a 1999 after-hours summit, which included the Commission, agreed that after hours prices do not reflect the more robust liquidity that is typically available during market hours. In a study issued after the summit, the Commission’s Division of Market Regulation concluded that “[w]hile further enhancements to market transparency and advances in linkages among after-hours trading venues may improve the liquidity of this market in the years to come, full-fledged 24-hour a day trading in U.S. stocks remains in the future.” Special Study: Electronic Communication Networks and After-Hours Trading (June 2000), *available at* <http://www.sec.gov/news/studies/ecnafter.htm>.

¹⁰ See Exchange Act Release No. 34,277 (June 29, 1994), 59 Fed. Reg. 34,885 (July 7, 1994).

¹¹ See Concept Release at 58,002.

¹² See Division of Market Regulation, SEC, Market 2000: An Examination of Current Equity Market Developments (January 1994), Study VII (noting that U.S. broker-dealers often execute transactions overseas to avoid U.S. regulatory requirements,

Market Maker Exception

If the Commission adopts the Regulation SHO bid test (or another uniform bid test), Lehman Brothers recommends that the Commission adopt an exception for sales in all securities subject to such new bid test that are effected by a market maker in connection with market making activities.¹³ Market makers facilitate the operation of markets by offsetting “temporary imbalances in the buying and selling interest for securities.”¹⁴ We believe a market maker exception to the Regulation SHO bid test would remove unnecessary impediments imposed on market making activities by allowing market makers to adjust inventory positions quickly and provide greater liquidity to the markets they serve.¹⁵ Therefore, the Commission should adopt the exception provided by current NASD Rule 3350(c)(1), exempting from the NASD bid test the short sales of Nasdaq NMS securities by market makers in such securities made in connection with bona fide market making activity.¹⁶

Hedging Exception

The Proposing Release states that a hedging exception would not be necessary under Regulation SHO because the proposed bid test and pilot program would provide market participants with additional flexibility in effecting short sales in order to hedge

including restrictions on short sales). The Commission has recently approved approved measures designed to minimize incentives for broker-dealers to execute transactions outside the United States. *See, e.g.*, Exchange Act Release No. 48,857 (Dec. 1, 2003) (approving the New York Stock Exchange’s plan to introduce Crossing Session III, which is to be used for the execution of guaranteed price coupled orders to fill the balance of orders at prices guaranteed before market closing) and Exchange Act Release No. 48,659 (Oct. 20, 2003) (noting that Crossing Session III is designed to “obviate any perceived need to execute these transactions in London or elsewhere.”)

¹³ The Proposing Release asks whether there should be a blanket exception for *bona fide* market making, but no such exception is included in Regulation SHO. Proposing Release at 62,990.

¹⁴ Proposing Release at 62,974.

¹⁵ This important role of market makers is otherwise recognized by the Commission in Regulation SHO, which includes a market maker exception to the proposed “locate” requirements. “[A] narrow exception for market makers and specialists engaged in bona fide market making activities is necessary because they may need to facilitate customer orders in fast moving markets without possible delays associated with complying with the proposed ‘locate’ rule.” Proposing Release at 62,997.

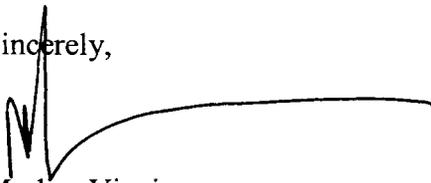
¹⁶ In this context, *bona fide* market making does not include certain speculative activity the NASD considers unrelated to normal market making activities, such as index arbitrage and risk arbitrage that are independent from a member firm’s market making function.

long exposure.¹⁷ We disagree with this assertion and propose adding a general exception to Regulation SHO for *bona fide* hedging activities by broker-dealers that are facilitating customer orders for all types of investment products, including stocks, options, exchange traded funds and futures.¹⁸ Lehman Brothers is a member of the OTC Derivative Products Committee of the Securities Industry Association, and we strongly support the more detailed comments made by the Committee to address this subject in its separately submitted comments on the Proposing Release.

* * *

We appreciate this opportunity to express our views on the Proposing Release. Lehman Brothers commends the Commission for its comprehensive review of current short sale regulations and encourages the continuation of this review through the implementation of the pilot program before making any further changes. If the Commission or its staff have any questions, please do not hesitate to contact me at (212) 526-0481.

Sincerely,



Marlisa Vinciguerra

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¹⁷ Proposing Release at 62,995.

¹⁸ Indeed, Lehman Brothers supports a hedging exception to any short sale price regulation (bid test, tick test or otherwise).