LEHMAN BROTHERS

MARLISA VINCIGUERRA
MANAGING DIRECTOR AND COUNSEL

July 30, 2004

Mr. Jonathan G. Katz
Secretary
U.S. Securities and Exchange Commission
450 115 Street, N.W.
Washington, D.C. 20549

Re: Proposed Regulation NMS (File No. S7-10-04)

Dear Mr. Katz:

Lehman Brothers Inc. ("Lehman Brothers") appreciates this opportunity to comment on the proposal by the Securities and Exchange Commission (the "Commission") to adopt rules modernizing the regulatory structure of the U.S. equity markets and to reorganize the existing national market system ("NMS") rules adopted under Section 11A of the Securities Exchange Act of 1934 (the "Exchange Act") as a new Regulation NMS ("Proposed Regulation NMS").[1] Founded in 1850, Lehman Brothers (directly and through its affiliates) participates actively in the U.S. and global equity markets in a variety of roles, including as broker, dealer, market-maker, institutional investor, investment bank, investment manager and exchange member.

Lehman Brothers commends the Commission's willingness to address the complex issues that affect equity market structure and its efforts to resolve these issues through an inclusive dialogue among a broad range of interested market participants. We fully support the Commission's effort to update the current regulatory framework for the U.S. equity markets. We also recognize the complex challenges faced by the Commission in endeavoring to reconcile a range of intersecting policy objectives, such as assuring liquid and transparent markets and investor protection while fostering fair competition among different business models and encouraging technological innovation and economic efficiency.

In reconciling these competing objectives, we believe the Commission must ensure that the new Regulation NMS effectively promotes liquidity and market transparency in an environment in which investors can accurately and reliably observe their execution alternatives and make the most informed decisions regarding how best to accomplish their

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[1] SEC Release No. 34-49325 (Feb. 26, 2004), 69 Fed. Reg. 11125 (Mar. 9, 2004) (the "Proposing Release"); *see also* SEC Release No. 34-497495 (May 20, 2004), 69 Fed. Reg. 30141 (May 26, 2004) (extending the period for comment on Proposed Regulation NMS and requesting further comments).

objectives, without being misled as to the effective costs of execution, the true availability of market quotations or the available depth of market. We believe the Commission should promote an environment in which there is no effective distinction between a displayed quotation and an executable order.

Such a market structure will enhance transparency and liquidity, will promote fair and vigorous competition among market centers and will ensure that investors enjoy reduced trading costs and more efficient order execution. For the reasons discussed below, however, we are concerned that aspects of Proposed Regulation NMS fall short of these objectives.

I. Overview.

We have summarized immediately below our principal recommendations regarding Proposed Regulation NMS.

- *Trade-through*. Auto-execution markets[2] should be linked in a manner that obviates any need for a trade-through rule by automatically routing orders to the inside bid/offer to the full extent of the available displayed interest. No trade-through prohibition should apply to a bid or offer that originates in an auto-execution market vis-à-vis a bid or offer that is displayed in a market that is not an auto-execution market (a "manual-execution market"). Instead, brokers should be guided by their best execution obligations in determining whether, under the circumstances, to route a customer order to a manual-execution market, on the one hand, or an auto-execution market that displays a higher/lower inside bid/offer, on the other hand.

- *Market Access*. We support the Commission's proposal to require that market centers provide non-discriminatory quote and execution access to non-subscribers regardless of the market center's share of trading volume in the relevant security. We also believe the Commission should require market centers to incorporate access fees in any displayed quote subject to such fees.

- *Sub-penny Pricing.* We support the Commission's proposal to prohibit market participants from accepting, ranking or displaying orders, quotes and indications of interest in an NMS stock in a pricing increment finer than a penny, subject to a limited exception in order to incorporate access fees in any displayed quote subject to such fees.

We discuss each of these recommendations briefly in the sections that follow.

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[2] By auto-execution market, we refer to any portion of a market center's limit order book in which (1) execution is automated and substantially instantaneous (free of any human intervention), (2) reports of execution or non-execution are automated and substantially instantaneous and (3) quotation updates are automated and instantaneous upon order execution, cancellation or modification.

II. Regulation NMS Should Promote an Integrated National Market System for Equity Securities in which Market Centers Are Appropriately Incentivized Either to Adopt Auto-Execution Capabilities or to Provide Market-tested Benefits to Investors Electing Manual Execution.

Lehman Brothers welcomes the Commission's efforts to improve the interaction between competing market venues on terms beneficial for investors. We strongly support the objective of fully integrated markets. It is critical, however, that in promoting this objective the Commission avoid inefficient interim solutions that cobble together disparate markets under a complex framework of restrictions and exceptions that, in the end, disincentivize legacy markets from developing on an expeditious basis into markets that are more responsive to the needs of investors. Clearly, the Commission cannot, and should not, mandate that markets adopt particular business models. At the same time, the Commission should not insulate market centers from the consequences that would otherwise result from their failure to be responsive to the legitimate interests of investors and related market forces.

We are concerned that Proposed Regulation NMS fails to appropriately incentivize the development of efficient markets that can be seamlessly linked as a single integrated market comprising all market centers. Instead, we believe that Proposed Regulation NMS will perpetuate market inefficiencies that impede accurate investor discovery of market price and depth and certainty of execution and that could impair the ability of more efficient markets, such as those operating automatic execution systems, from effectively delivering the benefits of their liquidity and efficiency to investors.

We urge the Commission to embrace a market structure model based on direct immediate access to quotations, regardless of where they are published, and automatic execution of bids and offers up to their full size. This model most closely approximates the market framework mandated by Congress in Section 11A of the Exchange Act and is made possible today by rapid technological advances that permit nearly instantaneous interaction among displayed quotations and automated order routing and execution.[3]

We believe that the Commission should require that all auto-execution markets be linked,[4] with uniform access standards as contemplated in Proposed Regulation NMS, in a manner that automatically routes orders to the inside bid/offer for execution to the full extent of the available displayed interest.[5] This structure will obviate any need for a trade-through rule. Within this framework, investors will both see and have reliable access to the market's inside bid/offer.

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[3] Section 11A of the Exchange Act "envisions a market structure characterized by full transparency where competing markets are linked together to provide the ability to effectively and efficiently execute customer orders in the best available market." Proposing Release at 11130.

[4] The Commission must ensure that intermarket linkages under Regulation NMS do not incorporate conflicts of interest and other structural obstacles to progress of the type that characterize the current ITS Plans.

[5] A broker or market center would not, of course, be obligated to route out an order to the extent the order can be filled by the broker or market center at a level equal to, or better than, the inside market.

While automatic linkages to manual-execution markets should be preserved, no trade-through rule should require a bid or offer that originates in an auto-execution market to be routed for execution against an offer or bid that is displayed in a manual-execution market. Instead, brokers and their customers should have the ability to do so and brokers should be guided by their best execution obligations in determining whether, under the circumstances, to route a customer order to a manual-execution market or an auto-execution market that displays a higher/lower inside bid/offer.

As the Commission is well aware, a significant debate has raged over recent years regarding the uncertainty of execution of agency-displayed bids and offers in manual-execution markets. This debate has been fueled by differing views regarding the role of specialists in supplying liquidity to the equity markets. We are not ourselves convinced that manual-execution markets are in fact superior to auto-execution markets in supplying liquidity. A comparison of spreads and effective execution costs associated with the execution of block transactions in large capitalization stocks in manual-execution and auto-execution markets suggests that manual-execution markets do not provide greater liquidity than auto-execution markets. Indeed, the opposite appears true.

In any event, we believe that market forces, rather than the Commission, should determine whether or when manual-execution markets are supplying better execution alternatives to other manual-execution markets or to auto-execution markets. Allowing market forces (together with the duty of best execution) to operate in this sphere will incentivize market centers either to adopt auto-execution capabilities that are competitive or to deliver reliable manual-execution benefits that the market can test and embrace (or not), based on their performance. In either case, investors and the market as a whole will benefit by every policy metric that the Exchange Act's national market system is designed to promote.

Based on the foregoing, we do not believe that the Commission should retain the trade-through prohibition in whole, or subject to specific exceptions. The Commission should instead promote incentives to modernization and allow brokers and investors to seek out the most efficient and reliable trading venues.[6]

III. The Commission Should Promote Uniform Intermarket Access Standards and Require the Incorporation of Access Fees in Displayed Quotes.

Lehman Brothers supports the Commission's determination to formulate consistent standards of market access across competing market centers. We endorse the Commission's proposal to require that market centers provide non-discriminatory quote and execution access to non-subscribers regardless of the market center's share of trading volume in the relevant security. We also share the Commission's concerns regarding the impact of access fees on such access and on market transparency in general.

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[6] We recognize that attaching differential regulatory consequences to quotes in auto-execution and manual-execution markets will raise systems-related implementation issues. Nonetheless, we believe the record established by the hearings on Regulation NMS indicates that it will not be unduly costly or burdensome to address these issues.

Nonetheless, we are concerned, as a matter of principle, by the Commission's proposed regulation of access fee levels. We are similarly concerned that the elimination of access fees (or capping such fees at "*de minimis*" levels) could impair the ability of market centers to fund their infrastructure and could limit prospectively the very technological innovation that has largely driven modernization and enhanced liquidity in the U.S. equity markets. We believe such steps would be fundamentally inconsistent with the important objectives of promoting competition and innovation.

In light of these concerns, we believe the Commission should instead require that access fees be incorporated in any displayed quotes that are subject to such fees.[7] We believe that doing so will improve transparency, promote fairness, protect investors, and facilitate compliance with best execution obligations, without adversely affecting innovation or fair competition. We further believe that the incorporation of access fees in displayed quotes will naturally incentivize market centers to minimize access fees, as outsized fees will make the market center a less desirable environment in which to display quotes. We firmly believe that the use of market forces to regulate access fees will further the Commission's national market system objectives in a manner that optimizes desirable consequences and minimizes undesirable effects.

IV. Participants in the Equity Markets Should Generally Be Prohibited from Accepting Quotes in a Pricing Increment Finer Than a Penny.

Lehman Brothers supports the Commission's proposal to prohibit market participants from accepting, ranking or displaying orders, quotes or indications of interest in an NMS stock in a pricing increment smaller than a penny, subject to a limited exception that would be necessary if, as we have suggested above, the Commission requires that access fees be incorporated in any displayed quote.[8] Lehman Brothers is not, however, opposed to sub-penny pricing for a limited category of securities that have substantially lower than average per share prices and that therefore would not give rise to the same risks as those associated by the Commission with sub-penny pricing generally. Lehman Brothers supports the Commission's proposal to continue permitting the execution of transactions (as opposed to quoting) in sub-penny increments.

While we are generally opposed to regulatory interference with competitive pricing mechanisms, we share the Commission's concerns regarding the potential disadvantages to less sophisticated investors, diminished depth at quoted price increments and related adverse effects that are associated with sub-penny pricing. We therefore generally agree with the Commission's conclusion that the economic benefits of any decrease in the pricing increment finer than a penny for equity securities are outweighed by the attendant costs and inequities.[9]

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[7] We discuss in the immediately following section the impact of this approach on minimum pricing increments.

[8] *See* Rule 612 of Proposed Regulation NMS.

[9] *See* Proposing Release at 11165.

As noted above, however, we believe that any access fee charged by ECNs, ATSs or other market centers should be incorporated in the displayed quotes that are subject to the fee. We recognize that doing so would potentially result in the display of quotes with sub-penny increments.[10] We do not believe that this would give rise to the perceived abuses or ill effects associated with the display of investor orders that originate in sub-penny increments. While the incorporation of access fees could somewhat diminish quoted depth at given pricing increments, we do not believe that this effect would be nearly as pronounced as it is in the case of orders intentionally submitted in sub-penny pricing increments specifically for the purpose of gaining order execution priority. We similarly do not believe that sub-penny pricing increments arising from the incorporation of access fees displayed in quotes would in any way disadvantage less sophisticated investors. To the contrary, as noted above, we believe that the resulting improvement in transparency would benefit all investors, including, in particular, less sophisticated investors and would, if anything, facilitate broker compliance with best execution obligations.

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Lehman Brothers appreciates the opportunity to comment on Proposed Regulation NMS. Should you have any questions regarding any of the matters discussed in this letter, please do not hesitate to contact the undersigned at (212) 526-0481.

Sincerely,

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Marlisa Vinciguerra
Lehman Brothers Inc.

cc: Annette Nazareth, Director, Division of Market Regulation, SEC
Robert L.D. Colby, Deputy Director, Division of Market Regulation, SEC
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[10] We would not be opposed, in the alternative, to an approach under which quote priority would reflect any sub-penny access fee component and some convention (other than display of the sub-penny increment) is used to indicate that a particular quote is subject to an additional sub-penny pricing increment (or conversely, subject to sub-penny price improvement).