

REGISTERED REP.

November 1, 2008

“Principal Protected” Products Weren’t

By John Aidan Byrne

As nervous retail investors, spooked by Wall Street's fading fortunes, started seeking a safer haven for their money in recent months — and the potential to juice returns with seemingly no downside risk — many were lured by offers of “principal protection.”

And so were many advisors. “The reps thought products that provided this principal protection looked pretty good for their customers, and also gave the brokers a nice way to make a commission,” said Roger Robson, founding principal of CapTrust Financial Advisors in Tampa, Florida.

These products, in fact, were the near perfect vehicle for some very frustrated registered reps. As the markets stumbled through the credit crisis, many faced humiliating resistance to their investment advice from clients worried about an ongoing financial bloodbath.

But in this challenging environment, reps discovered some willing takers for investments clearly labeled as “principal protected” investments — products that sounded as secure as boring FDIC-backed Certificates of Deposit and stodgy U.S. Treasuries. But they went one better: They had the potential to capture some of the

upside in the equity and debt markets. And protect principal — or so FAs thought,

The notes projected safety, with names like “Principal Protected Notes” from JPMorgan; “Principal Protected Bear Notes” from Barclays; Citi's “Principal Protected Trust Certificates” and UBS' “100% Principal Protection Notes.”

“This type of structure is designed for investors seeking to protect their entire investment while having the potential to participate in a possible increase (or decrease in a bearish strategy) in value of an equities-linked or other index (e.g. commodities), during the term of the note,” according to structuredinvestments.com, a website sponsored by Chicago-based securities firm Incapital LLC.

Unfortunately for investors and their advisors, these “protected” securities are part of the esoteric structured notes markets, which has an estimated value of \$114 billion — and they are not as trouble-free as some might have once thought. The investments — such as Lehman's “Equity Structured Solutions,” which just a few months ago was offering “100% Principal Protection Notes Linked to the S&P 500 Index” for a \$10,000 minimum down — were actually a ticking time bomb.

With Lehman in bankruptcy protection, that time bomb has just exploded, and the fallout threatens to wreak further havoc on big players like UBS, Merrill Lynch, Morgan Stanley and Goldman Sachs — who are racing to shore up their weakened capital bases — and to douse the flames of a global credit crisis. The fallout has chilling similarities to the collapse of the \$330 billion once-reliable auction-rate securities market. Earlier this year, the ARS markets froze, triggering a trail of investor lawsuits and the intervention of state governments siding with investors. About one-third of structured notes issued last year touted full or partial principal protection.

In an eerie echo of the ARS fiasco, some holders in Lehman structured products, (which are typically regarded as unsecured debt), have looked to the secondary market as they desperately seek liquidity at discounted prices. SecondMarket in New York, formerly Restricted Securities Trading Network, says it has been contacted by holders of over \$1 billion in Lehman structured paper, including principal protected notes. “We have a number of buyers lined up,” said CEO Barry Silbert.

Although news of the blow up in the structured notes market has been lost in the thicket of other grim news on Wall Street — including the U.S. government's bailout — legal eagles at major banks are seeing a steady stream of lawsuits from investors in principal protected notes. That's because despite their names, the notes weren't in fact bulletproof. If an underlying company failed — such as Lehman Brothers — the investor would lose money.

“SueBS”

Among the legal targets is Switzerland's UBS. Last month, UBS was promised a \$5.2 billion capital injection by

the Swiss government and assistance for \$60 billion in damaged assets, a much-needed rescue plan for the European powerhouse caught up in the credit crisis.

But the collapse of Lehman has compounded the woes for UBS, which sold some principal protected notes tied to Lehman — and has a slew of claims from aggrieved investors, running as high as multi-million dollars per individual cases, according to people familiar with the situation. UBS has sought to downplay its exposure to — and the fallout from — Lehman, which a spokesman in Singapore recently told a local reporter would not exceed \$300 million globally.

But others are not so sure. After all, UBS, which had some \$44 billion of credit losses and write-downs since the start of 2007, is struggling to stem the outflow of client assets. UBS is not alone.

“We have cases on structured notes involving Citi, Lehman, Merrill and others. I think these are the next wave of big cases brought by investors in arbitration,” said Jacob Zamansky, a New York-based securities industry attorney. “We are getting ready to file.”

Added Zamansky: “I am seeing a lot of pain. When investors are told their product is a principal protected note their expectation is that they can't lose their principal.”

Of course, that depends on what exactly reps did tell their clients, some experts will argue. Even though prospectuses and disclosure documents published by issuers may include standalone clauses and full disclosure about the risks, arbitration panels are not usually sympathetic when reps are cited for “oral misstatements,” according to Professor John Coffee, an expert in securities law at Columbia University.

Robson, of CapTrust, shied away from selling structured notes. He also has no

bone to pick with the numerous prospectuses for structured note offerings he reviewed, finding the disclosures adequate. "But if a broker called my mother to sell her principal protected notes, she would assume her principal was protected," he added. "Then she finds out later that the principal is only protected as long as the firm is around to pay — that's a different matter."

The material pitching Lehman's principal protected notes this past summer, just before it filed for bankruptcy, does mention the notes "will be subject to the credit risk of Lehman Brothers."

On its website, when describing its principal protection strategies, UBS says that the level of protection "is usually 100 percent, although some structured products may offer you principal protection as low as 80 percent, providing even greater potential return opportunities through greater exposure to the underlying asset in exchange for accepting the increased risk."

UBS' U.S. offices declined to comment for this story. A spokesman for Lehman did not return a phone call.

Zamansky, who's busy fielding phone calls from aggravated holders of principal protected paper, says the individual claims on his desk range from several hundred thousand dollars to as high as "millions of dollars." He doesn't buy the argument that Lehman is off the hook with its bankruptcy.

"Oh, we didn't expect Lehman to go out of business, so we can't pay you now,' Sure, I think that argument is going to be raised," he said. "But I think it was clear, certainly in the last few months, maybe earlier, that Lehman was in serious trouble."

So, Zamansky is making the case that for some investors these products

were not suitable. "I don't think these principal protected notes should have been sold to individual investors," he added. "To blame the credit crisis; to blame Lehman's troubles is just not going to work for the brokerage firms."

Robson, who advises wealthy families on their investments, warns that if reps made false statements to investors who later suffered steep losses on the notes, these investors could have grounds for a case against the original issuers in arbitration.

"The truth is some reps probably felt they'd provided enough disclosure," Robson said, noting the disclosure documents and the trust some reps place in their firms. "But I think there is going to be a lot of reps who were a little naïve.

WHAT ARE PRINCIPAL PROTECTED NOTES?

Principal Protected Notes (PPNs) are structured investment products, hybrid-style securities that include elements of fixed income notes with derivatives. PPNs are usually linked to an equities index, group of indices or other assets. As the name suggests, PPNs aim to protect principal for investors who also seek potential gains in the equities linked or other indices. Most PPNs have a term of three to eight years, and are generally tied in the U.S. to the S&P 500, NASDAQ 100 and the Dow Jones Industrial Average.

Total size of structured notes market (2008): \$114 billion

Notes held by individual investors (2008): \$40 billion (approx.)

33% of notes issued in 2007 offered full or partial principal protection