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### Structured Notes Start to Overcome the Lehman Taint

By Matthew Goldstein

Principal-protected notes, complex securities that are marketed as carrying a money-back guarantee, are starting to spring back to life after having lost much of their luster when Lehman Brothers collapsed.

This year, Bank of America (BAC.N), Barclays (BARC.L), Citigroup (C.N), HSBC (HSBA.L) and JPMorgan Chase (JPM.N) all have filed offering statements with U.S. securities regulators to sell principal-protected notes that guarantee investors the return of either 95 percent or 100 percent of their initial outlay, even if the underlying investment does not pay off.

Research firm Greenwich Associates predicts investor demand for principal-protected notes and other structured products will rebound in 2010, after evaporating in Lehman's wake.

U.S. regulators, meanwhile, have taken notice of the revival and some critics of structured products are not pleased to see Wall Street quickly returning to its old ways.

"Principal protected is pure marketing gloss and I think it is deceptive," said Craig McCann, director of the Securities Litigation Consulting Group, a research firm that frequently works with attorneys who side with investors. "They

have added this label to something that essentially is unsecured."

Most banks that issue and sell principal-protected notes declined to comment. But privately, banks pointed out that the prospectuses state that the guaranty is ultimately dependent on the creditworthiness of the issuer.

Indeed, for that reason, the Lehman bankruptcy was a rude awakening for retail investors around the globe who had purchased principal-protected notes as a supposedly safer way to wager a long-range bet on the performance of a basket of stocks, commodities, currencies or a major index.

Before Lehman collapsed, the Wall Street sales pitch for principal-protected notes was an easy one: Investors were told that even if the underlying wager did not pay off, they would get back their principal back if they held the notes to maturity. But when Lehman filed for bankruptcy, the guarantee the investment firm had written on some \$40 billion worth of principal-protected notes essentially went up in smoke.

Investor losses on Lehman-issued notes spawned lawsuits against brokers that sold them and investigations by overseas

regulators. Some predicted principal-protected notes and any other structured products would have a tough time recapturing the fancy of investors.

But over the past year, the deals have started to reappear and investors are overcoming some of their post-Lehman skittishness as the threat of another big bank failure recedes.

"I do think there is some merit to these products, especially once people feel like their counterparties are stronger," said Andrew Awad, a consultant with Greenwich Associates.

To be sure, principal-protected notes and structured products have a long way to go before they reach their pre-Lehman glory days. Greenwich Associates estimates that U.S. sales of structured notes in the two years since the financial crisis began slumped 30 percent to \$35 billion.

But the revival is not just confined to the United States. In Europe, Greenwich Associates said the market for structured products, in particular principal-protected notes, is coming back even faster.

For instance, Goldman Sachs (GS.N), in November, filed a registration statement with Irish regulators to sell "103 percent principal-protected index-linked" notes that are tied to the performance of a hedge fund managed by FTC Asset Management. A Goldman spokeswoman says the firm not only guarantees the return of an investor's principal if the 10-year notes are held to maturity, but "a minimum of a 3 percent return over its life."

One reason Wall Street is banking on a rebound for principal-protected notes is that these securities generate significant underwriting and sales fees. Principal-protected notes also serve as a cheap source of funding because the notes pay a return only if the underlying investment performs as anticipated.

Still, the renewed interest in these complex securities comes as Wall Street is grappling with the legal and regulatory fallout from the sale of all those now worthless Lehman notes.

In November, a securities industry arbitration panel ordered UBS to pay \$200,000 in damages to Patricia Flanagan, a 57-year-old South Carolina investor who had bought about \$300,000 worth of Lehman-backed principal-protected notes. Flanagan claimed UBS "failed to disclose" that Lehman "was a deeply troubled company at the time" she purchased the notes.

A UBS spokesman said the company met all regulatory requirements in selling Lehman notes and any "client losses were the direct result of the unexpected and unprecedented failure of Lehman Brothers."

The fallout from Lehman has prompted more scrutiny of the market from U.S. regulators.

The Securities and Exchange Commission recently created an enforcement team that will focus exclusively on complex financial products like principal-protected notes.

In December, the Financial Industry Regulatory Authority, the securities industry's main self-regulatory agency, issued a notice to firms reminding them that any "promotional materials" used to market principal-protected notes must be "fair and balanced" and not overstate the "level of protection."

The regulatory notice also cautioned firms that some principal-protected notes "involve high fees and hidden costs" and brokers must take that into account before selling them.

**Jacob Zamanksy, a securities lawyer who represented Flanagan in the arbitration against UBS, said a big problem with principal-protected notes and other structured products is that**

**deals are simply too complex for retail investors.**

**"The brokers often don't understand what they are selling and the**

**investors don't understand what they are buying," Zamansky said.**