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SEC Said to Review Principal-Protected Note Sales (Update 1)

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The U.S. Securities and Exchange Commission has asked several financial firms how they market “principal-protected” notes after investors said they lost more than \$1 billion on the securities when Lehman Brothers Holdings Inc. collapsed, according to people familiar with the matter.

The agency’s Division of Corporation Finance is looking at how companies describe the products’ risks and whether the term “principal protected” misleadingly implies the investment is guaranteed not to decline in value, said one of the people, who declined to be identified because the inquiry isn’t public.

Citigroup Inc., which used the phrase in its May marketing materials, removed it from a brochure filed June 15 with the SEC. “Citi is working with other banks and industry participants regarding the description of these products,” said spokesman Alexander Samuelson, who declined to comment on the inquiry.

Barclays Plc, Morgan Stanley and Bank of America Corp. are among banks that

in offering documents filed with the SEC describe some structured notes, which are bonds packaged with derivatives, as “principal protected.” Individual investors in the U.S. bought \$34 billion of all types of structured notes last year, according to StructuredRetailProducts.com, a database used by the industry.

Findings made by the SEC’s corporation finance division may be referred to the enforcement division, which investigates fraud. Kenneth Lench, head of the agency’s Structured and New Products enforcement unit, declined to comment on whether the enforcement division is looking into the securities. John Heine, an SEC spokesman, also declined to comment.

‘Marketing Materials’

Firms must include “full and accurate” disclosures of risks when marketing complex products, such as principal-protected notes,

to individual investors, Lench said in a June 25 telephone interview.

“You’ve got these long disclosure documents, but oftentimes there are marketing materials and those have to be accurate as well,” Lench said.

Kristin Friel, a spokeswoman for Barclays, Mark Lake, a spokesman for Morgan Stanley, and Selena Morris, a spokeswoman for Bank of America, declined to comment.

Issuers of principal-protected notes combine bonds with derivatives to offer investors bets on stocks and commodities, with a promise to return their initial outlay regardless of performance. That still leaves counterparty risk, or the danger of not being fully repaid because the issuer itself goes out of business, which is generally spelled out in the prospectuses.

‘Properly Sold’

When Lehman Brothers went bankrupt in September 2008, the principal-protected notes that it had guaranteed plummeted in value. A group of investors said in a lawsuit seeking class-action status that the firm sold at least \$1.7 billion of the securities. The investors also claimed that UBS AG brokers provided “misleading” information when using the term “100 percent principal protection” to market the notes.

Allison Chin-Leong a spokeswoman for UBS, said that the Zurich-based bank “properly sold” the Lehman products, “following all regulatory requirements, well-established sales practices and client disclosure guidelines.”

In April, Citigroup offered to compensate more than 2,700 Spanish investors who lost money on Lehman structured notes, without admitting liability. Some buyers of Lehman principal-protected notes have won restitution from their brokers in Financial Industry Regulatory Authority arbitration cases. Finra, the industry-funded brokerage regulator, sent a notice to brokers last year telling them to ensure that marketing materials for the securities are “fair and balanced.”