
PLAIN ENGLISH: A REAPPRAISAL OF THE INTENDED AUDIENCE OF DISCLOSURE UNDER THE SECURITIES ACT OF 1933

KENNETH B. FIRTEL*

I. INTRODUCTION

Over the years, bitter debate has surrounded the issue of for whom securities disclosure is intended. The Securities and Exchange Commission (“SEC”) has maintained that disclosure should be geared toward all types of investors, from the average investor to the professional financial analyst. Certain critics, however, contend that disclosure documents are too complicated to be used effectively by the layperson and should be used only by sophisticated investors.¹ The SEC has responded to this argument with consistent efforts to make disclosure documents more readable and understandable in an attempt to show that disclosure can be geared toward the average investor.² The most aggressive of these efforts has been the plain English disclosure rules, which the SEC adopted on January 22, 1998.³

Plain English stems from an Anglo-American legal tradition whereby famous scholars have continually called for the reform of legal writing to

* Class of 1999, University of Southern California School of Law; B.A. 1994, Yale University. I would like to thank Professor William Bogaard for his guidance; Shannon Rust for her suggestions; Walt Burkley for his valuable insight; and my family for their support.

1. *See infra* Part III.

2. *See infra* Part IV.

3. *See generally* Plain English Disclosures, Securities Act Release No. 7380, [1997 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 85,879, at 85,907 (Jan. 14, 1997) [hereinafter Proposed Plain English Rules]; Plain English Disclosure, Securities Act Release No. 33-7497, 63 Fed. Reg. 6370 (1998) [hereinafter Final Plain English Rules].

make it simpler and easier to understand.⁴ In the seventeenth century, Sir Edward Coke, the Chief Justice of England, advised his fellow lawyers that they should “speak effectively, plainly and shortly.”⁵ Likewise, in the eighteenth century Thomas Jefferson, when drafting a criminal bill, strove for “accuracy, brevity, and simplicity” instead of “modern statutory language, with all its tautologies, redundancies, and circumlocutions . . . unintelligible to those whom it most concerns.”⁶ In that same century, Jeremy Bentham characterized legal language as “excrementious matter” and “literary garbage” as he campaigned for written codes that were comprehensible to everyone.⁷

In the twentieth century, plain English gained appeal during World War II as the public struggled to understand government-enacted price-control regulations.⁸ As one critic remarked, “Almost all legal sentences . . . have a way of reading as though they had been translated from the German by someone with a rather meager knowledge of English.”⁹ After the war, however, the movement dwindled as the public relaxed due to the alleviation of wartime pressures. The movement remained dormant until the 1970s when the drive for plain English resurfaced as consumers rebelled against the obtuse language contained in insurance policies. In response, more than half of the states passed statutes requiring insurers to simplify the language in their policies.¹⁰ At the same time, a consumer movement was underway which focused on simplifying legal documents. In 1978, President Carter became the first President to require that government regulations be written in plain English.

During the 1980s the drive for plain English continued to gain momentum, and in 1991, Congress joined the movement as it began to ex-

4. See, e.g., Thomas W. Taylor, *Plain English for Army Lawyers*, 118 MIL. L. REV. 217, 223 (1987); DAVID MELLINKOFF, *THE LANGUAGE OF THE LAW* 252 (1963).

5. Taylor, *supra* note 4.

6. *Id.* (quoting Thomas Jefferson); MELLINKOFF, *supra* note 4, at 252-53 (quoting Thomas Jefferson).

7. Taylor, *supra* note 4.

8. See generally *id.*

9. *Id.*

10. See Robert Tie, *Plain English, Please*, INV. DEALERS DIG., Nov. 17, 1997, at 24. See also Proposed Plain English Rules, *supra* note 3, at 88,911 (discussing the plain English movement). The many simplified automobile insurance policies drafted in 1974 and the many simplified consumer loan agreements drafted in 1975 exemplify this resurgence in plain English. See Taylor, *supra* note 4, at 224. See also Reed Dickerson, *Plain English Statutes and Readability*, 64 MICH. B.J. 567, 567 (1985). Coupled with these developments, New York passed a consumer transactions law requiring plain English in 1978. This law, the first of its kind, stated that plain English is English “written in a clear and coherent manner using words with common everyday meanings.” Taylor, *supra* note 4, at 219.

press concerns about the complexity and length of limited partnership prospectuses.¹¹ Despite these developments, however, the plain English movement did not truly capture the attention of the SEC until 1993, when Arthur Levitt Jr. became Chairman of the SEC. Upon his election, Levitt immediately dedicated himself to the task of improving the clarity of disclosure as he knew that the language in prospectuses, and in many SEC rules and regulations, was so convoluted as to be nearly incomprehensible. Because of this fact, Levitt set out on what has become for him “a crusade”: to mandate the use of plain English in disclosure documents.¹² Five years later, Levitt realized this goal as the SEC adopted the plain English disclosure rules on January 22, 1998.

This Note will reappraise the intended audience of disclosure through an analysis of the SEC’s plain English rules. Part II of the Note will analyze the legislative intent of the Securities Act of 1933 (“‘33 Act”),¹³ the relevant case law, and the pertinent SEC regulations to elucidate the SEC view that disclosure is geared toward all types of investors. Part III will present the two alternate theories of the intended audience of disclosure: the “myth of the informed layman”¹⁴ and the filtration theory. Both of these theories will highlight the shortcomings in the prevailing SEC view by showing that any attempt to gear disclosure toward the average investor hinders the efficacy of the disclosure regime. Part IV will discuss how the SEC has continually ignored the alternate theories, choosing instead to focus on the form and style of disclosure as the reason why the average investor has been unable to read and use the prospectus. Part V will analyze these conflicting theories under the plain English rules and will assert that plain English does not strengthen the SEC’s view. Rather, its view falters under the scrutiny of the alternate theories and does little to show that the average investor is part of the intended audience of disclosure. Part VI will offer a reconciliation which asserts that plain English can be successful if the SEC accepts the fact that disclosure should not be geared toward

11. As former SEC Chairman Richard Bredden stated in the Congressional hearings on the need to reform the roll-up process in limited partnerships, “I have taken a look at some of the documents filed with us in these roll-up transactions and I would like to meet the person who can understand all of the disclosures in some of those documents.” H.R. REP. NO. 102-254, at 11 (1991).

12. Tie, *supra* note 10.

13. *See generally* 15 U.S.C. §§ 77a-77aa (1994 & Supp. II 1996).

14. Homer Kripke coined the phrase: “the myth of the informed layman.” Today, it is widely used to refer to a compelling critique of the traditional SEC view of disclosure. *See generally* Homer Kripke, *The Myth of the Informed Layman*, 28 BUS. LAW. 631 (1973) [hereinafter *The Myth*]. The use of “layman” instead of “layperson” does not reflect the view of the author of this Note with regard to the gender of investors.

the average investor and incorporates this idea into the plain English disclosure rules.

II. TO WHOM IS DISCLOSURE DIRECTED? THE TRADITIONAL SEC VIEW

The SEC's view of the intended audience of disclosure has gone through two different phases. First, looking to the legislative intent of the '33 Act, the SEC determined that Congress meant for disclosure to be aimed at the average investor. In the following years, the SEC and the courts, as they struggled to apply the disclosure requirements, further broadened this view to encompass not only the average investor but also the financial analyst and the market professional.

A. THE BIRTH OF DISCLOSURE UNDER THE '33 ACT

In the United States during the early 1920s, unsophisticated investors invaded the securities market for the first time in great numbers. Throughout the mid to late 1920s, the resulting growth in demand for securities, coupled with the rise in the standard of living, caused stock prices to rise. This further increased the influx of investors. The continued wave of investor attraction to the stock market drove stock prices even higher and created a false public expectation that the price of securities would "indefinitely advance."¹⁵ Of course, the market could not sustain the inflated prices and, in October of 1929, the stock market crashed, causing enormous real and paper losses for investors.

In the following years, the United States Senate investigated the underlying causes of the crash. Senate hearings uncovered evidence of unethical and fraudulent conduct on the part of investment bankers and corporate promoters during the late 1920s consisting of the manipulation of stock prices, conflicts of interest, and self-dealing. Also, underwriters, who were confronted with an insatiable public desire for securities, had abandoned traditional standards of banking as they urged corporations to offer highly speculative and fraudulent securities to uninformed investors.¹⁶ Confronted with this lack of integrity and morality, the Senate re-

15. VINCENT CAROSSO, *INVESTMENT BANKING IN AMERICA* 253 (1970) (quoting then Secretary of the Treasury Mellon). See also Alison Grey Anderson, *The Disclosure Process in Federal Securities Regulation: A Brief Review*, 25 *HASTINGS L.J.* 311, 316 (1973); Laylin K. James, *The Securities Act of 1933*, 32 *MICH. L. REV.* 624, 629 (1934).

16. See Anderson, *supra* note 15, at 317; CAROSSO, *supra* note 15, at 322-51; RALPH F. DE BEDTS, *THE NEW DEAL'S SEC: THE FORMATIVE YEARS 17-24* (1964). See generally FERDINAND PECORA, *WALL STREET UNDER OATH* (1939).

lized that the investing public had no legal remedy for losses caused by these breaches in fiduciary duty.¹⁷ It was at this time, in order to regain higher standards of conduct, that political leaders first acknowledged the need for a regulated capital market.

Following the Senate hearings, the need for federal securities regulation became a central theme of the presidential campaign of 1932. A major tenet of the Democratic Party Platform was corrective legislation aimed at remedying abuses associated with the Crash. Franklin D. Roosevelt had been a strong advocate of corporate and securities reform for several years. Once he was sworn in as President, the issue was thrust to the forefront of domestic policy. This is epitomized by a speech that President Roosevelt gave to Congress on March 29, 1933 in which he stated, "There is . . . an obligation upon us to insist that every issue of new securities to be sold in interstate commerce shall be accompanied by full publicity and information, and that no essentially important element attending the issue shall be concealed from the buying public."¹⁸ After this impassioned demand Congress quickly produced a legislative draft, and on July 7, 1933, just over three months after Roosevelt's fervent plea, Congress enacted the first of the federal securities acts, the '33 Act.¹⁹

The final draft of the '33 Act remained nominally true to Roosevelt's message, requiring full and fair disclosure of all material facts concerning securities publicly offered for sale through interstate commerce by an issuer or control person.²⁰ In fact, after its release the '33 Act was instantly

17. Writers such as Adolf A. Berle and Louis D. Brandeis reached this realization several years earlier as they argued that neither the members of the financial community nor the directors of public corporations were subject to liability for breaches of their duties to the investing public. See generally ADOLF A. BERLE & GARDNER C. MEANS, *THE MODERN CORPORATION AND PRIVATE PROPERTY* (Harcourt, Brace & World rev. ed. 1968) (1932); LOUIS D. BRANDEIS, *OTHER PEOPLE'S MONEY AND HOW THE BANKERS USE IT* (1914).

18. H.R. REP. NO. 73-85, at 1-2 (1933). See also James M. Landis, *The Legislative History of the Securities Act of 1933*, 28 GEO. WASH. L. REV. 29, 30 (1959) (presenting an in-depth discussion of the events leading up to the '33 Act).

19. For an insightful discussion of the governmental process and debate preceding the adoption of the '33 Act, see Edward N. Gadsby, *Historical Development of the S.E.C.-The Government View*, 28 GEO. WASH. L. REV. 6 (1959). See also THE WHEAT REPORT, *DISCLOSURE TO INVESTORS: A REAPPRAISAL OF FEDERAL ADMINISTRATIVE POLICIES UNDER THE '33 AND '34 ACTS* 3 (1969) [hereinafter THE WHEAT REPORT].

20. See HAROLD S. BLOOMENTHAL, *CASES AND MATERIALS ON SECURITIES LAW* 1 (1966). See also Landis, *supra* note 18, at 34; Harry Heller, *Disclosure Requirements Under Federal Securities Regulation*, 16 BUS. LAW. 300, 300 (1961), reprinted in *SELECTED ARTICLES ON FEDERAL SECURITIES LAW* 87 (Herbert S. Wander & Warren F. Grienberger eds. 1968); Harry Shulman, *Civil Liability and the Securities Act*, 43 YALE L.J. 227, 227 (1933). The '33 Act was based on Britain's Company Clauses Consolidation Act of 1845 which first established the system of mandatory disclosure. The Companies Consolidation Act had two main objectives: "(1) to obviate the evils of fraudulent and

dubbed the "truth in securities" bill because of its requirement that any company selling securities must publicly disclose all factual data concerning the company.²¹

B. THE LEGISLATIVE INTENT OF THE '33 ACT'S DISCLOSURE REQUIREMENTS

The legislative intent of the '33 Act provides initial insight into the intended audience of disclosure. Congress designed disclosure, as the keystone of the new federal securities regulation, to achieve several objectives. The first of these was investor protection. Congress, through mandated disclosure, sought "to prevent further exploitation of the public by sale of unsound, fraudulent, and worthless securities through misrepresentation . . . to protect honest enterprise, seeking capital by honest presentation against the competition afforded by dishonest securities offered to the public through crooked promotion."²² Congress viewed the new disclosure system as a means to protect average investors, many of whom had lost their savings through the Crash, by forcing issuers to divulge all facts, favorable or unfavorable, to the public for examination. This view is best expressed through the famous quote by Justice Brandeis, "Publicity is justly commended as a remedy for social and industrial diseases. Sunlight is said to be the best of disinfectants; electric light the most efficient policeman."²³ By mandating disclosure, Congress intended to protect the layperson from fraudulent practices in the capital markets.

Along with investor protection, Congress also hoped that mandatory disclosure would deter the financial community from engaging in dubious

fictitious companies and (2) to protect the public from companies which . . . were faulty in their nature because of unsound calculations and inadequate management." Robert L. Knauss, *A Re-Appraisal of the Role of Disclosure*, 62 MICH. L. REV. 607, 611 (1964).

21. Knauss, *supra* note 20, at 608. See also Milton H. Cohen, "Truth in Securities" Revisited, 79 HARV. L. REV. 1340, 1340 (1966) (arguing that the '33 Act was designed to achieve "truth in securities" in connection with public offerings). Disclosure is obtained, under the '33 Act, by requiring the issuer to file a registration statement with the SEC. The registration statement consists of two parts. The first part contains the prospectus which provides information required by section 10(a) and Schedule A of the '33 Act. The second part consists of additional information and exhibits which are not sent out to the investor in the prospectus but are available for public inspection in the SEC files.

22. S. REP. NO. 73-47, at 4 (1933). See also LOUIS LOSS, FUNDAMENTALS OF SECURITIES REGULATION 3 (1983) (arguing that mandatory disclosure followed from many years of development in order to protect investors); William O. Douglas & George E. Bates, *The Federal Securities Act of 1933*, 43 YALE L.J. 171, 172-73 (1933) (arguing that the '33 Act seeks to give maximum protection to investors while minimizing the interference to business); Fred Rodell, *Regulation of Securities by the Federal Trade Commission*, 43 YALE L.J. 272, 273 (1933) (stating that the purpose of the '33 Act is "to protect before punishing").

23. BRANDEIS, *supra* note 17, at 92.

practices. Through forced publication of all information and the imposition of serious civil and criminal liability for fraud and misrepresentation, the disclosure scheme sought to prevent the abuses which had epitomized the pre-1933 securities market era.²⁴ Some advocates of mandatory disclosure even hoped that disclosure would not only deter through the threat of liability, but would also have the prophylactic effect of promoting integrity and honesty in the financial community.²⁵ Thus, disclosure also sought to hold the financial community accountable for ethical transgressions so that it would feel compelled to fulfill a duty of care and loyalty to the investing public.

Coupled with the goals of investor protection and deterrence was a desire to restore investor confidence in the capital markets. The Crash created a national distrust of the capital markets as average investors withdrew their capital for fear of exploitation by the issuers of securities.²⁶ The '33 Act sought to assuage this fear and coax the average investor back into the marketplace through promises of full disclosure. Hopefully, if investors knew all of the material facts they would feel comfortable reentering the marketplace and investing in the securities. As argued by then SEC Commissioner A.A. Sommer, Jr., "I do not believe investor confidence can be measured empirically. It is a matter of subtle psychology. Investors should be assured that they are receiving the information necessary to make informed decisions."²⁷ Once again, underlying this statement was the idea that disclosure is intended for the unsophisticated investor.

Taken together, these three initial goals of disclosure imply that Congress intended the average investor to be the beneficiary of the disclosure regime; however, they do not provide any clear insight into exactly to whom disclosure is geared. With the fourth, and arguably most important objective of disclosure, Congress expressly addressed this issue. Through disclosure Congress also sought to provide a means for the investor to make an educated investment decision through an analysis of all relevant

24. See, e.g., *Gustafson v. Alloyd Co.*, 513 U.S. 561 (1995) (applying section 12(a)(2) to misrepresentations in a prospectus); *Aaron v. SEC*, 446 U.S. 680 (1980) (showing the use of section 17(a) to prohibit the use of fraud in the sale of a security); *Escott v. BarChris Constr. Corp.*, 283 F. Supp. 643 (S.D.N.Y. 1968) (applying section 11 of the '33 Act to impose liability for material misrepresentations and omissions in a registration statement).

25. See 77 CONG. REC. 2918 (1933) (stating that the '33 Act sought "to define the duty of officers of corporations issuing securities, of syndicates underwriting issues, the duties of these corporate officials to the investing public. It [sought] to fix responsibility for information.").

26. See Frank H. Easterbrook & Daniel R. Fischel, *Mandatory Disclosure and the Protection of Investors*, 70 VA. L. REV. 669, 692 (1984).

27. HOMER KRIPKE, *THE SEC AND CORPORATE DISCLOSURE: REGULATION IN SEARCH OF A PURPOSE* 28-29 (1979) (quoting then SEC Commissioner A.A. Sommer, Jr.).

information about a transaction. Disclosure would provide investors with access to all material facts concerning a security, thus placing them on a parity with management and enabling them to “make a realistic appraisal of the merits of the securities and thus exercise an informed judgment in determining whether to purchase them.”²⁸ As Representative Rayburn, who was later to become Speaker of the House, said of the proposed legislation:

The purpose of this bill is to place the owners of securities on a parity, so far as is possible, with the management of the corporations, and to place the buyer on the same plane so far as available information is concerned, with the seller.

....

This bill is drawn to enable a would-be purchaser of a bond or of a stock to require some information from the officials of the issuing company.

....

... The purpose of this section is to insure that prospective buyers of securities may have a complete understanding of the transaction in which they are invited to participate.

... [W]e seek ... to make available to the prospective purchaser, if he is wise enough to use it, all information that is pertinent that would put him on notice and on guard, and let him beware.²⁹

This statement indicates that Congress intended disclosure to enable the average investor to make an informed investment decision. Therefore, the legislative intent of the '33 Act provides the first insight into the audience to whom disclosure is directed. Through the '33 Act, Congress sought to provide for full and fair disclosure to the average investor.³⁰

28. MARC I. STEINBERG, UNDERSTANDING SECURITIES LAW 8 (2d ed. 1996). See also HUGH L. SOWARDS, COMMENTS, CASES AND MATERIALS ON CORPORATE FINANCE 696 (1950) (“The theory behind Congress’ choice of the full disclosure alternative was that if the public knew all of the facts it would buy or not buy at least on an informed basis.”); Bruce Alan Mann, *Prospectuses: Unreadable or Just Unread?—A Proposal to Reexamine Policies Against Permitting Projections*, 40 GEO. WASH. L. REV. 222, 222 (1971) (arguing that the purpose of disclosure is to provide the necessary information to make an investment decision).

29. 77 CONG. REC. 2918-19 (1933). See also LOSS, *supra* note 22, at 36 (quoting Representative Rayburn).

30. See LARRY D. SODERQUIST, UNDERSTANDING THE SECURITIES LAWS 102 (2d ed. 1990).

C. THE PRACTICAL APPLICATION OF THE DISCLOSURE REQUIREMENTS

Although the legislative intent of the disclosure requirements is easy to identify and explain, the most effective way to structure the disclosure regime has proven more difficult to achieve, as disclosure is not a simple method of regulation having universal application and effectiveness. On the contrary, it assumes a different role and meaning depending upon the disclosed information and the disclosing party.³¹ Because of this unanticipated complication, both the courts and the SEC were left with the duty of applying disclosure in an attempt to fulfill the legislative intent.

One of the first major cases to address this issue was *SEC v. Ralston Purina Co.*,³² in which the Supreme Court discussed disclosure in the context of section 4(1) of the '33 Act.³³ In *Ralston Purina* the corporation offered shares to a number of key employees without complying with the registration requirements of the '33 Act.³⁴ Speaking for the majority, Justice Clark declared, "[T]he focus of the inquiry should be on the need of the offerees for the protections afforded by registration."³⁵ Since the employees in this case did not have access to the kind of information that disclosure would reveal, the Court ruled that the corporation must comply with the registration requirements of section 5.³⁶ Although not directly illustrative of the intended audience of disclosure, this case foreshadows later judicial interpretation of the '33 Act's disclosure requirements, i.e., disclosure in order to protect investors and allow them to make informed

31. See Knauss, *supra* note 20, at 607.

32. 346 U.S. 119 (1953).

33. Section 4(1) exempts "transactions by an issuer not involving any public offering." 15 U.S.C. § 77d (1994 & Supp. II 1996). The SEC will consider such factors as: "1. [t]he number of offerees and their relationship to each other and to the issuer; 2. [t]he number of units offered; 3. [t]he size of the offering; and 4. [t]he manner of offering" to decide if the transaction is a public or private offering. Letter of General Counsel Discussing Factors to be Considered in Determining the Availability of the Exemption from Registration Provided by the Second Clause of Section 4(1), Securities Act Release No. 285, 11 Fed. Reg. 10,952 (Jan. 24, 1935), available in 1935 SEC LEXIS 955, at *1-2. See also JAMES D. COX, ROBERT W. HILLMAN & DONALD C. LANGEVOORT, SECURITIES REGULATION: CASES AND MATERIALS 373-74 (2d ed. 1997).

34. See *Ralston Purina*, 346 U.S. at 119.

35. *Id.* at 127. See also THE WHEAT REPORT, *supra* note 19, at 19 (discussing the relevance of *Ralston Purina* to the disclosure debate). Section 5 of the '33 Act prohibits the use of interstate commerce or the mails unless a registration statement has been filed. See 15 U.S.C. § 77e (1994 & Supp. II 1996).

36. Section 5 of the '33 Act states that a person may not, directly or indirectly, make use of any means or instrumentalities of transportation or communication in interstate commerce to offer to sell or buy a security unless a registration statement is in effect, or to transmit a prospectus relating to any security that does not comply with section 10. 15 U.S.C. § 77e (1994 & Supp. II 1996).

decisions. Once again, this hints that disclosure is intended for the average investor.³⁷

Finally, in 1969 the SEC expressly addressed the subject as it stated its official position in *The Wheat Report*.³⁸ *The Wheat Report* set forth the consensus of an SEC-appointed committee whose task was to reappraise the administrative disclosure policies of the '33 and '34 Acts. It stated:

At what audience should disclosure be aimed? Is the literature elicited by the Commission's requirements intended primarily to aid the unsophisticated? Is it, on the contrary, designed to assist the assiduous student of finance who searches for every clue to the intrinsic value of securities? Or should the Commission strive to meet the needs of a hypothetical "reasonable" investor of "reasonable" sophistication? Throughout its history, the Commission has struggled with these questions. They may well be unanswerable. A balance must be struck which reflects, to the extent possible, the needs of all who have a stake in the securities markets.³⁹

This represented a shift in interpretation, as *The Wheat Report* stated that disclosure should both help the layperson and assist the professional to whom the investor looks for advice.⁴⁰ Thus the disclosure documents are designed to serve a dual purpose. First, they inform investors of the neces-

37. The courts reiterated this view in *SEC v. Capital Gains Research Bureau, Inc.*, 375 U.S. 180 (1963). The *Capital Gains* Court stated that "[i]t requires but little appreciation . . . of what happened in this country during the 1920's and 1930's to realize how essential it is that the highest ethical standards prevail in every facet of the securities industry." *Id.* at 186-87. See also *Silver v. N.Y. Stock Exch.*, 373 U.S. 341, 366 (1963) (discussing "whether and to what extent the federal antitrust laws apply to securities exchanges regulated by the Securities Exchange Act of 1934." 373 U.S. at 342.); *Affiliated Ute Citizens v. United States*, 406 U.S. 128, 151 (1972) (stating, inter alia, that the defendants violated Rule 10b-5 because "[a]ll that is necessary [for liability] is that the facts withheld be material in the sense that a reasonable investor might have considered them important in the making of this decision." 406 U.S. at 153-54.).

38. In November, 1967, the SEC under the direction of Commissioner Francis M. Wheat announced the formation of a small, internal study group "to examine the operation of the disclosure provisions of the Securities Act of 1933 . . . and Commission rules and regulations thereunder." SEC Disclosure Study Proposed, Securities Act Release No. 4885, [1967-1969 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 77,501, at 83,011 (Nov. 29, 1967). See also THE WHEAT REPORT, *supra* note 19, at 3. The group was assigned the task for several reasons: (1) the rapid increase in the American shareholder population and the accompanying increase in the number of investment decisions; (2) the trend toward a greater measure of professionalism in the securities business with the accompanying demand for more information about issuers; (3) the expansion in the coverage of the '34 Act's reporting and proxy provisions effected by the 1964 Amendments; (4) technological advances that enabled users of information to obtain it from sources such as the Commission's files more rapidly and at less expense than was previously possible; and (5) growing criticism of the status quo of disclosure. See *id.* at 9-10.

39. THE WHEAT REPORT, *supra* note 19, at 51-52.

40. See *id.* at 53.

sary factors to consider in order to make informed investment decisions. Second, due to the complexity of securities, disclosure enables the professional analyst to look behind the piece of paper and analyze the merits of the company in order to intelligently advise the investor of the appropriate place to invest.⁴¹

Two years later in *Feit v. Leasco Data Processing Equipment Corp.*,⁴² at least one court adopted the same view. The analysis in *Feit* began with a general statement of the underlying goals of disclosure:

Given an honest and open statement adequately warning of the possibilities of error and miscalculation and not designed for puffing, the outsider and the insider are placed on more equal grounds for arm's length dealing. Such equalization of bargaining power through sharing of knowledge in the securities market is a basic national policy underlying the federal securities laws.⁴³

After this affirmation of the general objectives of disclosure, *Feit* restated the view that disclosure was geared toward the average investor, "The focus on disclosure reflects the insight gained by experience that without complete, accurate and intelligible information about a company, investors cannot make intelligent investment decisions with regard to its securities."⁴⁴ At this point, however, the *Feit* Court, following *The Wheat Report*, recognized that a delicate balance must be struck between the unsophisticated investor and the professional financial analyst, as disclosure is intended for a greater portion of the public than merely the average investor.⁴⁵

The *Feit* Court, for the first time, expressed exactly to whom disclosure is directed, articulating three distinct classes of investors whom the prospectus must inform:

(1) the amateur who reads for only the grosser sort of disclosures; (2) the professional advisor and manager who studies the prospectus closely and makes his [or her] decisions based on the insights he [or she] gains from

41. See Mann, *supra* note 28; Knauss, *supra* note 20, at 610.

42. 332 F. Supp. 544 (E.D.N.Y. 1971).

43. *Id.* at 549.

44. *Id.* at 563. "No investor, no speculator, can safely buy and sell securities . . . without having an intelligent basis for forming his judgment as to the value of the securities he buys or sells." *Id.* at 564 (quoting THE WHEAT REPORT, *supra* note 19, at 50).

45. See *id.* at 565. "In an industry in which there is an unmistakable 'trend toward a greater measure of professionalism . . . with the accompanying demand for more information about issuers' 'a pragmatic balance must be struck between the needs of the unsophisticated investor and those of the knowledgeable student of finance.'" *Id.* (quoting THE WHEAT REPORT, *supra* note 19, at 9-10) (alteration in original).

it; and (3) the securities analyst who uses the prospectus as one of many sources in an independent investigation of the issuer.⁴⁶

The *Feit* Court also noted the importance of striking a balance between the different groups, noting that the objectives of full disclosure could only be achieved by completely divulging all relevant facts that not only the average investor but also the market professional would deem important. At the same time, however, the court recognized that disclosure "must not slight the less experienced. They are entitled to have within the four corners of the document an intelligible description of the transaction."⁴⁷ Thus, by 1971 the SEC and the courts had definitively stated that disclosure was intended for all types of investors. As the above analysis of legislative intent reveals, disclosure was meant for the average investor who could glean a certain amount of knowledge from the four corners of the document. But, more broadly, disclosure was also geared toward the professional analyst and sophisticated investor who could look into and beyond the document to the heart of the corporation and the offered securities. Also, the complex features of the transaction would not escape the average investor since an integral part of this scheme was the transfer of information from professionals to average investors, thus enabling them to make informed investment decisions.

III. TO WHOM IS DISCLOSURE DIRECTED? THE ALTERNATE THEORIES

Following Roosevelt's demand for regulation, the '33 Act passed quickly through Congress with little to no debate over its merits.⁴⁸ Critics from other circles, however, greeted the '33 Act with skepticism, as they questioned its preoccupation with the average investor. They expressed concern that the goals of disclosure were not attainable; the '33 Act was ideally suited neither to protect the investor from the abuses prevalent in the 1920s, nor to enable the investor to make an informed investment decision.⁴⁹ William Douglas, who was later to become Chairman of the SEC, argued that disclosure simply was not suited for the average investor:

46. *Id.* at 565-66.

47. *Id.* at 566.

48. See Knauss, *supra* note 20, at 613.

49. See LOSS, *supra* note 22, at 33; Anderson, *supra* note 15, at 320, 331; Roger J. Dennis, *Mandatory Disclosure Theory and Management Projections: A Law and Economics Perspective*, 46 MD. L. REV. 1197, 1199 (1987) (arguing that the SEC's traditional policy exacerbated the problem of selective disclosure to favored analysts, thus putting the average investor, although the intended beneficiary of disclosure, at a competitive disadvantage).

[T]he results of the Act so far as investors are concerned are primarily two-fold: (1) the requirement that the truth about securities be told will in and of itself prevent some fraudulent transactions which cannot stand the scrutiny of publicity; (2) even though an investor has neither the time, money, nor intelligence to assimilate the mass of information in the registration statement, there will be those who can and who will do so, whenever there is a broad market. Through them investors who seek advice will be able to obtain it.⁵⁰

Over the years this argument has splintered into two complementary theories: (A) “the myth of the informed layman”⁵¹ and (B) the filtration theory.

A. “THE MYTH OF THE INFORMED LAYMAN”

Since 1933 the securities market has become significantly more complicated. Each year corporations entering the marketplace use increasingly advanced technology to produce highly technical goods and services. Also, modern accounting principles have increased in complexity as man-

50. William Douglas, *Protecting the Investor*, 23 YALE REV. (n.s.) 508, 523 (1933). See also THE WHEAT REPORT, *supra* note 19, at 53 (quoting Douglas). Douglas offered an even more scathing appraisal of the ‘33 Act and its disclosure regime as he stated that three propositions were “tolerably clear”:

First, that the Securities Act falls short of accomplishing its purposes. Second, that in any programme for the protection of investors and in any genuine and permanent correction of the evils of high finance an Act like the Securities Act is of a decidedly secondary character. And, third, that a vigorous enforcement of the Act promises to spell its own defeat because it is so wholly antithetical to the programme of control envisaged in the New Deal and to the whole economy under which we are living.

LOSS, *supra* note 22, at 33.

51. The primary sources discussing the “myth of the informed layman” are written by Homer Kripke. This does not mean that he is an extremist. To the contrary, most who doubt the SEC’s traditional view agree with Kripke’s analysis. Thus, Kripke will be cited, instead of corroborating authors, because he is the founder of the theory and provides the most persuasive authority. For a discussion of the “myth of the informed layman” in other articles, see Barbara Black, *Fraud on the Market: A Criticism of Dispensing with Reliance Requirements in Certain Open Market Transactions*, 62 N.C. L. REV. 435, 457 (1984); John C. Coffee, Jr., *Market Failure and the Economic Case for a Mandatory Disclosure System*, 70 VA. L. REV. 717, 728 (1984); Joseph De Simone, *Should Fraud on the Market Theory Extend to the Context of Newly Issued Securities?*, 61 FORDHAM L. REV. S151, S151 (1993); C. Edward Fletcher, III, *Sophisticated Investors Under the Federal Securities Laws*, 1988 DUKE L.J. 1081, 1119; Dennis S. Karjala, *Federalism, Full Disclosure, and the National Markets in the Interpretation of Federal Securities Law*, 80 NW. U. L. REV. 1473, 1533 (1986) (citing Kripke); Donald C. Langevoort, *Selling Hope, Selling Risk: Some Lessons for Law from Behavioral Economics About Stockbrokers and Sophisticated Customers*, 84 CAL. L. REV. 627, 682 (1996) (citing Kripke); L. Brett Lockwood, *The Fraud-on-the-Market Theory: A Contrarian View*, 38 EMORY L.J. 1269, 1292 (1989); Tira Harpaz, Note, *Financial Reporters, the Securities Laws and the First Amendment: Where to Draw the Line*, 53 FORDHAM L. REV. 1035, 1060 (1985); David J. Schulte, Note, *The Fraud on the Market Theory: Efficient Markets and the Defenses to an Implied 10b-5 Action*, 70 IOWA L. REV. 975, 983 (1985) (citing Kripke).

agers, in an effort to portray their companies in the best possible light, have started employing highly technical methods of calculation.⁵² Amidst these developments, however, the SEC has continued to support the theory that the average investor is one of the key groups to whom disclosure is aimed. The SEC continues to cling to the ideal that the disclosure documents, on their own, enable the investor to make an informed investment decision:⁵³

[S]ecurities have become increasingly intricate Yet the SEC goes on the theory that in the selection of investments from the numerous offerings of this very intricate merchandise, a simple readable prospectus on one company will enable the man in the street to make a wise choice between one company and the thousands of others about which no one may be telling him anything.⁵⁴

In the face of increasing complexities in the marketplace, however, the SEC's traditional view is based on a false assumption: "the myth of the informed layman."

The conventional "myth" is that the average investor can understand and effectively use disclosure to make "an intelligent investment decision."⁵⁵ Three different marketplace realities, however, refute this idea and support the competing view that prospectuses should be geared only toward professionals in the marketplace, and not toward the average investor. First, the nonprofessional does not possess the skill or expertise to read and understand the complex financial information contained in disclosure documents. As Kripke stated, "[T]he SEC overestimates the average investor's ability to master the complexities of the financial picture of the typical issuer, and therefore has failed . . . to understand that its disclosure documents can be used effectively only by professionals."⁵⁶ The typical prospectus cannot enable the lay investor to reach an informed in-

52. Among these methods are "dirty pooling," "partial pooling," "dirty purchasing," and using estimates and "funny money" to bolster earnings. Homer Kripke, *The SEC, the Accountants, Some Myths and Some Realities*, 45 N.Y.U. L. REV. 1151, 1167 (1970) [hereinafter Kripke, *The SEC*]. See also *The Myth*, *supra* note 14, at 632-33.

53. See *supra* Part II. Although this view was expanded slightly to include advice from professionals, the focal point of disclosure still remains the average investor. See also *Feit v. Leasco Data Processing Equip. Corp.*, 332 F. Supp. 544, 563-66 (E.D.N.Y. 1971); *THE WHEAT REPORT*, *supra* note 19, at 9-10, 51-53.

54. *The Myth*, *supra* note 14, at 633. See also Kripke, *The SEC*, *supra* note 52, at 1164 ("For nearly forty years it has been customary to begin any sympathetic discussion of the federal securities legislation with an incantation to the virtues of disclosure and the desirability of enabling the investor to make his investment on the basis of adequate and informed knowledge of the facts concerning the security.").

55. Kripke, *The SEC*, *supra* note 52, at 1164.

56. KRIPKE, *supra* note 27, at 14 (citation omitted).

vestment decision, and any layperson who makes a decision based solely on their interpretation of the disclosure is not the individual who can or does usefully read the prospectus.

Second, because of this reality, coupled with the complexity of the securities industry, any effort to gear disclosure toward the layperson is a waste of time and money. Since the “whole truth”⁵⁷ cannot be told in a complete, intelligible fashion to the average investor, any effort to do so should be discouraged. As Kripke argued:

The first casualties of this reasoning should be all of the efforts designed to make a prospectus short and readable by a layman. The goal is inconsistent with the reality of the complexity of modern securities and the fact that the prospectus should not really be addressed to the layman.⁵⁸

Third, the SEC’s efforts to appeal to the average investor are not only inefficient but are hazardous to the disclosure regime. To appeal to the layperson, the SEC is forced to compel simplified, concise disclosure which often leaves out many issues that are potentially valuable to the professional.⁵⁹ Also, “the myth forces the SEC into requiring emphasis on risk features of the offering with a simplicity that is sometimes less than a full picture.”⁶⁰ The result of these SEC efforts is that the prospectus has ceased to operate as it should and “has become a routine, meaningless document which does not serve its purpose.”⁶¹

In recent years, a complimentary theory has arisen which slightly criticizes and shifts Kripke’s “myth of the informed layman.” In a panel discussion on disclosure in 1972, Harold Marsh, Jr. proposed a theory which he termed “the myth of the ‘expert’ expert.”⁶² This theory is premised on the rationale that Kripke takes his analysis too far. Instead of blindly assuming that (1) only the expert can understand the disclosure documents; and (2) all experts have the ability to understand disclosure, the SEC should direct disclosure to “those persons who are capable of un-

57. Douglas & Bates, *supra* note 22, at 171.

58. Kripke, *The SEC*, *supra* note 52, at 1170.

59. See *The Myth*, *supra* note 14, at 633 (“The myth that it is the layman to whom the prospectus is addressed permeates the SEC’s concept of disclosure. It limits the usefulness of disclosure to those who should be its proper objective, the sophisticated investor and professional through whom information ought to filter down to the layman.”).

60. *Id.*

61. *Id.* at 631.

62. Panel Discussion, *New Approaches to Disclosure in Registered Security Offerings*, 28 BUS. LAW. 505, 527 (1972) (quoting Marsh as saying, “With regard to Professor Kripke’s obeisance to the so-called experts in securities investment, one can, I believe, with equal justification oppose his concept of the ‘myth of the informed layman’ with the ‘myth of the “expert” expert.’”) [hereinafter Panel Discussion].

derstanding the transactions being described.”⁶³ According to Marsh, this group would include a small portion of the investing public and a small minority of self-appointed professionals.

This theory has some support in relevant case law. For example, in *Shvetz v. Industrial Rayon Corp.*,⁶⁴ Judge Murphy stated:

While it might be true that a person of limited education or non familiarity with corporate finances and legal matters would find it difficult to understand many of the facets of the proposed merger, that is not the test. The statute requires the absence of false and misleading statements, as do the S.E.C. rules. Nowhere does either require that corporate reorganizations and mergers be explained in language comprehensible to school children.⁶⁵

However, this theory has not been cited with enough approval to evidence a shift in SEC or court ideology. In sum, regardless of whether one subscribes to the theories of Kripke or Marsh, the argument is compelling: The SEC should not attempt to disclose to lay investors because they are not able to understand the complexities of transactions, and any attempt to do so only causes inefficiencies within the system.

B. THE FILTRATION THEORY

Ideally, the objectives of full disclosure would best be served if all issuers disclosed as many facts as possible with total objectivity and accuracy in a form that would be easy for all interested investors to read and understand.⁶⁶ Unfortunately, as shown by Kripke, this theoretical maximum is unattainable due to the inability of the investment community to fully utilize the volume of information that would be produced.⁶⁷ Thus, the capital markets are forced into the position of finding an effective compromise between the ideal result of placing tangible, understandable disclosure into the hands of all interested parties and the inferior result of merely burying the relevant facts in the disclosure documents without an efficient method of public dissemination. In order to achieve the highest

63. *Id.*

64. 212 F. Supp. 308 (S.D.N.Y. 1960). *See also* Walpert v. Bart, 280 F. Supp. 1006, 1014 (D. Md. 1967) (quoting this language with approval); Panel Discussion, *supra* note 62, at 528; Marc I. Steinberg & Robin M. Goldman, *Issuer Affirmative Disclosure Obligations—An Analytical Framework for Merger Negotiations, Soft Information, and Bad News*, 46 MD. L. REV. 923 (1987) (providing an insightful discussion of disclosure in the merger context).

65. *Shvetz*, 212 F. Supp. at 310.

66. *See* Cohen, *supra* note 21, at 1367.

67. *See id.* This is only exacerbated by the fact that so much information is now available online.

level of effective disclosure, the public's access to the disclosure materials "must be an indirect one," as disclosure should be geared toward the professional through whom information *filters* to the layperson.⁶⁸

In the filtration process, sophisticated investment intermediaries collect all of the relevant information about the transaction. These intermediaries then analyze the information and disseminate it to the investing public through recommendations. The average investor, who is unable to make an informed decision based solely on the prospectus, relies on these recommendations when deciding how to invest.⁶⁹ This policy, in perfect conformity with the "myth of the informed layman," emphasizes the importance of the recommendations of professional intermediaries while deemphasizing the importance of the prospectus as the key tool for the layperson's investment decisionmaking process.⁷⁰

The movement toward filtration of, and away from sole reliance on, the disclosure documents stems from the inability of prospectuses to capture all the relevant information necessary for average investors to make informed decisions. First, an indispensable amount of information is gained by comparing disclosure to other market information and other available investment opportunities. Disclosure is used more to verify information learned informally than to gain unknown knowledge about an issuer.⁷¹ The professional intermediary, and not the average investor, is able to do this effectively:

[T]he investor's choice is never whether to sit on his cash or to make the particular investment proposed by a prospectus. The choice is always whether he should keep his cash or use it for any of the thousands of other possible investments No prospectus can possibly give him any information which will enable him to decide the real question of whether the investment is a good one in relation to other opportunities available.

Even if an investor could from a single prospectus reach a reliable conclusion that a particular company was doing well and seemed likely

68. *Id.* at 1377. *See also The Myth*, *supra* note 14, at 638; THE WHEAT REPORT, *supra* note 19, at 52 ("[A] fully effective disclosure policy would require the reporting of complicated business facts that would have little meaning for the average investor. Such disclosures reach average investors through a process of filtration in which intermediaries . . . play a vital role.").

69. *See Mann*, *supra* note 28, at 226-27. *See also Cohen*, *supra* note 21, at 1353 ("Expert sifters, distillers, and weighers are essential for an informed body of investors, and a system of public filing, with maximum accessibility, probably comes close to being the practical ideal for most purposes.").

70. *See Mann*, *supra* note 28, at 226. *See also THE WHEAT REPORT*, *supra* note 19, at 10 (arguing that the filtration effect is becoming even more important because of the growing reliance on the professional intermediary and the increasing brokerage firm stress on research and analysis).

71. *See KRIPKE*, *supra* note 27, at 29.

to continue to do well in the future, he could get no basis of comparison from the prospectus.⁷²

Thus, intelligent investment decisions require a comparison of the security to others available in the marketplace—a process that the lay investor cannot accomplish by looking at the prospectus alone.

Also, filtration is more effective because the prospectus is unable to convey issuer confidence in the security's future. The prospectus effectively discloses many historical facts relating to the issuer. It cannot, however, be expected to mirror the corporation's "shining faith" in its future or to reflect its confidence that a new product, still in the research stage, will revolutionize an industry.⁷³ Through filtration, however, the professionals are able to examine an issuer with a focus on "futurity, comparison, and diversification guided by the analysis of risk."⁷⁴ They are thus able to complete a more detailed analysis of a security, and, by disseminating this information to the average investor, allow the layperson to make an informed investment decision.

Therefore, although the desired audience for disclosure is the investing public and not the professional community, the "latter is an essential middleman in seeking out, digesting, and evaluating data that would otherwise be far too voluminous to be of real use to most investors."⁷⁵ The

72. Kripke, *The SEC*, *supra* note 52, at 1168-69 (footnote omitted). *See also The Myth*, *supra* note 14, at 637 ("Disclosure should be oriented to disclosing what the informed investor may think is important to that judgment: value estimates, earnings projections, probable and potential minerals—not exclusively what is in the past and not limited to what the layman can handle.").

73. Francis M. Wheat & George A. Blackstone, *Guideposts for a First Public Offering*, 15 BUS. LAW. 539, 561 (1960), reprinted in SELECTED ARTICLES ON FEDERAL SECURITIES LAW 1 (Herbert S. Wander & Warren F. Grienberger eds., 1968). It is important to note, however, that in recent years the SEC has begun to allow more projections and speculation into the disclosure documents. These projections are commonly known as soft or forward-looking information. In 1973, after years of public pressure to amend the rules toward soft information, the SEC announced the intention to change its policy. *See* Statement by the Commission on the Disclosure of Projections of Future Economic Performance, Securities Act Release No. 5362, [1972-1973 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 79,211, at 82,665 (Feb. 2, 1973). Five years later, in 1978, the SEC officially changed its policy as it began to allow and encourage the disclosure of soft information. *See* Guides for Disclosure of Projections for Future Economic Performance, Securities Act Release No. 5992, [1978 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 81,756, at 81,034 (Nov. 7, 1978). The SEC also promulgated Rule 175 which provides a safe harbor for the disclosure of certain types of forward-looking information. It is essential to note, however, that although the SEC has begun to accept soft information in the disclosure documents, such disclosure still pales in comparison to the information that professionals can glean from a careful examination of all relevant information about an issuer. *See* COX, HILLMAN & LANGEVOORT, *supra* note 33, at 71-82 (discussing in greater detail the SEC policy toward the disclosure of forward-looking information).

74. KRIPKE, *supra* note 27, at 26.

75. Cohen, *supra* note 21, at 1377. *See also* Rodell, *supra* note 22, at 272 n.1.

intermediaries to whom disclosure is directed are threefold. The first are the underwriters who receive information from the corporation when they price the securities. Investors realize that underwriters may have access to information that has not been adequately disclosed to the public and that they have “strong reputational interests in not deceiving customers.”⁷⁶ For this reason, underwriters play an integral role in the filtration process. Second, accountants serve as effective intermediaries. They enable investors to efficiently verify information, as accountants’ reputations hinge on the accuracy of disclosure.⁷⁷ And the third group are the securities analysts. Analysts promote efficiency in the marketplace because they are able to quickly spread information to the public. This serves a vital role for both the corporation and the investor. The corporation uses analysts to increase investor awareness and interest in the transaction, as well as to affirm the accuracy of the disclosure.⁷⁸ Also, analysts assist investors by effectively releasing information which they have gathered through corporate meetings and a careful analysis of the disclosure documents.⁷⁹

In sum, both the “myth of the informed layman” and the filtration theory convincingly argue that the intended audience of disclosure is not average investors, because they possess neither the skill nor the expertise to read and understand the information contained within the prospectus. Rather, the issuer should gear disclosure toward professionals who can then filter information to lay investors, thus enabling them to make informed investment decisions.

IV. THE NEED FOR A MORE READABLE AND UNDERSTANDABLE PROSPECTUS

A. THE LOSS OF INVESTOR CONFIDENCE IN DISCLOSURE

The impact of the “myth of the informed layman” and the filtration theory forced the SEC to adopt a cautionary and negative attitude toward disclosure. In turn, this outlook caused the investing public to lose confidence in the disclosure process. The issue of whether disclosure is intended for average investors decreases in importance if the investors are

76. Easterbrook & Fischel, *supra* note 26, at 688.

77. *See id.*

78. *See* Stephen J. Schulte, *Corporate Public Disclosure: Primer for the Practitioner*, 15 *CARDOZO L. REV.* 971, 978 (1994).

79. The recommendations of analysts should not be blindly followed, but rather should be utilized as one piece of information used to make an intelligent investment decision.

not reading the prospectus because they do not have faith in its ability to clearly present the information.

Traditionally, the SEC has feared that an investor will misinterpret the information in the prospectus.⁸⁰ As a result, the SEC has forced issuers to inundate the prospectus with disclaimers both that expectations may not be borne out and that the SEC does not vouch for or endorse the accuracy of the disclosed information.⁸¹ The SEC's cautionary approach led one scholar to comment that "the lay[person] might as readily suppose that the '33 Act was intended to harass innocent dealers in securities and drive honest investment bankers out of business."⁸² This fear created a fundamental rift between the purpose of disclosure and the actual utility of the disclosure documents. Instead of portraying companies in a positive and optimistic light, the prospectus presents expectations shrouded in cautionary terms and generic risk factors, thereby giving little insight into the corporation's competitive position. As a result of this pessimistic view, prospectuses and registration statements have been "converted . . . from disclosure documents to rituals . . . which an intelligent investor would not take seriously."⁸³

Negativity surrounding the disclosure process has caused investors to lose confidence in the ability of disclosure documents to serve as a valuable decisionmaking tool.⁸⁴ As stated by Homer Kripke, "A prospectus loses its effect if every prospectus cries 'wolf' all the time."⁸⁵ As a result, the average investor does not read the prospectus, thereby removing the ability of disclosure to perform its prescribed purpose and forcing the investor to rely on the filtration method. Furthermore, Hugh Sowards has stated that "[t]here is no doubt that the ordinary prospectus fully discloses all facts necessary to the investor for an independent appraisal of the merits of the security. The trouble is that nobody bothers to read it—that is,

80. See KRIPKE, *supra* note 27, at 15.

81. See *id.* See also Ernest L. Folk, III, *Civil Liabilities Under the Federal Securities Acts: The BarChris Case*, 55 VA. L. REV. 1 (1969) (discussing the court's decision in *BarChris*, *supra* note 24, which imposed liability upon the directors, the underwriters, and the accountants of BarChris for losses resulting from misleading statements in a prospectus).

82. Rodell, *supra* note 22, at 272.

83. KRIPKE, *supra* note 27, at 15. See also *The Myth*, *supra* note 14, at 635. These trends are also exacerbated by the statutory provision that the prospectus need not be sent to the buyer until the purchased securities are delivered, the increasing complexity of the securities markets and transactions, and the investor realization that macroeconomic conditions can render insignificant a wholly firm-oriented prospectus.

84. See KRIPKE, *supra* note 27, at 29 ("[H]istory . . . shows that the investors have no confidence that SEC disclosure enables them to make 'informed investment decisions.'").

85. *The Myth*, *supra* note 14, at 635.

except the SEC, underwriters, brokers, and a relatively few individual investors."⁸⁶ Thus, the SEC has been unable to create a prospectus that compels the attention of the average investor. This strengthens the critics' argument, as investors feel comfortable relying on recommendations of industry analysts because they do not have faith in the disclosure process.

B. THE SEC REACTION

Despite the critiques of the disclosure process, the SEC has steadfastly maintained *The Wheat Report's* view that disclosure is meant for all types of investors. Recently, however, the SEC has acknowledged that a fundamental problem exists with the disclosure documents. The SEC's interpretation, however, is far different than the one espoused by the critics. The SEC has adopted the view that the prospectus is unread because it is unreadable, and not because the average investor (1) does not have the ability to read the prospectus; or because the investor (2) does not have confidence in the disclosure process. The problem lies in the fact that the current style of these documents makes it impossible to adequately inform the investors. It is this view that has dominated SEC policymaking in recent years and which led to the adoption of the plain English rules on January 22, 1998.

According to the SEC, one of the disclosure's key deficiencies is that issuers fail to make the prospectus readable and understandable to the general investing public.⁸⁷ This problem stems from two sources: (1) the issuers' efforts to obscure rather than explain certain key topics in the prospectus; and (2) the length and complexity of the documents. In certain situations, the SEC claims that issuers are not endeavoring to clearly explain the information in the prospectus. Instead of the full and fair disclosure envisioned by Congress, issuers produce documents that obscure, rather than elucidate, and make it close to impossible to discover the important information.⁸⁸ If a statement does not clearly reveal the critical

86. SOWARDS, *supra* note 28, at 696.

87. See THOMAS LEE HAZEN, *THE LAW OF SECURITIES REGULATION* 110 (2d ed. 1990). See also LOUIS LOSS, *SECURITIES REGULATION* 148-66 (1st ed. 1951) (citing the unreadable prospectus as one of the four basic problems which stood out in a survey of the effectiveness of the registration scheme); *THE WHEAT REPORT*, *supra* note 19, at 77-78.

88. See *Feit v. Leasco Data Processing Equip. Corp.*, 332 F. Supp. 544, 565 (E.D.N.Y. 1971) ("In at least some instances, what has developed in lieu of the open disclosure envisioned by the Congress is a literary art form calculated to communicate as little of the essential information as possible while exuding an air of total candor. Masters of this medium utilize turgid prose to enshroud the occasional critical revelation in a morass of dull, and to all but the sophisticates—useless financial and historical data. In the face of such obfuscatory tactics the common or even the moderately well informed investor is almost as much at the mercy of the issuer as was his pre-SEC parent. He cannot by

elements of a proposed transaction, the investor has no way to analyze the information. But, according to the SEC, if they could somehow compel clear writing, all investors could understand the information.

An added concern is the fact that the prospectus is presented in a form that is so long and complex that it discourages "reading by all but the most knowledgeable and tenacious."⁸⁹ Instead of being prepared as "a detailed book of reference with respect to the issuer and its securities," the prospectus in many instances is "so long and cumbersome as partially to destroy [its] usefulness."⁹⁰ Thus, the disclosed information falls far short of achieving its statutory purpose because it is "organized and expressed in such a way as not to convey the required information to the investor in an understandable fashion."⁹¹ Thus, the SEC argues that an increase in the clarity and simplicity of the prospectus would greatly increase the utility of the document for the average investor.

Over the years the SEC has continually attempted to make the prospectus more readable and understandable. First, in the initial thirty-five years after Congress enacted the '33 Act, several Securities Act Releases encouraged greater clarity in the disclosure documents with an emphasis on not compromising full and fair disclosure.⁹² On August 5, 1966 in Securities Act Release No. 4844, the SEC encouraged issuers to avoid com-

reading the prospectus discern the merit of the offering."). See also Panel Discussion, *supra* note 62, at 524 (quoting Judge Weinstein).

89. *Feit*, 332 F. Supp. at 565-66. See also Knauss, *supra* note 20, at 618-19.

90. THE WHEAT REPORT, *supra* note 19, at 77 (quoting then-Director of the Commission's Division of Forms and Regulations). See also Proposed Plain English Rules, *supra* note 3, at 88,907-08 (summarizing the SEC's motivation for plain English).

91. The Division of Corporation Finance's Procedures Designed to Curtail Time in Registration Under the Securities Act of 1933, Securities Act Release No. 5231, [1971-1972 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 78,509, at 81,103, 81,805 (Feb. 3, 1972) [hereinafter Securities Act Release No. 5231]. As one magazine writer mused about the Tucker car fiasco, "Perhaps if the S.E.C. had required the Tucker prospectus to be written in simple English, and in four pages instead of 15, the facts might have trickled down to the public. As it was, millions were convinced that Tucker had a revolutionary car ready for production." Hugh L. Sowards, *The Wheat Report and Reform of Federal Securities Regulation*, 23 VAND. L. REV. 495, 530 (1970) (citations omitted). Sowards also made this argument 20 years earlier when he stated, "Yes [the prospectus] contains the truth. But who wants to read the truth in a 43-page document with 'fine print'? Can an Italian barber be persuaded to read it? Or a scrubwoman? Or a hurried businessman?" SOWARDS, *supra* note 28.

92. See, e.g., Adoption of Amendments to Rules and Forms Under the Securities Act of 1933, the Securities Exchange Act of 1934, and the Investment Company Act of 1940, Securities Act Release No. 3519; Securities Exchange Act Release No. 3519, [1952-1956 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 76,312, at 79,344 (Oct. 13, 1954). See also Guides for Preparation and Filing of Registration Statements, Securities Act Release No. 4936, [1967-1969 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 77,636, at 83,370 (Dec. 9, 1968).

plex legal and other technical language in their prospectuses.⁹³ Recognizing that the chief goal of registration was to provide investors with disclosure that they could readily understand, the SEC concluded that a “[f]ailure to use language that is clear and understandable by the investor may operate to defeat the purpose of the prospectus.”⁹⁴

Second, this issue gained momentum with the 1969 release of *The Wheat Report*.⁹⁵ *The Wheat Report* first noted that the SEC has, throughout its history, attempted to simplify the prospectus to maximize its utility. It then recommended two additional steps that would further development in this area: “(1) no acceleration of the effective date where the prospectus is unnecessarily complex, lengthy or verbose; and (a) [sic] a requirement of an expanded table of contents or ‘guide’ where the text of the prospectus, exclusive of financial statements and the list of underwriters, exceeds 10 pages in length.”⁹⁶ According to *The Wheat Report*, these actions would make the prospectus easier to read and understand.

Third, responding to this call to action, the SEC quickly adopted a large number of regulations designed to increase the readability of the disclosure documents and thus enhance the meaningfulness of disclosure. On July 20, 1971, the SEC adopted an amendment which allowed issuers to include pictorial and graphic representations in the prospectus in order to make the information more readable and understandable.⁹⁷ Six days later the SEC adopted amendments to Rules 425A and 426 and to Registration Guides 5, 6 and 21 which altered the requirements for information on the cover page of prospectuses in order to make them more readable.⁹⁸ On February 3, 1972, the SEC expressly stated that issuers should “[p]repare prospectuses with an emphasis on ‘readability’ and ‘understandability.’”⁹⁹

93. See Clarification of Prospectuses, Securities Act Release No. 4844, 31 Fed. Reg. 10,667 (1966), available in 1966 SEC LEXIS 12.

94. *Id.* at *3. See also Proposed Plain English Rules, *supra* note 3, at 88,909-10 (discussing problems associated with current language used in prospectuses).

95. THE WHEAT REPORT, *supra* note 19.

96. THE WHEAT REPORT, *supra* note 19, at 12. Rule 461 stemmed from this initial suggestion in *The Wheat Report*.

97. See generally Amendment of Registration Guide No. 8 of Guides for Preparation and Filing of Registration Statements to Make Prospectuses More Readable and Understandable, Securities Act Release No. 5171, [1970-1971 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 78,155, at 80,496 (July 20, 1971).

98. See generally Notice of Adoption of Amendments to Rules 425A and 426 Under the Securities Act of 1933 and of Amendments to Registration Guides 5, 6 and 21 to Improve Readability of Prospectuses, Securities Act Release No. 5278, [1972-1973 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 78,888, at 81,921 (July 26, 1972).

99. Securities Act Release No. 5231, *supra* note 91, at 81,105. The Release suggested several means to achieve this goal. The SEC suggested that issuers:

And, on June 1, 1973, the SEC adopted several amendments which were geared specifically toward eliminating boilerplate language and discouraging verbosity.¹⁰⁰

Finally, the SEC adopted Rule 421 of Regulation C of the '33 Act, which was a major step toward increasing the readability of the prospectus. Rule 421(a) states that "[t]he information required in a prospectus . . . shall not . . . be set forth in such fashion as to obscure any of the required information or any information necessary to keep the required information from being incomplete or misleading."¹⁰¹ Rule 421(b) states that "[t]he information set forth in a prospectus should be presented in a clear, concise and understandable fashion."¹⁰² Rule 421(c) requires that "[a]ll information required to be included in a prospectus shall be clearly understandable."¹⁰³

In sum, despite the fact the SEC has been unable to successfully create a prospectus that effectively discloses information to average investors, it continues to assert that disclosure is intended for the average investor. Through various releases and amendments, the SEC has attempted to improve the ability of average investors to read and understand the prospectus.

(a) Write short and simple sentences rather than complex ones. (b) Do not clutter up the cover page. (c) Use visual aids, such as tables and charts. (d) Where appropriate, include an introductory statement in the forepart of the prospectus which would enumerate in a clear, concise manner the specific factors which make the purchase of securities one of high risk . . . [and] (e) In the case of lengthy or complex prospectuses, include a relatively short, readable summary in the forepart of the prospectus.

Id. (citation omitted).

100. See generally Notice of Adoption of Guide 59 and of Amendments to Guides 5 and 16 of the Guides for Preparation and Filing of Registration Statements Under the Securities Act of 1933, Securities Act Release No. 5396, [1973 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 79,384, at 83,124 (June 1, 1973). At least one court recognized at this time that the average investor was not reading the prospectus. In *Feit v. Leaseco Data Processing Corp.*, Judge Weinstein stated:

There are also the perennial questions of whether prospectuses, once delivered to the intended reader, are readable, and whether they are read. The cynic's answer to both questions is 'No'; the true believer's is 'Yes'; probably a more accurate answer than either would be: 'Yes'—by a relatively small number of professionals or highly sophisticated non-professionals; 'No'—by the great majority of those investors who are not sophisticated and . . . are not 'able to fend for themselves' and most 'need the protection of the ['33] Act.'

Feit, 332 F. Supp. at 544, 565 (E.D.N.Y. 1971) (quoting Cohen, *supra* note 21, at 1351-52). See also THE WHEAT REPORT, *supra* note 19, at 77-78.

101. 17 C.F.R. § 230.421(a) (1998).

102. 17 C.F.R. § 230.421(b) (1998).

103. 17 C.F.R. § 230.421(c) (1998). Also, Rule 461 requires the SEC, when presented with a request for acceleration, to consider whether there has been "a bona fide effort to make the prospectus reasonably concise and readable, so as to facilitate an understanding of the information required or permitted to be contained in the prospectus." 17 C.F.R. § 230.461(b)(1) (1998).

V. PLAIN ENGLISH

Amidst all of these efforts to make disclosure documents easier to read and understand, the SEC has embarked on its most committed effort yet to show that disclosure is geared toward the average investor as well as the professional. This new movement is known as “plain English.”

A. THE RISE OF PLAIN ENGLISH UNDER SEC CHAIRMAN LEVITT

As his first major step toward adopting plain English, Levitt created the Task Force on Disclosure Simplification (“Task Force”) in August of 1995. Responding to the criticism that disclosure did not allow investors to make intelligent investment decisions, the Task Force investigated ways to deliver disclosure in a more effective fashion.¹⁰⁴ The Task Force presented Phase One of its report on March 5, 1996, effective on May 31, 1996, and Phase Two on July 18, 1997, effective September 2, 1997.¹⁰⁵ In these reports the Task Force criticized prospectuses for their dense writing, legal boilerplate language, and repetition which obscured information and discouraged investors from reading the disclosure documents.¹⁰⁶ The Task Force also noted that trivial points sometimes received as much attention as material ones, thereby making it virtually impossible for investors to extract the significant information. To alleviate these problems, the Task Force’s recommendation was simple: The SEC should require the use of plain English principles in the drafting of the prospectus.¹⁰⁷

Following the Task Force’s proposals, Levitt initiated both a program and a contest to foster interest in plain English. The program was the plain

104. See Memorandum from Sullivan & Cromwell to Clients, SEC Proposes Plain English Rules 2 (Feb. 7, 1997) (on file with Sullivan & Cromwell) [hereinafter Sullivan & Cromwell Memo]; Proposed Plain English Rules, *supra* note 3, at 88,908-09.

105. See generally Recommendations of Task Force on Disclosure Simplification, Securities Act Release No. 7271, [1996-1997 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 85,740, at 87,580 (Mar. 11, 1996) (proposing Phase One rules); Phase One Recommendations of Task Force on Disclosure Simplification, Securities Act Release No. 33-7300, [1996-1997 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 85,812, at 88,089 (May 31, 1996) (adopting Phase One rules); Phase Two Recommendations of Task Force on Disclosure Simplification, Securities Act Release No. 7431, [1997 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 85,953, at 89,776 (July 18, 1997) (proposing Phase Two rules, effective September 2, 1997).

106. See Proposed Plain English Rules, *supra* note 3, at 88,908; Sullivan & Cromwell Memo, *supra* note 104; Securities Uniformity; Annual Conference on Uniformity of Securities Laws, Securities Act Release No. 33-7413, [1997 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 85,930, at 89,464 (Apr. 4, 1997) [hereinafter Securities Uniformity].

107. See Mark Malyszko, *Plain English*, 4 COMPLIANCE REP. 12, 12 (1997); Sullivan & Cromwell Memo, *supra* note 104, at 1; Final Plain English Rules, *supra* note 3; Securities Uniformity, *supra* note 106, at 89,468.

English pilot program, started in April of 1996, which strove to encourage companies to use plain English to increase clarity.¹⁰⁸ In exchange for these efforts, the SEC offered expedited review of the corporations' documents as well as suggestions on how to improve the readability of the documents.¹⁰⁹ Through the pilot program the SEC also sought to assess whether investors found the plain English prospectuses more readable and more helpful in making investment decisions.¹¹⁰

In April of 1996, Bell Atlantic and NYNEX, in conjunction with the merger of the two companies, were the first companies to accept the challenge of the pilot program. The two companies drafted a plain English cover page and summary for their joint merger proxy statement and prospectus.¹¹¹ The SEC approved the merger on September 9, 1996. Chairman Levitt declared the initial foray into plain English a success, stating in a press release:

This is a victory for investors, for public companies, and for state and federal regulators—to say nothing of the English language . . . We still have much to accomplish, but I'm confident that we are well on our way to creating a new generation of disclosure documents, documents that investors can read and understand.¹¹²

After the Bell Atlantic/NYNEX merger, many other companies began to write in plain English. By June of 1997, approximately forty-five com-

108. See Tie, *supra* note 10 (“Plain English will benefit underwriters and investors alike. To that end . . . underwriters are participating in a plain English pilot program to help them understand not only what the SEC means by plain English, but how they can use it to their own advantage as well as investors.”).

109. See Sullivan & Cromwell Memo, *supra* note 104; Proposed Plain English Rules, *supra* note 3, at 88,908-09, 88,911.

110. See Proposed New Disclosure Option for Open-End Management Investment Companies, Securities Act Release No. 33-7399, [1997 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 85,914, at 89,363 (Feb. 27, 1997).

111. See Proposed Plain English Rules, *supra* note 3, at 88,911 & n.35; *SEC Considers Plain English Rules*, MERGERS & ACQUISITIONS REP., Nov. 3, 1997, at 4; *First Plain English Disclosure Documents Filed with SEC by Bell Atlantic and NYNEX* (visited Sept. 9, 1996) <<http://www.sec.gov/news/press/96-106.txt>> [hereinafter *Bell Atlantic-NYNEX Merger*] (printout on file with author).

112. *Bell Atlantic-NYNEX Merger*, *supra* note 111. Isaac Hunt, Jr., Commissioner of the SEC, also declared the first effort in plain English a success from the issuers' side as he stated that “[t]he companies found that the switch to plain English did not cause delays or greater costs.” Isaac C. Hunt, Jr., Investor Education Policies and Program, Remarks to Financial Services Board of South Africa (May 26, 1997), available at 1997 WL 299667 (S.E.C.) [hereinafter Hunt II]. See also Samuel C. Thompson, Jr., *Introduction to This Symposium and a Guide to Issues in Mergers and Acquisitions*, 51 U. MIAMI L. REV. 533, 561 (1997) (discussing the Commissioner's view of the importance of plain English in the merger and acquisition context). But see Final Plain English Rules, *supra* note 3, at 6376 (stating that the pilot participants found that legal and technical writing costs rose by approximately 15% for the plain English filings).

panies had participated in the pilot program. This number increased to seventy-five by the beginning of 1998.¹¹³

The feedback from the pilot program strongly encouraged the SEC to formally adopt plain English.¹¹⁴ The Commissioners believed that it affirmed the view that preparing documents in plain English could increase investor understanding and assist average investors in making informed investment decisions. Also, it supported the idea that disclosure documents could be made more readable without sacrificing substantive business and financial information.

The second SEC effort to foster interest in plain English was the Gobbledygook Contest which commenced in July of 1997. The contest challenged all SEC employees to find the worst piece of "gobbledygook" and transform it into plain English.¹¹⁵ Through the contest, Levitt hoped to incite interest in plain English within the SEC as SEC employees would realize that the use of plain English would greatly improve the readability of disclosure.¹¹⁶ This, in turn, would cause the employees to wholeheart-

113. See, e.g., ITT Corp., SEC No-Action Letter, [1997 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 77,340, at 77,701 (Dec. 6, 1996); Baltimore Gas and Electric Co., SEC No-Action Letter, available in 1997 SEC No-Act. LEXIS 14 (Jan. 6, 1997); Premium Cigars International, Ltd., SEC No-Action Letter, available in 1997 SEC No-Act. LEXIS 848 (Aug. 21, 1997) ("We continue to participate in the 'plain English' pilot project, and have continued to revise the front and back covers, summary section, risk factors section and other parts of the Prospectus in an attempt to make that document easy to understand."). See also Kelley R. Bowers, *Plain English Pilot Program at SEC Tries to Tame Jargon*, CORP. LEGAL TIMES, June, 1997, at 14; Final plain English Rules, *supra* note 3.

Also, two recent efforts have gained considerable attention and have significantly bolstered the SEC's optimism in plain English. First, on December 16, 1997, Dollar Thrifty Automotive Group completed the first initial public offering in plain English. See Steve Goldstein, *First Underwritten IPO Prospectus in Plain English to be Filed This Week*, CORP. FINANCING WEEK, Nov. 3, 1997, at 1; *Chrysler Spinoff Is First to Use SEC Plain-English Rules*, CORP. FINANCING WEEK, Dec. 1, 1997, at 2. Second, the SEC expects MBNA Master Credit Card to complete the first asset-backed securities offering in plain English in the near future. For a complete list of all plain English pilot program participants, see Final Plain English Rules, *supra* note 3, at 6389 app. B.

114. See Isaac C. Hunt, Jr., *Plain English: A Work in Progress*, Remarks at the First Annual Institute on Mergers and Acquisition: Corporate, Tax, Securities and Related Aspects (Feb. 6, 1997), available in 1997 WL 228744 (S.E.C.) [hereinafter Hunt I] (quoting Nancy Smith of the SEC's Educational Office).

115. *Chairman Arthur Levitt Issues Challenge to SEC Staff to Heighten Awareness of Need for Plain English*, SEC NEWS DIGEST, July 16, 1997, available in 1997 WL 395433 (S.E.C.) [hereinafter *Challenge*]. See also Malyszko, *supra* note 107; *Chairman Levitt Announces Winner of Gobbledygook Contest* (visited Oct. 28, 1998) <<http://www.sec.gov/news/press/98-8.txt>> [hereinafter *Winner*]. "Gobbledygook" is any writing whose key message or meaning is clouded or lost because of the unnecessary complexity of the words or grammatical structure.

116. As Chairman Levitt asked, "What is the point of disclosure if the people who need it most don't understand it? This contest will heighten the awareness of everyone at the SEC that communicating in plain English is the best way to serve investors. Gobbledygook must go!" *Challenge*, *supra* note 115.

edly support the drive to mandate plain English. Levitt offered a \$250 U.S. Savings Bond to the winner as an extra added incentive.

On January 21, 1998, Chairman Levitt announced that Dorothy Heyl, from the Northeast Regional Office, had won first place in the contest. In the same announcement, Levitt proclaimed the contest a rousing success:

As the Commission considers a rule to require that prospectuses be written in plain English, it's important that we practice what we preach by communicating clearly. This contest has helped raise awareness within the Commission of the turgid legalese that surrounds us every-day—produced both within and outside the Commission.¹¹⁷

Thus, Levitt strove to increase issuer involvement through the pilot program and SEC participation through the Gobbledygook Contest. The SEC began its final drive to amend the '33 Act to require plain English disclosure on January 14, 1997 by proposing certain amendments and rule changes.¹¹⁸ Over the next year the SEC, through the pilot program, the Gobbledygook Contest, comment letters, and public speeches and seminars, gathered information about the proposed rules.¹¹⁹ Finally, on January 22, 1998, the SEC voted 4-0 to adopt the proposal and require the use of plain English in disclosure documents.¹²⁰

B. THE PLAIN ENGLISH RULES

Throughout the years, plain English has accumulated a variety of definitions.¹²¹ According to the SEC, however, plain English is a method

117. Winner, *supra* note 115 (providing an excerpt of Heyl's winning entry).

118. See Securities Uniformity, *supra* note 106, at 89,468; Malyszko, *supra* note 107; Mark H. Anderson, *SEC Rules That Require Prospectuses to Be in Plain English Are Proposed*, WALL ST. J., Jan. 14, 1997, at C22; Bowers, *supra* note 113. See generally Proposed Plain English Rules, *supra* note 3.

119. For an example of seminars that were held in order to discuss the proposed plain English rules, see *Seminar Will Discuss the Whys and Hows of the SEC's New Plain English Rules*, METROPOLITAN CORP. COUNS., Sept., 1997, at 20; *Matthew Bender Seminar to Review SEC's New Plain English Rules*, METROPOLITAN CORP. COUNS., Aug., 1997, at 58.

120. See *Plain-English Documents Worth the Cost, SEC Says*, RECORD (Bergen County, N.J.), Jan. 23, 1998, at A10; *SEC Adopts Rule on Use of Plain English*, FIN. POST, Jan. 23, 1998, at 8; *SEC Approves Plain-English Regulations for Prospectuses; Securities: Companies Must Replace Legal Jargon with Plain English in Documents with Everyday Language, Easy-To-Read Tables*, L.A. TIMES, Jan. 23, 1998, at D1 [hereinafter *SEC Approves*]; *SEC Requires Parts of Prospectuses Be in Plain English*, ORANGE COUNTY REG., Jan. 23, 1998, at C4; *SEC Votes to Require Plain Words*, DAILY NEWS OF L.A., Jan. 23, 1998, at B1; *SEC Adopts Rule Requiring Plain English in Prospectuses* (visited Oct. 28, 1998) <<http://www.sec.gov/news/press/98-10.txt>> [hereinafter *SEC Adopts Rule*].

121. Several of these are:

(1) Good English. (2) English easily understood by an ordinary person. (3) English expected of someone with an eighth or ninth grade education. (4) English that is written the way we talk. (5) English you would want someone to use if you were the reader and knew nothing

of writing in which the author clearly expresses complex ideas so they are easy for the investor to read and understand. Plain English is not an excuse for shorter, simpler ideas or a substitute for a decent education and developed writing skills. As written in Chapter 1 of the *Plain English Handbook (Draft)*:

We'll start by dispelling a common misconception about plain English writing. It does *not* mean deleting complex information to make the document easier to understand. For investors to make informed decisions, disclosure documents must impart complex information. Using plain English assures the orderly and clear presentation of complex information so that investors have the best possible chance of understanding it.¹²²

In order to analyze these plain English disclosure rules, they will be separated into two parts: (1) the elements of plain English that are necessary in order to successfully write disclosure documents that are easy to read and understand; and (2) the actual amendments to the '33 Act which compel the use of plain English in disclosure documents.

1. *The Plain English Elements*

The elements of plain English can be divided into three separate categories: (a) know your audience; (b) know what material information needs to be disclosed; and (c) use clear writing techniques to communicate the information. First, the writer must know the audience to whom the disclosure is directed. Before writing a disclosure document, the writer should ask several key questions, "[W]ho is our intended reader? What percentage of the company's shareholders are retail investors versus institutional investors? What will investors need to know to make informed investment decisions?"¹²³ According to the *Plain English Handbook (Draft)*, asking

about the subject . . . [and] (6) English 'written in a clear and coherent manner using words with common and everyday meanings.'

Taylor, *supra* note 4, at 218-19.

122. *Draft: A Plain English Handbook: How to Create Clear SEC Disclosure Documents*, at ch. 1 (last modified Jan 23, 1998) <<http://www.sec.gov/consumer/plaine.htm>> [hereinafter *Plain English Handbook*]. The *Proposed Rules* also contain an accurate depiction of the SEC's definition of plain English:

There is no one absolute form of plain language. It does not consist only of onesyllable [sic] words and one-clause sentences. It is not simplified or reduced English. It is the opposite not of elaborate language but of obscure language, for it seeks to have the message understood on the first reading. The plainness of a passage is defined in terms of the audience for that passage. It is clear, straightforward language for that audience.

Proposed Plain English Rules, *supra* note 3, at 88,912 (quoting George Hathaway).

123. Isaac C. Hunt, Jr., Plain English and the U.S. Securities Markets, Remarks Given by the Commissioner at the Plain English Campaign's 5th International Conference (July 17, 1997), *available in* 1997 WL 414433 (S.E.C.) [hereinafter Hunt III].

these questions is the most important step in assuring that the prospectus is written in an understandable fashion.¹²⁴ The import of these questions lies in the need to know whether the intended audience is average investors, professionals and sophisticated investors, or a mix of the groups.

Where the intended audience is average investors, the SEC encourages writers to remove as much legal jargon as possible. This will enable the lay person to better understand the legal and technical concepts underlying the transaction. As Isaac Hunt stated:

When your audience is retail investors, I would follow Warren Buffet's [sic] advice. He says that when he's writing Berkshire Hathaway's annual report, he pretends that he's talking to his sisters. He has no trouble picturing them: Though highly intelligent, they are not experts in accounting or finance. They will understand plain English but not legal jargon.¹²⁵

In contrast, if the audience is a mix of sophisticated and unsophisticated investors, the issuer should present information in a format that allows the average investor to easily locate the basic information while providing additional detailed information for the more advanced. Also, even if the audience is solely the market professional, plain English will allow the reader to dissect more information from the pages of the prospectus.¹²⁶ According to the SEC, if this general strategy is followed, the disclosure documents will be useful to all investors in the marketplace.

Second, the issuer must know what information needs to be disclosed. The issuer should study and understand the information to be disclosed before writing the prospectus.¹²⁷ If this is done, the issuer will be able to clearly communicate the information through disclosure. As stated in Chapter 1 of the *Plain English Handbook (Draft)*, "Plain English means analyzing and deciding what information investors need to make informed decisions—before words, sentences, or paragraphs are considered."¹²⁸ All too often, issuers haphazardly "combine material and immaterial informa-

124. See *Plain English Handbook*, *supra* note 122, at ch. 3.

125. Hunt I, *supra* note 114, at *4; Hunt III, *supra* note 123, at *3.

126. See Proposed Plain English Rules, *supra* note 3, at 88,912-13.

127. The *Plain English Handbook (Draft)* suggests that the issuer engage in five acts in order to accomplish this goal. The issuer should: First, read through and outline the existing content to get a general understanding of the information already contained within the document; second, meet with the authors of the original document or others who understand it to decide which information should remain in the document; third, eliminate all redundant information; fourth, discuss the cover page and summary, as these are the parts of the prospectus that invite the investor to read; and, fifth, use defined terms sparingly on the cover page and summary because they dissuade reading. See *Plain English Handbook*, *supra* note 122, at ch. 4.

128. *Id.* at ch. 1.

tion in dense and long sentences, in effect dumping large amounts of information on the reader.”¹²⁹ Also, disclosure documents fail to prioritize and organize information in a way that is easy for the investor to grasp. Plain English will force the issuer to study the information, make value judgments about its importance, and present it in a clear style.

Third, the issuer should use clear writing techniques to communicate the information. The SEC has presented six plain English principles that will enable clearer writing: (a) active voice; (b) short sentences; (c) definite, concrete, everyday language; (d) tabular presentation and “bullet lists” for complex material whenever possible; (e) no legal jargon or highly technical business terms; and (f) no multiple negatives.¹³⁰ The first of these principles is use of the active voice. The active voice is easier to understand because “the reader can clearly identify the person or the thing performing the action. The passive voice delays readers’ comprehension, and in some cases, allows the writer to delete who is performing the action altogether, further hindering comprehension.”¹³¹ The second plain English principle is the use of short sentences. It is commonplace for sentences in prospectuses to be anywhere from 60 to 100 words with needless clauses that only complicate the disclosure.¹³² Shorter sentences can be achieved by replacing legal jargon with common words, choosing simpler synonyms, keeping the subject and the verb closer together, and using parallel sentence structure.¹³³

The third principle is the use of definite, concrete and everyday language. The use of clear, everyday words will not only help reduce sentence length, but will also enable the reader to better understand complex financial ideas. When vague words and concepts are used, the investor is left with the desire for more information or is discouraged from reading the prospectus at all. As stated in the proposed rules, “If you avoid distant and abstract language like ‘the company’ and ‘a shareholder,’ your writing becomes clearer and more appealing because you are communicating di-

129. Proposed Plain English Rules, *supra* note 3, at 88,913.

130. *Id.* at 88,913-17 (presenting and explaining the six principles). See also *Plain English Handbook*, *supra* note 122, at ch. 6; Brett D. Fromson, *In Plain English; With a Grammar Lesson, SEC Seeks Stock Prospectus Clarity*, WASH. POST, Jan. 14, 1997, at D1.

131. Proposed Plain English Rules, *supra* note 3, at 88,913. The *Plain English Handbook (Draft)* provides a clear example of the difference between active and passive voice: “Active: The investor bought the stock . . . Passive: The stock was bought by the investor.” *Plain English Handbook*, *supra* note 122, at ch. 6.

132. See Proposed Plain English Rules, *supra* note 3, at 88,914.

133. See *Plain English Handbook*, *supra* note 122, at ch. 6.

rectly with your reader.”¹³⁴ Also, the issuer must be able to decide when additional information would make the language more understandable.

The fourth principle is tabular presentations and bullet lists for complex information. Tabular presentations, such as if-then tables, and bullet lists help to organize complex material in a way that makes it easier to read and understand.

No legal jargon or highly technical business terms is the fifth plain English canon. Legalese runs rampant throughout the disclosure documents even though it greatly inhibits the investor’s ability to understand the information. It also has the deleterious effect of discouraging many people from reading the prospectus.¹³⁵ As stated in the proposed rules:

One of the persistent criticisms of the prospectus writing style is the use of legal jargon and legalese When you use defined terms and excessive cross-references, practices common to legal drafting, you force the reader to learn a new vocabulary—your vocabulary. These writing conventions may be a short hand for the writer but they inhibit the reader’s ability to understand the information.¹³⁶

The last of the plain English principles is to refrain from using multiple negatives. Negative sentences and multiple negatives hinder comprehension because it takes the reader too long to discover what is important. In sum, according to the SEC the use of these six principles will help create a prospectus that is easy to read, inviting to read, and effective in giving the average investor the requisite information to make an informed investment decision.

2. *The Plain English Amendments*

Plain English disclosure consists of amendments to Rule 421, Rule 461, and Items 501, 502 and 503 in Regulations S-K and S-B.¹³⁷ In an ef-

134. Proposed Plain English Rules, *supra* note 3, at 88,917.

135. A perfect example of legalese is: “The new debt will rank *pari passu* with other senior debt of the company.” A legalese-free sentence might read: “The new debt will rank equally with the other senior debt of the company.” *Id.* at 88,916.

136. *Id.* Warren Buffett also supports this idea as he wrote, “Perhaps the most common problem, however, is that a well-intentioned and informed writer simply fails to get his message across to an intelligent, interested reader. In that case, stilted jargon and complex constructions are usually the villains.” *Plain English Handbook*, *supra* note 122, at preface.

137. Although the SEC adopted the rules on January 22, 1998, they did not go into effect, officially, until October 1, 1998. The SEC added this provision because it was estimated that the new plain English requirements would cost U.S. companies approximately \$56 million to implement, and the SEC wanted to give them a period in which to make an easy transition. See Final Plain English Rules, *supra* note 3, at 6370; Marcy Gordon, *Mutual Clarity Is Aim of ‘Plain English’ Rule*, ARK. DEMOCRAT-GAZETTE, Jan. 25, 1998, at G1. During this transition period, the SEC planned to con-

fort to make disclosure easier to read and understand, Rule 421(d) requires the use of “plain English principles in the organization, language, and design of the front and back cover pages, the summary, and the risk factors¹³⁸ section” of the prospectus.¹³⁹ Also, the rule compels the issuer to comply with the six plain English principles when drafting these sections of the prospectus.¹⁴⁰ As Levitt said on the eve of the release of the proposed rules:

Disclosure has two aspects: the information that is made available to investors, and the information that actually gets across to investors. We have excelled at the first part, now we need to focus on the second. We need to acknowledge that disclosure is not disclosure if it doesn't communicate. The . . . rule requires prospectuses to have cover pages, summaries, and risk factors written in plain English. It asks issuers to use the hallmarks of plain English in those sections of the prospectus . . .¹⁴¹

Under the new rule, these four sections are the only portions of the prospectus that must include the plain English principles, although the rule does apply to all different types of prospectuses. Despite the rule's limited application, the SEC has urged registrants to use plain English throughout the entire prospectus and in other disclosure documents in hopes of broadening the scope of the rule in the future.¹⁴² As stated by Chairman Levitt, “Our eventual goal is to purge the entire document of words that, in the famous phrase of George Orwell, ‘fall upon the facts like soft snow, blurring the outlines and covering up all the details.’”¹⁴³

tinue the pilot program and hold workshops to help issuers, underwriters, and attorneys comply with the rules, although expedited review would no longer be offered because of the expected influx of plain English documents.

138. Risk factors are defined as:

any factors that make the offering speculative or risky. The factors may include, among other things, the following: (i) Your lack of an operating history; (ii) Your lack of recent profits from operations; (iii) Your poor financial position; (iv) Your business or proposed business; or (v) The lack of a market for your common equity securities.

Final Plain English Rules, *supra* note 3, at 6380.

139. *Id.* at 6371. See also Malyszko, *supra* note 107; Merrill Stone & Geraldine Cunningham, *Will ‘Plain English’ Expose Issuers to Liability Risks?*, NAT'L L.J., July 14, 1997, at B11, reprinted in 11 BOWNE DIG. FOR CORP. & SEC. L. 7 (1997); Dawn Gilbertson, *Prospectus Answers Call for ‘Plain English’*, ARIZ. REPUBLIC, Aug. 31, 1997, at D1; *SEC Considers Plain English Rules*, *supra* note 111; *Bell Atlantic-NYNEX Merger*, *supra* note 111; Sullivan & Cromwell Memo, *supra* note 104, at 9.

140. See Final Plain English Rules, *supra* note 3, at 6370. See also Tie, *supra* note 10; Hunt III, *supra* note 123 at *1-2; Securities Uniformity, *supra* note 106, at 88,468; Sullivan & Cromwell Memo, *supra* note 104, at 1. For a discussion of the six plain English principles, see *supra* Part IV.B.

141. *SEC to Consider Plain English Proposal and Plain English Handbook (Draft)* (visited Jan. 13, 1997) <<http://www.sec.gov/news/press/97-2.txt>> [hereinafter *SEC to Consider*] (printout on file with author).

142. See Sullivan & Cromwell Memo, *supra* note 104, at 3.

143. *SEC to Consider*, *supra* note 141. This same viewpoint is reiterated in the proposed rules, “We are committed to providing investors with better and more understandable disclosure documents.

Before the adoption of plain English, Rule 421(b) already required the entire prospectus to be “clear, concise, and understandable.”¹⁴⁴ In the amended rule, the SEC articulates the standards to follow when pursuing this goal. When writing the entire prospectus, the issuer should:

- (1) Present information in clear, concise sections, paragraphs, and sentences. Whenever possible, use short explanatory sentences and bullet lists;
- (2) Use descriptive headings and subheadings;
- (3) Avoid frequent reliance on glossaries or defined terms as the primary means of explaining information in the prospectus. Define terms in a glossary or other section of the document only if the meaning is unclear from the context. Use a glossary only if it facilitates understanding of the disclosure; and
- (4) Avoid legal and highly technical business terminology.¹⁴⁵

The rule also includes a note which lists certain drafting conventions that the issuer should avoid because they make the prospectus more difficult to read and understand: (1) “Vague boilerplate explanations that are readily subject to differing interpretations;” (2) “Complex information copied directly from legal documents without any clear and concise explanation of the provision(s);” and (3) “Repetitive disclosure that increases the size of the document, but does not enhance the quality of the information.”¹⁴⁶ Through these amendments to Rule 421(b), the SEC has demonstrated its commitment to maximizing the utility of disclosure for the average investor. If the issuer follows these guidelines, then the prospectus should be more clear, concise and understandable, thus enabling the average investor to use the information in order to make an informed investment decision.

Rule 461 addresses the acceleration of the registration statement’s effective date. This rule requires the SEC to consider whether the issuer has

Our ultimate goal is to have all disclosure documents written in plain English, and we have undertaken several initiatives to improve the readability of these documents.” Proposed Plain English Rules, *supra* note 3, at 88,910. See also Malyszko, *supra* note 107; Stone & Cunningham, *supra* note 139, at 7 (stating that many supporters of plain English call for extending the requirements to the entire prospectus); Sullivan & Cromwell Memo, *supra* note 104, at 3.

144. Proposed Plain English Rules, *supra* note 3, at 88,918; Final Plain English Rules, *supra* note 3, at 6370.

145. Final Plain English Rules, *supra* note 3, at 6371. See also Hunt II, *supra* note 112, at *2; Malyszko, *supra* note 107; Proposed Plain English Rules, *supra* note 3, at 88,918; Stone & Cunningham, *supra* note 139, at 7; Sullivan & Cromwell Memo, *supra* note 104, at 5.

146. Final Plain English Rules, *supra* note 3, at 6371. See also Sullivan & Cromwell Memo, *supra* note 104, at 5; Hunt III, *supra* note 123, at *1-2; Proposed Plain English Rules, *supra* note 3, at 88,918.

made “a bona fide effort to make the prospectus reasonably concise and readable, so as to facilitate an understanding of the information required or permitted to be contained in the prospectus.”¹⁴⁷ The plain English amendment expands this rule to also require the SEC to “consider also whether [the issuer] has made a bona fide effort to satisfy the plain English rule in drafting the front part of the prospectus.”¹⁴⁸ Through this new amendment, the SEC hopes to further entice issuers into using plain English in order to make prospectuses easier for the average investor to read and understand.

The SEC also made three key revisions to Regulations S-K and S-B which strive to increase the aesthetic attractiveness of the prospectus. First, the SEC amended Item 501 by eliminating the formal design requirements for the prospectus’ cover page.¹⁴⁹ The amendment also requires the cover page to be no more than one page in length and allows the issuer to include plain English legends and graphs. The purpose of these modifications is to create “a cover page that will focus investors on key information about the offering and encourage them to read the important information in the prospectus.”¹⁵⁰ As stated in the draft of the *Plain English Handbook*:

A cover page should be an introduction, an inviting entryway into your document, giving investors some key facts about your offering, but not telling everything all at once. If it looks dense and overgrown with thorny details, no one will want to pick it up and start reading. If it looks like a legal document written *by* lawyers and *for* lawyers, many investors will not even attempt to read it.¹⁵¹

Second, changes to Item 502 complement Item 501 by limiting the information to be placed on the inside front and outside back cover pages.¹⁵² A significant portion of the technical information is moved from these pages to the appropriate sections in the prospectus in order to create a document that more efficiently and clearly conveys information to the average investor.

147. 17 C.F.R. § 230.461(b)(1) (1998).

148. Final Plain English Rules, *supra* note 3, at 6375. *See also* Malyszko, *supra* note 107; Sullivan & Cromwell Memo, *supra* note 104, at 4.

149. Item 501 is titled, “Forepart of Registration Statement and Outside Front Cover Page of Prospectus.” 17 C.F.R. § 229.501 (1998).

150. Final Plain English Rules, *supra* note 3, at 6372. *See also* Proposed Plain English Rules, *supra* note 3, at 88,919-21; Sullivan & Cromwell Memo, *supra* note 104, at 6.

151. *Plain English Handbook*, *supra* note 122, at ch. 4, § 4. *See also* Fromson, *supra* note 130.

152. Item 502 is titled, “Inside Front and Outside Back Cover Page of Prospectus.” 17 C.F.R. § 229.502 (1998).

Third, the SEC amended Item 503 in several places.¹⁵³ Item 503(a) already required a summary “where the length or complexity of the prospectus makes such a summary appropriate.”¹⁵⁴ In the new rules, if the issuer includes a summary, then plain English must be used. This change seeks to create a summary that is an invaluable tool for making investment decisions. The summary should “orient the reader, highlighting the most important points that are presented in greater detail in the prospectus.”¹⁵⁵ The amendment is intended to replace the summaries that “seem as long as the prospectus itself” and merely duplicate entire paragraphs that appear in the body of the prospectus.¹⁵⁶ Also, the SEC, after considering various comment letters, decided not to limit the length of the summary, not to require a summary section, and not to specify the information that must be included in the summary. The SEC did not adopt these changes because they wanted to give the issuer flexibility to provide, if chosen, a summary of maximum utility to investors.

The plain English rules amended Item 503(c) to require that the issuer write the risk factor section, if included in the prospectus, in plain English and without boilerplate language. The issuer is also required to put any risk factors in context so investors can understand the specific risks as they apply to the company and its operations.¹⁵⁷ The proposed revisions to this section were among the most hotly debated during the pilot program and the comment period. Originally, the SEC had proposed requiring the issuer to restrict the number of risk factors and to prioritize them in order of importance.¹⁵⁸ These proposals engendered violent criticism from issuers who argued that no way existed to accurately rank the risk factors. Issuers convincingly showed that these proposed amendments would stunt the efficacy of plain English and, as a result, the SEC decided not to adopt either of these requirements.¹⁵⁹ Finally, Item 503(d) previously required the issuer to disclose a ratio of earnings to fixed charges when offering debt or

153. Item 503 is titled, “Summary Information, Risk Factors, and Ratio of Earnings to Fixed Charges.” 17 C.F.R. § 229.503 (1998).

154. 17 C.F.R. § 229.503(a) (1998).

155. *Plain English Handbook*, *supra* note 122, at ch. 4, § 4.

156. *Id.*

157. See Final Plain English Rules, *supra* note 3, at 6373.

158. See Proposed Plain English Rules, *supra* note 3, at 88,924; Tie, *supra* note 10 (arguing that there is no way an issuer can correctly know in what order risk factors should be presented); Sullivan & Cromwell Memo, *supra* note 104, at 9.

159. See Final Plain English Rules, *supra* note 3, at 6373 (discussing risk factor disclosure requirements). See also *Deals*, ASSET SALES REP., Jan. 26, 1998, at 1; *SEC to Ease Restrictions on Plain English Proposal*, CORP. FINANCING WEEK, Sept. 29, 1997, at 8; *SEC Adopts Rule*, *supra* note 120.

preferred equity. The amended rule requires this ratio to be included in the summary as part of the summarized financial data.

C. THE SHORTCOMINGS OF PLAIN ENGLISH

Instead of accepting the critics' view of disclosure's intended audience, the SEC doubled its efforts to prove that disclosure could effectively communicate vital information to the lay investor. As expressed by Commissioner Hunt, "Over the past several decades, many of us have lost sight of the fact that the disclosure documents that are filed with the SEC every year are not only liability documents—but are intended to be one of the primary ways that the corporate community communicates with investors."¹⁶⁰ The SEC has embraced plain English as the means to achieve this goal, as it will help the issuer produce a prospectus that is meant to be read, that is inviting to read, and that is easy to understand.¹⁶¹

According to the SEC, the prospectus' utility will increase when the plain English principles are used to remove the turgid prose that has dominated disclosure in recent years. As Chairman Levitt stated in the *Plain English Handbook's* Introduction:

Whether you work at a company, a law firm, or the [SEC], the shift to plain English requires a new style of thinking and writing. We must question whether the documents we are used to writing highlight the important information investors need to make informed decisions. The legalese and jargon of the past must give way to everyday words that communicate complex information clearly.¹⁶²

160. Hunt III, *supra* note 123, at *1. See also Hunt II, *supra* note 112, at *1-2; Isaac C. Hunt, Jr., *Plain English-Changing the Corporate Culture*, 51 U. MIAMI L. REV. 713, 713-14 (1997). For a discussion of how plain English will affect the liability side of the prospectus, see *infra* notes 175-80 and accompanying text.

161. See Hunt I, *supra* note 114; *SEC Adopts Rule*, *supra* note 120 (quoting Chairman Levitt as saying, "Today's plain English rule is very important for investors who will now be able to read and understand the information that up to this point had been unintelligible to all but a few lawyers and market professionals."); *SEC Considers Plain English Rules*, *supra* note 111; Tie, *supra* note 10; *Marketplace* (PRI Network television broadcast, Nov. 20, 1997); *SEC Approves*, *supra* note 120 ("We need investors to understand these documents that are so critical and are those that aren't being read now."); Proposed Plain English rules, *supra* note 3, at 88,907; Sullivan & Cromwell Memo, *supra* note 104, at 1.

162. *Plain English Handbook*, *supra* note 122, at introduction. See also *SEC to Consider*, *supra* note 141; *SEC Considers Plain English Rules*, *supra* note 111; Dominic Bencivenga, *Short Cut for Investors; Why Read a Prospectus When a Profile Will Do?*, N.Y. L.J., March 6, 1997, at 5; Bowers, *supra* note 113, at 14; *SEC Set to Adopt Plain-English Rule*, SAN DIEGO UNION-TRIB., Dec. 11, 1997, at C-8; *SEC Leaders Ready to Enact "Plain English" Guidelines*, SACRAMENTO BEE, Dec. 11, 1997, at E3; Neil Roland, *SEC Wants Language in Prospectuses Simplified; 'Plain English' to Be Goal of Requirement*, ROCKY MTN. NEWS, Dec. 11, 1997, at 5B; *SEC Likely to Require Plain English Starting Next Month*, CORP. FINANCING WEEK, Dec. 15, 1997, at 7.

If unnecessarily vague language is removed, the investor will be able to grasp the information, thus allowing the prospectus to perform its two vital roles of investor protection and investor education. First, the plain English rules will greatly increase the ability of disclosure to perform its legislative purpose of investor protection. By communicating more clearly, the protective role of disclosure will be brought to more investors as they will be able to understand the transactions and their inherent risks. In support of this idea, Isaac Hunt stated that the plain English rules are part of the “continuing effort”¹⁶³ to extend the protection of the ‘33 Act to many more investors. If plain English works as the SEC anticipates, the SEC may be able to prove that disclosure is indeed intended for the average investor.

Another key goal of plain English is to enable the average investor to make an informed investment decision from the prospectus. As Chairman Levitt wrote, “No matter what route you take to plain English, we want you to produce documents that fulfill the promise of our securities laws. I urge you . . . to speak to investors in words they can understand. Tell them plainly what they need to know to make an intelligent investment decision.”¹⁶⁴

If plain English can effectively create readable and understandable documents, it would substantiate the SEC’s claim that the lay investor can effectively use disclosure. Also, if average investors can understand the prospectus, they will certainly be included within the intended audience of disclosure. In sum, if plain English functioned per the desires of the SEC it would greatly support the SEC’s argument that all investors can utilize the information in the prospectus.

The plain English movement, however, suffers several major shortcomings which derail the SEC’s effort to prove that disclosure is intended for all investors. Primarily, plain English neither refutes the “myth of the informed layman” nor accounts for the filtration theory.¹⁶⁵ First, plain English still will not enable average investors to understand prospectuses and make informed investment decisions because they will still not have the requisite background knowledge. It is probably true that the use of plain English will result in documents that are more easy and inviting to

163. Hunt I, *supra* note 114, at *1. See also Proposed Plain English Rules, *supra* note 3; Hunt III, *supra* note 123, at *1; Final Plain English Rules, *supra* note 3, at 6370-71.

164. *Plain English Handbook*, *supra* note 122, at introduction. See also Final Plain English Rules, *supra* note 3, at 6370; Proposed Plain English Rules, *supra* note 3, at 88,909; Gilbertson, *supra* note 139.

165. See *supra* Part III.

read. The amendments to Rules 501, 502 and 503 will create a more superficially appealing document, and Rules 421(d) and 421(b) will encourage more concise writing.¹⁶⁶ However, a greater understanding of the words will still neither allow investors to understand the complex legal/financial concepts underlying the words nor will it enable investors to make intelligent investment decisions because “the general public, without the benefit of a professional legal education, has difficulty understanding the law because they do not understand legal concepts”¹⁶⁷ Simple language does not mean simple concepts, and, therefore, plain English will fail because the average investor, as foreshadowed by the “myth of the informed layman,” still will not be able to understand disclosure.

Second, the plain English rules do not account for certain complexities of the securities industry. The concepts contained in the prospectuses are incredibly complex because the securities industry is itself highly advanced and technical. Often, advanced terminology is the only means to convey the appropriate message to the securities professional; it is simply not possible to adequately explain the transaction in plain English. Many transactions are so complex that any attempt to boil down the language would be a waste of time and money because the simpler words just do not exist.¹⁶⁸ Before enacting plain English, the SEC realized this was a potential problem. The Commissioners wrote in the final rules release that “[s]everal comment letters stated that we should permit public companies to use legal and technical business terminology. . . . We recognize that certain business terms may be necessary to describe your operations properly. But, you should avoid using excessive technical jargon that

166. This Note does not attack the concept of plain English nor does it minimize the SEC’s desire to employ plain English. Rather, it focuses on the inability of plain English to further the SEC’s goal of showing that disclosure can be effectively geared toward the average investor. If the SEC used plain English with the goal of maximizing the utility of the prospectus for the professional then it could be a successful program.

167. Taylor, *supra* note 4, at 222.

168. As argued by one critic of plain English, “Many financial products simply cannot be boiled down to simple terms. Try describing an inverse floating-rate mortgage-backed security, for instance, in words a ninth-grader would understand.” *One for the Writers*, INVESTMENT DEALERS DIG., Nov. 17, 1997, at 4. (“A funny thing happens when people try to implement the SEC’s new ‘plain English’ requirements. They learn, very quickly, how difficult it is to write clearly—especially when the subject is finance.”). See also Final Plain English Rules, *supra* note 3, at 6374; Matthew J. Arnold, *The Lack of Basic Writing Skills and Its Impact on the Legal Profession*, 24 CAP. U. L. REV. 227, 249 (1995) (arguing that “[a] common criticism levied against the Plain English movement is that it neglects the perceived need to retain certain terms of art in the legal profession”); Stone & Cunningham, *supra* note 139, at 7; *SEC Considers Plain English Rules*, *supra* note 111; Goldstein, *supra* note 113, at 1 (noting the argument that summarizing a company’s line of work may be difficult when the company engages in a complex computer or technical business).

only . . . an industry specialist can understand.”¹⁶⁹ This SEC concession creates a double standard which hinders the ability of plain English to accomplish its goals.

Another SEC-proposed solution to this problem was the plain English principle of knowing the audience to whom the disclosure is directed.¹⁷⁰ The SEC has stated that different language can be used depending upon the intended audience. This concession is fraught with practical problems. First, since virulent debate surrounds the issue of the intended audience of disclosure, it is naive to think that an issuer can accurately gear disclosure toward a specific group that, in reality, is almost impossible to identify and whose understanding of the disclosure regime is difficult to quantify. Second, even if the issuer could make an educated guess, the results would be disastrous if the issuer was incorrect. If an issuer used advanced language in a prospectus directed to professionals, and average investors attempted to use the prospectus, the central goals of plain English would be thwarted. Third, avoiding the consistent use of plain English creates a dangerous loophole. Once an issuer starts tailoring disclosure toward a specific group, different standards result which can lead to chaos and inefficiency. Thus the SEC’s proposed solution not only weakens the effectiveness of plain English but could also cause added confusion within the disclosure process. Therefore, one of plain English’s central flaws is its inability to counter “the myth of the informed layman.”

The plain English rules also falter because they minimize the filtration theory. First, the use of plain English will result in oversimplification. If an issuer attempts to use simple words to explain complex concepts, then inevitably something will be left out. This creates risks to both the average investor and the professional.¹⁷¹ In terms of the layperson, it greatly reduces the level of investor protection. Skeptics have pointed out that the SEC initiatives do not adequately address the potential risks of a transaction, especially considering the fact that investors “need more, not less, information at the time of purchase.”¹⁷² By simplifying the language for the average investor, the issuer will not be able to adequately convey the risks. This furthers the argument for filtration as the average investor

169. Final Plain English Rules, *supra* note 3, at 6371.

170. See *supra* Part V.B.1.

171. See Taylor, *supra* note 4, at 222 (“[T]he best case against plain English is that there are risks in trying to make complicated facts, issues and concepts appear too simple . . .”).

172. Bencivenga, *supra* note 162. Henry Hu, a Professor in Law at the University of Texas School of Law in Austin, furthers this argument by adding that the new disclosure rules “might have the effect of lulling some investors into thinking they are going to continue to experience extraordinary gains.” *Id.*

should not be encouraged to make investment decisions without the assistance of a market professional. Also, because the average investor cannot make an informed investment from the prospectus alone, since other sources must be examined, the plain English movement will fail because it encourages investors to rely on the prospectus.

Advocates of plain English deny that oversimplification will be a problem. They feel that “[i]n using plain English, you are not forced to choose between clarity and precision. The disclosure obviously must be correct, but plain English is often more precise than the obscure and complex writing style that is prevalent in prospectuses.”¹⁷³ As one advocate stated, “It’s not like taking a prospectus and putting it in a kettle and boiling it for 3 days and all you have left is this little shrunken thing that has the essence of truth that the original one had. It’s much more like a fresh start.”¹⁷⁴ Unfortunately, this argument bears little practical weight. Although it is true that plain English will make the prospectus more inviting to read, it is not true that oversimplification will not occur; it is difficult to use more simple language without omitting key information.¹⁷⁵

Issuers, underwriters, and securities attorneys (in sum, “issuers”) provide the most compelling argument warning against the oversimplification caused by plain English. Through comment letters, issuers have continually expressed fears that plain English would increase liability. Since issuers are responsible under section 11 of the ‘33 Act to ensure that prospectuses contain no material omissions, they are concerned that the use of plain English would inevitably lead to the omission of material facts. The issuers would be “responsible for walking the fine line between meeting the SEC’s objective of keeping the [prospectus] easy to read and ensuring enough disclosure to avoid liability under the Securities Act of 1933.”¹⁷⁶ Noting the imprecision in simple language, these critics would prefer

173. Proposed Plain English Rules, *supra* note 3, at 88,911. See also *SEC Considers Plain English Rules*, *supra* note 111; Joseph Kimble, *Lawyers Need to Learn the Elements of Style*, NAT’L L.J., Nov. 10, 1997, at A21.

174. *The Money Club* (CNBC television broadcast, Jan. 27, 1997). See also Malyszko, *supra* note 107 (quoting Nancy Smith, director for the SEC Office of Investor Education and Assistance as saying that “Plain English is not ‘You Tarzan, me Jane.’ . . . It’s really just writing well.”).

175. Even some proponents of plain English realize that oversimplification is a problem and are willing to accept the risks in order to increase overall understanding. See Taylor, *supra* note 4, at 222-23.

176. Bencivenga, *supra* note 162 (arguing that securities attorneys, underwriters, and issuers will continually ask, “Did I leave out something that might . . . lead to liability?”). See also Dennis Taylor, *SEC’s Goal for Prospectuses: Simplicity*, 15 BUS. J. 3, 3 (1997); Gilbertson, *supra* note 139 (stating that “many attorneys have resisted plain English because they fear the simplification will make them more susceptible to lawsuits”); Hunt I, *supra* note 114, at *4; Proposed Plain English Rules, *supra* note 3, at 88,912.

dense but complete language over the oversimplified, concise version produced by plain English.¹⁷⁷ The issuers presented two alternate plain English schemes to protect against the increase in liability: (1) a safe-harbor rule that would prevent legal liability from the use of plain English;¹⁷⁸ and (2) making plain English voluntary instead of mandatory.¹⁷⁹ Both alternatives would encourage a good faith use of plain English while removing the threat of increased liability.

The SEC rejected both of these proposals. They discounted the issuers' view that plain English would increase liability, stating that plain English does "not reduce the substantive information that must be given to an investor; plain English does not mean leaving out anything important or material."¹⁸⁰ In light of the threat of oversimplification, however, this argument is not compelling. The SEC also stated that they knew of no case that held anyone liable under section 11 for clearly disclosing material information to investors. This, also, is a weak argument because the plain English rules require clear disclosure at all times, not merely when it is convenient or easy. Furthermore, the SEC argued that plain English will decrease liability by reducing the likelihood that an investor will misunderstand the prospectus.¹⁸¹ Like the others, this argument is similarly flawed. First, the average investor will understand the words and not the concepts. Second, because of the oversimplified language, the professional will lose valuable insight into the transaction which, under the filtration theory, results in more egregious consequences such as incorrect or incomplete recommendations. In sum, if plain English will oversimplify disclosure, then it will hurt both the professional and the average investor while also making it impossible for the SEC to reach its goals.

177. See Taylor, *supra* note 4, at 221; *One for the Writers*, *supra* note 168.

178. See Tie, *supra* note 10; Final Plain English Rules, *supra* note 3, at 6374; Stone & Cunningham, *supra* note 139, at 7 (arguing that a safe harbor covering good faith compliance with the plain English rules could reduce potential liability).

179. The American Bar Association and numerous investment banking institutions embraced the voluntary rule. In a letter to the SEC, Morgan Stanley and Dean Witter argued that plain English should be a recommendation, not a rule. They wrote, "While we concur in the Commission's belief that full and fair disclosure is one of the cornerstones of investor protection, we do not believe that the way to achieve this goal is by requiring compliance." *SEC Considers Plain English Rules*, *supra* note 111. See also Final Plain English Rules, *supra* note 3, at 6374; *SEC Approves*, *supra* note 120.

180. Proposed Plain English Rules, *supra* note 3, at 88,912. In the final rules the SEC stated: "Using plain English does not mean omitting important information. These rules only require you to disclose information in words investors can understand and in a format that invites them to read the document. For these reasons, we do not believe that a safe harbor rule is necessary or appropriate." Final Plain English Rules, *supra* note 3, at 6374.

181. See Kimble, *supra* note 173; Final Plain English Rules, *supra* note 3, at 6374.

The inability of plain English to achieve the SEC's goals is exacerbated by the imprecision of the plain English doctrine. What constitutes plain English is a subjective standard that will be hard to determine and virtually impossible to enforce. It could easily digress into a chaotic standard which only adds confusion to the prospectus and does not increase the utility of disclosure for either the average investor or the market professional.¹⁸² In a worst case scenario, it could even result in the creation of a new type of legal boilerplate language that confuses everyone in the securities industry.¹⁸³ At least with the present boilerplate, securities professionals are able to use and understand it, and through filtration, can pass this information on to the average investor. In sum, because plain English does not refute "the myth of the informed layman" or the filtration theory, it cannot be used to justify the SEC view that disclosure is geared toward everyone, including the average investor.

VI. PROPOSED CHANGES TO THE SEC OUTLOOK AND THE PLAIN ENGLISH RULES

The SEC has fervently argued that plain English will enable market analysts to more easily read and understand the prospectus and to more accurately analyze the information contained therein. They will therefore be able to make better recommendations to the average investor about the securities and their inherent risks.¹⁸⁴ However, accompanying this belief is the SEC's traditional view that average investors can effectively read and understand disclosure without any outside assistance. This traditional view, as discussed throughout this Note, is fraught with many problems that have hindered and will continue to hinder the ability of plain English to function effectively. The plight of plain English, however, is not hopeless. If the SEC were to make three changes, plain English may be able to function effectively and efficiently, and the SEC may be able to create the disclosure system that it has been seeking since Congress ratified the '33 Act.

First, the SEC must accept the reality that disclosure should be directed only toward the sophisticated investors who have the requisite knowledge and skills to understand it. Second, the SEC must make several changes to the plain English rules with this realization in mind in order to increase the utility of disclosure for the sophisticated investors. And third,

182. See Tie, *supra* note 10.

183. See Stone & Cunningham, *supra* note 139, at 7.

184. See *Plain English Handbook*, *supra* note 122, at introduction; Proposed Plain English Rules, *supra* note 3, at 88,911.

the SEC should embark on an educational campaign that seeks to teach the average investor how to effectively use disclosure and plain English and how to rely on the filtration process.

At present, as discussed in Part IV, the SEC is clinging to the traditional view that lay investors can read and understand disclosure documents without assistance. It has attempted to restore lay investor interest in the prospectus by asserting that plain English will enable the investor to accomplish this goal. This endeavor, similar to the others that the SEC has attempted in the past, will not succeed and should be abandoned. Instead, the SEC should embrace the “myth of the informed layman” and the filtration theory and change their outlook to reflect these ideas.

The SEC should be communicating to investors the need to seek out the information and knowledge that filters down from the market professionals. Investors should not be encouraged to make investment decisions without outside assistance as this causes them to lose the protection provided by the analysts’ recommendations, which incorporate information both within and outside the disclosure documents that is too advanced for lay investors to understand on their own. If the SEC abandoned its unrealistic ideal that plain English can enable the lay investor to read and understand disclosure then it would be able to more successfully achieve the disclosure goals of protecting the investor, deterring the financial community from engaging in dubious practices, and restoring investor confidence in disclosure. Most importantly, it would take major strides toward enabling the lay investor to make educated investment decisions.¹⁸⁵

A change in the SEC’s attitude is only the first step toward enabling plain English to effectively increase the utility of the disclosure documents. The next step involves two fundamental changes to the actual plain English rules. Both of these changes will minimize any effort to make disclosure more accessible to the average investor. Using plain English with a focus on the lay investor only creates problems such as oversimplification that destroy the ability of the sophisticated investor to effectively analyze the disclosure and filter information to the lay investor. First, the SEC should not encourage issuers to guess as to the intended audience of the disclosure documents. The issuer should assume that the intended audience is, at all times, the sophisticated investor. Then, the issuer can

185. This argument does not encourage lay investors to totally ignore the disclosure documents. In contrast, lay investors could (and perhaps should) read a prospectus in order to familiarize themselves with the fundamentals of the transaction. But they should not rely solely on their understanding of the information contained within the disclosure because they do not possess the expertise to fully comprehend it.

use plain English to create a document that reflects, in the best way possible, all the relevant information that the professional market analyst needs in order to assist the lay investor in making an informed investment decision. This will reduce the inconsistent and subjective application of plain English, as the issuer will not attempt to use different language in different situations in order to appeal to various groups of investors. In order to be effective plain English must be used consistently and uniformly, with an eye toward the sophisticated investor.

Second, of the plain English elements, the one most in need of change is the principle which requires the issuer to use no legal jargon or highly technical business terms. As discussed in Part V.C, the use of common terms to describe complex business transactions inevitably results in oversimplification which destroys the efficacy of plain English. As Commissioner Hunt recognized:

Securities professionals often must describe complex business transactions and agreements without losing crucial nuances. And, not all complex concepts can be explained in simple language. Drafters of prospectuses and other disclosure documents may have developed the legal and highly technical business terminology that they use because simpler, everyday terminology did not convey the appropriate meaning.¹⁸⁶

If the issuer is forced to use simplified language in order to appeal to the average investor, it is inevitable that important information will be left out or glossed over. The professional will not be able to as accurately analyze the information, and, in the end, the average investor will suffer. However, if the SEC adopts the view that disclosure should be geared toward sophisticated professionals then the need to remove legal jargon is alleviated because the professionals are able to understand and assimilate the legal and financial terms used throughout the disclosure documents. Therefore, a key step toward making plain English successful is to abolish this particular plain English principle.¹⁸⁷

After making these changes, the SEC should enact a program that seeks to educate lay investors in the proper way to use the disclosure system and plain English. The SEC spent valuable time and money raising interest in plain English within the financial and business community

186. Hunt III, *supra* note 123, at *3. See also Proposed Plain English Rules, *supra* note 3, at 88,912 (discussing the skeptics' view that "plain" is equated with "simplistic").

187. This, of course, does not mean that issuers should blindly use legalese and boilerplate when a more clear and effective means exists to present the information. It does mean, however, that issuers should not be overly concerned with using a certain term of art because an average investor may not understand its meaning. Through filtration, the average investor will be educated as to the meaning and import of the complex terminology.

through the plain English pilot program and within the SEC through the Gobbledygook Contest.¹⁸⁸ The SEC, however, provided the average investor with no information about the goals of plain English or any knowledge as to the most effective way for the lay investor to benefit from the added clarity in the disclosure documents that plain English created. Once the SEC accepts filtration as an effective means for the dissemination of disclosure information to average investors, it is essential that average investors understand their role and position within the process. This can be accomplished if the SEC takes proactive steps to educate lay investors through seminars, workshops, or other similar educational endeavors. Only then will the SEC be able to truly realize the benefits offered by plain English.

In sum, if the SEC is able to accept the fact that disclosure should be geared toward the sophisticated investor and is able to incorporate this philosophy into the plain English rules, the SEC will be able to create a disclosure regime which efficiently disseminates all necessary information to the average investors, thus allowing them to make informed investment decisions.

VII. CONCLUSION

The intended audience of disclosure has been one of the most vehemently debated subjects of securities regulation since Congress enacted the '33 Act. The legislative history of the Act shows that Congress intended disclosure to be directed at the average investor. Through disclosure, the average investor would be protected from the risks within the securities market and would be able to make an informed investment decision about the securities. In the years that followed, the SEC and the courts struggled to apply the legislative mandate in a uniform and efficient fashion. Through these efforts, they stretched the intended audience of disclosure to also include market professionals and analysts.

The public, however, greeted the SEC view with skepticism and several alternate theories arose that challenged the position that disclosure should be directed to the average investor. First, the "myth of the informed layman" argued that the average investor did not possess the skill or the expertise to read and understand disclosure. This theory, coupled with the complexity of the securities industry, showed that disclosure directly to the average investor was useless and inefficient. Second, the filtration theory forwarded this view by arguing that disclosure should be di-

188. See *supra* Part V.A.

rected to the professional who disseminates the relevant information to the lay investor.

The accuracy of these alternate theories was profound as the SEC was unable to produce a readable and understandable prospectus. Negativity began to characterize disclosure as the SEC forced the issuer to couch all information in disclaimers because they feared the average investor would misinterpret the vital information. In turn, the lay investor began to lose confidence in the disclosure process. The SEC, however, attributed this loss of confidence to the style and form of the prospectus which made disclosure difficult to read and understand. Under this theory the SEC, through the leadership of newly elected Chairman Arthur Levitt, Jr., embarked on a crusade to require the use of plain English in the drafting of the prospectus.

The SEC adopted the plain English disclosure rules on January 22, 1998 after a one-year trial period. The rules require the use of plain English in the front and back cover pages, the summary, and the risk factors section of the prospectus. Through plain English, the SEC hopes to prove that disclosure can indeed be geared toward the average investor. Once again, however, the SEC will fall short of accomplishing this goal. Plain English falls prey to the same problems that have epitomized SEC action in recent years: it fails to counter the "myth of the informed layman" and does not account for the filtration theory. Because of this, plain English will not be able to substantially improve the utility of disclosure until and unless the SEC accepts the fact that disclosure should be geared toward the sophisticated investor and amends plain English accordingly.