Four Reasons to Use Plain English in Your Securities Disclosure Documents

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This article discusses the four primary reasons public companies should use plain English in their securities disclosure documents. Specifically:

- **Investors expect, need, and deserve plain English.**
- **The SEC expects plain English.**
- **Using plain English makes an issuer look better, and coincidentally improves documents.**
- **Using plain English saves money.**

Investors expect, need, and deserve plain English.

Bad writing (legalese, boilerplate, poor organization, etc.) is disrespectful; it implies that the writer's time is more valuable than the reader's. Someone writing in plain English will explain things, not force readers to figure things out.

Does plain English really matter to investors? Absolutely. True, there are traders who make so-called investment decisions without reading anything, and there always will be people who trade based solely on rumors or mathematical formulae. But think of the millions of investors who are attempting to do responsible research. These are not sophisticated analysts and money managers who understand the industry and its language and have the time and resources to ferret out details. They are ordinary individuals who are struggling to read and understand EDGAR filings. Why not make it as easy for them as you can?

When the SEC proposed the first plain English rules in 1997, one of the most frequent criticisms was that there are more sophisticated investors making decisions than unsophisticated ones, and sophisticated investors want technical language. The first part of this statement has become progressively less accurate, as retail investors have entered the market and demanded equal access to information. (Consider the groundswell of investor support for Regulation FD.) The second part of the statement just doesn't make sense. If you were a "sophisticated" portfolio manager looking at a stack of things to read, wouldn't you focus first on the documents that are visually appealing, highlight the most important information, and explain what you need to know in clear language?

The rash of corporate scandals several years ago highlighted the market's desperate need for plain English and clear, complete explanations (also known as "transparency"). It seems like every politician and bureaucrat in Washington, up to and including the President, has called on public companies to explain things more clearly to investors. (We'll be polite and ignore the irony here.) Would people have bought Enron if the Description of Business section of the annual report said "we're running a shell game"? Would people have bought Tyco if the annual letter from Mr. Kozlowski thanked investors for furnishing his Park Avenue apartment?

But it isn't just companies intent on committing fraud that fail to truly communicate with their investors. Example #1 (at the back of this package) came from a company that is honest (as far as I know) but didn't think about its audience. The original version uses a lot of words, but does not communicate well.

The SEC expects plain English.

You can begin to get a sense of how committed the SEC is to plain English by looking at Updated Staff Legal Bulletin #7, Plain English Disclosure, which was issued in 1999. The bulletin starts with a Q&A that summarizes the plain English rules for prospectuses, and then reproduces the 41 most common plain English comments that the SEC had issued up to that point. You may find the level of detail astounding.

- Some comments focus on purely mechanical problems. For example, the sentences are too long; the same information appears in several places; the headings are not descriptive enough; or common words used for their common meanings (such as "preferred stock" or "merger agreement") are unnecessarily defined and capitalized.
- Some comments reflect plain English philosophy. For example, issuers focus on technical legal points that are wholly irrelevant to investors trying to make decisions, or bury key information among less important details.
- One grin-inducing comment chides the issuer for offering a standard disclaimer that the summary section is not complete and does not describe all of the details of the proposed transaction. As the SEC cheerfully points out, if the section did include all the details, it wouldn't be a "summary," would it?

Once the disclosure rules for prospectuses were in place, the SEC expanded issuers' plain English obligations. For example, a package of rules that went into effect in 2000 entitles shareholders to receive a plain English summary term sheet for all tender offers, mergers, and going-private transactions. In a Sarbanes-Oxley-based rule requiring public companies to disclose whether they have a code of ethics for executive officers, the definition of code of ethics includes "standards that are reasonably designed to . . . promote . . . full, fair, accurate, timely, and understandable disclosure" in SEC filings and other public communications. The 2005 Securities Offering Reform rules require companies to disclose their risk factors in plain English in annual reports on Form 10-K. And most recently, the Commission adopted rules requiring plain English disclosure of executive compensation.

All the while, the SEC has proclaimed displeasure with public company filings. In 2003, Commission staff reviewed the annual reports filed by all the Fortune 500 companies in 2002. High on the list of persistent problems were excessive use of boilerplate and rote language, failure to offer thoughtful (rather than mechanical) analysis of the company's business and financial condition, and failure to be more forthcoming with helpful details. The same themes appear in a December 2003 Interpretive Release focusing just on the MD&A. And no one has been more dogged in the pursuit of clear, understandable disclosure than the current SEC Chairman, Christopher Cox, as a review of some of his published speeches demonstrates.

Don't you think your overworked SEC examiner will be happier if he or she can easily find everything that is required to be in your documents and can understand that disclosure on the first reading?

Using plain English makes an issuer look better, and coincidentally improves documents.

Rewriting something (particularly a legal document) in plain English will usually expose a mistake or ambiguity because it will be the first time in a long time that anyone actually analyzed the text.

Look at Example #2, which contains an error and two ambiguities. Someone who knows what a corporate bond is can spot the error pretty quickly, but apparently no one from the Fund took the time to read the document carefully. You need some sensitivity to investor concerns to spot the ambiguities.

You also need some sensitivity to understand the problem with Example #3. Why force an investor to keep track of three sets of numbers buried in sentences when you can easily present the same information in a chart?

Investors are understandably skeptical. Hit them over the head with your information so they can't fail to understand it. If you say something that is susceptible to more than one meaning, rest assured it will be interpreted in a way you didn't intend. If you hold back useful details, it will come back to haunt you.

Using plain English saves money.

This is not just an academic or moral exercise. Plain English documents offer several economic advantages:

- People can understand things faster and thus do what you want them to do (invest, vote, whatever). They won't puzzle over what you are trying to tell them or call your office with questions.
- Staff people who use the documents (or explain them to the public) require less training and supervision and make fewer mistakes.
- When investors understand what they are buying (or can be deemed to understand because the risks and rewards are clearly explained), there are fewer disputes, and those that do arise are easier to defend. As former SEC Commissioner Isaac Hunt once said, "I know of no case that has held anyone liable for clearly and accurately disclosing material information to investors. In all likelihood, liability should decrease with the use of plain English because it results in less confusing disclosure."
- Market professionals will understand companies better and make more appropriate recommendations.

♦ Lawyers can counsel clients better and more efficiently. Like anyone, a lawyer who sees the same language over and over will skim it without thinking and assume it is correct. (We said it the same way last year, right?) Change the words and you will force your lawyers to read them. Change the words to plain English and they can't bill too much for doing so!

♦ Courts and regulators can more easily determine whether a company's disclosure is adequate.

♦ It takes less time to update a document each reporting period if the starting point is coherent.

♦ Investors will have more confidence in available information.

Plain English documents often are shorter than the original (reducing printing, duplicating, and mailing costs), but not always. In Example #4, I cut over 100 words from a client's safe harbor disclosure (and still kept more than enough hedge words!). Conversely, the rewrite in Example #1 is longer than the original, but I think that my version (which includes some definitions and breaks the original single paragraph into six) says something an investor can understand, which justifies the length.

Attachments

Example #1	This company forgot who it was talking to
Example #2	This disclosure was wrong
Example #3	This must be rewritten
Example #4	This is overkill

Example #1

This company forgot who it was talking to.

Original

All of the Company's securities with the exception of $35,000 in equities are issued by the U.S. Treasury or by a U.S. Government Agency. Therefore, little credit risk exists in the portfolio. The risk inherent in the Company's security portfolio is interest rate risk and option risk. The U.S. Treasury Note and Agency debentures are purchased with a final maturity of no greater than four years. The Company owns a limited number of Agency callables. It is the Company's policy not to buy callables with a final maturity of greater than five years. The Company owns a $35.0 million portfolio of Agency issued mortgage-backed securities. These are comprised of $5 million in Collateralized Mortgage Obligations with the remainder of the portfolio in mortgage-backed pass-through securities. These securities are subject to prepayment risk when rates decline, and to extension risk when rates increase. Prepayments can lower the yield on securities that were purchased at a premium. The Company manages prepayment risk by buying its mortgage-backeds with a variety of coupon rates and at a variety of price levels. Extension risk, on the other hand, increases the average life of the security without a corresponding increase in yield. The Company minimizes its extension risk by maintaining the majority of its mortgage-backed securities in balloon mortgage-backed securities with original maturities no greater than seven years.

Major Problems

- There is far too much complicated information in one long paragraph.
- The Company refers to three sophisticated types of securities (callables, mortgage-backed securities, and collateralized mortgage obligations) without defining the terms.
- The Company talks about four types of risk (interest rate, option, prepayment, and extension) without explaining what they are.
- Please don't ever say "comprised of"!

(Note to anyone who thinks the Company's investors would understand the terminology: this paragraph is from the 10-K of a community bank holding company. Not all of the shareholders are your classic widows, orphans, and elderly, but many come close.)

Rewritten

There is little credit risk in the Company's securities portfolio. Except for $35,000 in common stock of a publicly traded company, all of the securities are issued by the U.S. Treasury or by a U.S. government agency. However, the Company's portfolio poses other types of risk.

First, the Company owns U.S. Treasury Notes and debentures issued by various government agencies. These instruments bear a fixed rate of interest, which presents "interest rate risk." If the Company holds fixed-rate debt while interest rates are rising, the Company will be earning less than a market rate on its investment. To mitigate this risk, the Company does not acquire fixed-rate instruments with maturities exceeding five years.

Second, the Company owns a limited number of "Agency callables." These securities are issued by government agencies, and may be redeemed before maturity if the issuer so chooses. Agency callables pose both "interest rate risk" and "option risk." Again, interest rate risk is triggered by rising interest rates. If rates increase after the Company purchases a fixed-rate callable, the Company will have an investment that earns less than market rates. Declining interest rates trigger option risk. If market rates fall, issuers of callable fixed-rate instruments may choose to redeem them early. In such a case, the Company will earn a return on its investment that is less than we currently expect. To mitigate these risks, the Company does not buy callables with maturities exceeding five years.

Third, the Company owns a $35.0 million portfolio of mortgage-backed securities issued by government agencies. This portfolio comprises $5 million in collateralized mortgage obligations and $30 million in mortgage-backed pass-through securities.

> *A **"mortgage-backed security"** represents ownership of a pool of mortgage loans. As the mortgages are paid off, a portion of the principal and interest payments are "passed through" to the owners of the securities.*
>
> *A "**collateralized mortgage obligation"** is a debt security that is secured by a portfolio of mortgages, mortgage-backed securities, U.S. government securities, or corporate debt obligations.*

These securities are subject to risk when interest rates rise or fall. When interest rates are fairly constant, borrowers prepay mortgages (and issuers of mortgage-backed securities prepay their holders) at a predictable rate. Dramatic changes in interest rates will alter the ordinary pace of mortgage prepayments and the related payments to the holders of mortgage-backed securities:

- When interest rates decline, borrowers may choose to prepay their mortgages at a faster pace, which means the related securities earn less interest. This is "prepayment risk."

- When interest rates increase, borrowers may refrain from prepaying at the expected rate, which slows the flow of cash to holders of the related securities. This is "extension risk."

The Company manages prepayment risk by buying mortgage-backed securities with a variety of interest rates, and minimizes extension risk by ensuring that most of its mortgage-backed securities have balloon payments and original maturities no greater than seven years.

Example #1, Page Two

Example #2

This is not entirely accurate and ignores substantial investor concerns.

Original

What We Invest In and Why

The Fund invests in a broad range of investment-grade, income-producing corporate bonds and, to a lesser extent, below investment-grade bonds.

Under normal market conditions, the Fund invests at least 65% of its total assets in U.S. dollar-denominated investment-grade debt securities issued by companies that are established in their industries, have stable cash flows and strong balance sheets. The Fund may also invest up to 35% of its total assets in high yield, high-risk corporate debt securities that are rated below investment-grade.

Investment-grade debt securities are those rated in one of the four highest categories by Standard & Poor's, Moody's Investors Service, Inc., Fitch Investors Service, Inc., and other nationally recognized rating organizations, or which the Fund deems to be of comparable credit quality. High yield, high-risk debt securities are considered predominantly speculative with respect to their capacity to pay interest and repay principal. They generally involve a greater risk of default and, at times, can have more price volatility than higher-rated securities.

Intermediate Investment Grade Corporate Bonds

Corporate bonds represent the debt of companies that are established in their industries, have stable cash flows and strong balance sheets. The Fund's investment philosophy stresses a back-to-basics approach to select investment-grade corporate bonds: we use extensive research to buy the bonds of growing companies at value prices and hold on to them for the long-term. Over the years, the Fund has developed a list of ten characteristics that we believe foster sustainable long-term growth, minimize risk and enhance the potential for superior long-term returns. While very few companies have all ten, we search for companies that demonstrate several of the characteristics that are listed in the following chart.

Major Problems

- The first sentence is superfluous. It does not contain any information that isn't also in the second paragraph (in greater detail).
- Consider the definition of "investment grade securities" in the third paragraph. Can the Fund decide that a security the rating agencies have trashed is really "investment grade"? Or does the Fund only evaluate unrated securities? If 65% of my money is supposedly going into investment grade securities, I want to know the scope of the Fund's discretion.

- Look at the definition of "corporate bonds" in the fourth paragraph. It's flat out wrong. Maybe this is the definition of *investment grade* corporate bonds, or maybe this is the kind of corporate bonds the Fund tries to buy, but not all corporate bonds are issued by healthy companies.
- The phrase "established in their industries, have stable cash flows and strong balance sheets" appears twice in the span of four paragraphs.
- Does the last paragraph describe how the Fund determines whether a security is "investment grade," or does it describe how the Fund chooses from among securities that an independent rating agency has already prequalified?

<u>Rewritten</u>

(I had to make some assumptions to rewrite this passage. This is why a writer needs access to well-informed people in the company, and why those people need to commit their time and resources to answering the writer's questions.)

What We Invest In and Why

Under normal market conditions, the Fund devotes at least 65% of its total assets to a broad range of U.S. dollar-denominated, income-producing corporate bonds that are either investment grade or of comparable quality. Investment grade debt securities are those rated in one of the four highest categories by a nationally recognized rating organization (such as Standard & Poor's Corporation). The Fund may also buy unrated securities that we believe are comparable to investment grade securities. Our standards for evaluating unrated securities are described below under the heading "Intermediate Investment Grade Corporate Bonds."

The Fund may invest up to 35% of its total assets in high yield, high risk corporate debt securities. High yield, high risk debt securities are considered speculative because they generally present a greater risk of default, and can have more price volatility, than higher-rated securities.

Intermediate Investment Grade Corporate Bonds

Investment grade corporate bonds represent the debt of companies that are established in their industries, and have stable cash flows and strong balance sheets. The Fund looks for these same features when we evaluate unrated securities to determine whether they are "investment quality." In particular, our extensive research directs us to bonds issued by growing companies at value prices that we can hold for the long term. Over the years, the Fund has developed a list of ten characteristics that we believe foster sustainable long-term growth, minimize risk, and enhance the potential for superior long-term returns. While very few companies have all ten, we search for companies that demonstrate several of the characteristics listed in the following chart.

Example #2, Page Two

Example #3

You cannot edit this. Throw it out and rewrite from scratch.

Original

Potential problem bonds are fully current but judged by management to have certain characteristics that increase the likelihood of problem classification. ABC Insurance had $69 million of potential problem bonds, including amounts attributable to policyholder contracts as of December 31, 1998, compared with $63 million as of December 31, 1997. These amounts are net of $14 million and $10 million of cumulative write-downs, respectively. Potential problem bonds attributable to policyholder contracts represented 35% and 45% of total potential problem bonds at December 31, 1998 and 1997, respectively.

ABC Insurance considers bonds that are delinquent or restructured as to terms, typically interest rate and, in certain cases, maturity date, problem bonds. As of December 31, 1998 and 1997, ABC Insurance had problem bonds, including amounts attributable to policyholder contracts of $119 million and $137 million, net of related cumulative write-downs of $19 million and $30 million, respectively. Problem bonds attributable to policyholder contracts represented 29% and 24% of total problem bonds at December 31, 1998 and 1997, respectively.

Major Problems

- The definition of "potential problem bonds" in the first paragraph is not helpful without the definition of "problem bonds." That definition does not appear until the second paragraph and doesn't stand out as it should.
- In order to understand the numbers, you need to track three sets of figures (a gross amount, a write-off, and an allocation of the gross amount between policyholders and the insurance company) for two years. It is much more effective to present that kind of information in a chart.

Rewritten

A "problem bond" is either delinquent or restructured—typically to reduce the interest rate or extend the maturity date. "Potential problem bonds" are fully current, but management believes they have certain characteristics that make them likely to become "problem bonds."

The table below provides information about the potential problem bonds and problem bonds in ABC Insurance's investment portfolio as of December 31:

Type of bond	**Year**	**Amount (in millions) . . .**	**. . . net of cumulative write-downs of . . . (in millions)**	**Portion of total attributable to policyholder contracts**
Potential problem	1998	$69	$14	35%
	1997	$63	$10	45%
Problem	1998	$119	$19	29%
	1997	$137	$30	24%

Example #3, Page Two

Example #4

This is overkill.

Original

STATEMENT REGARDING FORWARD-LOOKING DISCLOSURE

Certain statements in this report that are not reported financial results or other historical information are "forward-looking statements" and within the meaning of the Private Securities Litigation Reform Act of 1995. Forward-looking statements give current expectations or forecasts of future events and are not guarantees of future performance. They are based on management's expectations that involve a number of business risks and uncertainties, any of which could cause actual results to differ materially from those expressed in or implied by the forward-looking statements. You can identify these statements by the fact that they do not relate strictly to historic or current facts. They use words such as "anticipate," "estimate," "expect," "project," "intend," "plan," "believe" and other words and terms of similar meaning in connection with any discussion of future operating or financial performance. In particular, these include statements relating to future actions; prospective changes in raw material costs, product pricing or product demand; future performance or results of current and anticipated market conditions and market strategies; sales efforts; expenses; and financial results. There are risks and uncertainties that may cause results to differ materially from those set forth in these forward-looking statements. In particular, unanticipated changes in the economic, competitive, governmental, technological, marketing or other factors identified in this report and in the Company's other filings with the Securities and Exchange Commission could cause such results to differ materially and could include, but are not limited to, changes in U.S., regional or world polymer growth rates affecting the Company's markets; changes in global industry capacity or in the rate at which anticipated changes in industry capacity come online in the polyvinyl chloride or other industries in which the Company participates; fluctuations in raw material prices, quality and supply and in energy prices and supply, in particular fluctuations outside the normal range of industry cycles; and an inability to raise prices or sustain price increases for products.

The Company cannot guarantee that any forward-looking statement will be realized, although it believes that management has been prudent in its plans and assumptions. Achievement of future results is subject to risks, uncertainties and inaccurate assumptions. Should known or unknown risks or uncertainties materialize, or should underlying assumptions prove inaccurate, actual results could vary materially from those anticipated, estimated or projected. Investors should bear in mind as they consider forward-looking statements.

The Company undertakes no obligation to publicly update forward-looking statements, whether as a result of new information, future events or otherwise. You are advised, however, to consult any further disclosures the Company makes on related subjects in its filings with the Securities and Exchange Commissions. You should understand that it is not possible to predict or identify all risk factors. Consequently, you should not consider any such list to be a complete set of all potential risks or uncertainties.

Major Problems

- The first paragraph is a long, daunting block of text. The meat of the Company's legal protection—the specific list of likely risks and uncertainties that could affect forecasted results—is buried at the end.
- I have highlighted five places (in 470 words!) that the Company makes the generic statement that forward-looking statements are not a sure thing.
- The first sentence helpfully explains that "forward-looking statements" do not relate to reported financial results or historical information. The fourth sentence unnecessarily repeats some of that explanation.

[rewritten version starts on next page.]

Rewritten

STATEMENT REGARDING FORWARD-LOOKING DISCLOSURE

Certain statements in this report are “forward-looking statements” within the meaning of the Private Securities Litigation Reform Act of 1995. Forward-looking statements give management’s current expectations or forecasts of future events; they are not guarantees of future performance. Any one of a number of business risks and uncertainties could cause actual results to differ materially from those expressed in or implied by the forward-looking statements.

Forward-looking statements do not relate strictly to historic or current facts. They use words such as “anticipate,” “estimate,” “expect,” “project,” “intend,” “plan,” “believe,” and terms of similar meaning to discuss future operating or financial performance. Forward-looking statements in this report relate to future actions; prospective changes in raw material costs, product pricing, or product demand; future performance or results of current and anticipated market conditions and market strategies; sales efforts; expenses; and financial results.

There are risks and uncertainties that may cause results to differ materially from those projected in the Company’s forward-looking statements. It is not possible to predict or identify all risk factors, but unanticipated changes that could cause such results to differ materially could include:

- Changes in U.S., regional, or world polymer growth rates affecting the Company’s markets;
- Changes in global industry capacity or in the rate at which anticipated changes in capacity are realized in the polyvinyl chloride or other industries in which the Company participates;
- Fluctuations in raw material prices, quality, and supply and in energy prices and supply—particularly fluctuations outside the normal range of industry cycles; and
- An inability to raise prices or sustain price increases for products.

The Company cannot guarantee that any forward-looking statement will be realized, although management believes its plans and assumptions are prudent. Should risks or uncertainties materialize, or should our underlying assumptions prove inaccurate, actual results could vary materially from those we expect.

The Company undertakes no obligation to publicly update forward-looking statements, whether as a result of new information, future events, or otherwise. Investors should consult any further disclosures the Company makes on related subjects in its filings with the Securities and Exchange Commission.

Example #4, Page Three