THE LEHMAN MINIBONDS CRISIS IN HONG KONG: LESSONS FOR PLAIN LANGUAGE RISK DISCLOSURE

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I INTRODUCTION

The trigger for this article was the crisis caused by the collapse of an investment product arranged by Lehman Brothers Asia Limited and marketed in Hong Kong[1] under the name 'Minibonds'. As outlined in Part III below, this product proved popular among retail investors, many of whom incurred substantial losses as a result of the collapse of Lehman Brothers Holdings Inc. and companies associated with it in September 2008. The crisis sparked investigations by the Hong Kong Securities and Futures Commission[2] ('SFC') and the Hong Kong Monetary Authority[3] ('HKMA'), each of which issued a report on the crisis at the end of 2008.[4]

As part of its regulatory response to the crisis, the SFC urged the issuers of retail investment products 'to ensure that their applications and related offering documents and marketing materials contain clear upfront explanations of the

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1 The Minibonds were also marketed and sold in Singapore, where a similar crisis arose.

2 The SFC is the regulator of the Hong Kong securities and futures market and is empowered under the *Securities and Futures Ordinance* ('SFO'). It regulates three main groups: (1) intermediaries, such as brokers and investment advisers; (2) issuers of securities; and (3) market operators such as the Hong Kong Stock Exchange. Where banks conduct securities and futures business, the Hong Kong Monetary Authority oversees their compliance with SFO regulations. See Securities and Futures Commission, *SFC Annual Report* (2007–2008) < http://www.sfc.hk/sfc/html/EN/speeches/public/annual/rep07-08/index.html> at 23 August 2009.

3 The HKMA is the government authority in Hong Kong responsible for maintaining monetary and banking stability. It regulates and supervises banks. See the HKMA website <http://www.info.gov.hk/hkma/eng/hkma/index.htm> at 23 August 2009.

4 Securities and Futures Commission, *Issues Raised by the Lehman Minibonds Crisis – Report to the Financial Secretary* (2008) ('SFC Lehman Report') <http://www.sfc.hk/sfc/html/EN/whatsnew/review_lehman.html> at 23 August 2009; Hong Kong Monetary Authority, *Report of the Hong Kong Monetary Authority on Issues Concerning the Distribution of Structured Products Connected to Lehman Group Companies* (2008) ('HKMA Lehman Report') <http://www.info.gov.hk/hkma/eng/new/lehman/lehman_report.pdf> at 23 August 2009.

product and risks with sufficient prominence and clarity'.[5] This article considers the call by the SFC for more prominent risk disclosure and recommends ways in which this might be achieved. The hypothesis that this article sets out to prove is that the benefits of the traditional approach to risk disclosure, with its heavy reliance on plain language techniques and its focus on disclosing all risks, are limited in the case of complex retail investment products. The Lehman Minibonds crisis highlights the need to look beyond the adoption of plain language prospectuses and to consider additional techniques for increasing risk awareness on the part of retail investors. In this respect, the crisis provides some useful insights for other jurisdictions to consider.

It should be acknowledged that written disclosure is just one of several concerns arising out of the Minibonds crisis and that it cannot be viewed in isolation from other concerns such as improper selling practices and inadequate financial advice (both of which are referred to generally as 'misselling'). This article does not examine the broader regulatory response to the Minibonds crisis, nor the effectiveness or adequacy of the role played by the regulators. Instead, its goal is to consider the call for better risk disclosure and to offer some insights and suggestions as to how this might be achieved.

This article proposes four tests to determine whether written disclosure is adequate in terms of highlighting risk:

- *Risk in isolation*: has risk been effectively isolated from other information concerning the investment product?
- *Risk in context*: has the risk been contextualised sufficiently to enable consumers to understand how the risk arises in relation to the investment product and to relate the risk to their own situation?
- *Risk in lay language*: has the risk been explained in lay language; namely, in language that does not use technical terminology or industry jargon?
- *Risk in stark language*: have the risk warnings been expressed in stark language; namely, in language that is direct and unambiguous?[6]

The above tests are based on the following propositions:

- retail investors will pay due regard to risk only if it is isolated from other information (for example, risk in isolation)
- retail investors will understand the nature and extent of risk only if (1) they understand how it arises in relation to the investment product (for example risk, in context); and (2) the product and the associated risks are explained in lay language (for example, risk in lay language)

5 Securities and Futures Commission, *Circular to Issuers of Retail Investment Products* (2008) <http://www.sfc.hk/sfcRegulatoryHandbook/EN/displayFileServlet?docno=H522> at 23 August 2009.

6 Like the first test, this test goes to the issue of prominence.

- retail investors will pay due regard to risk warnings only if they have been expressed in a direct and unambiguous manner (for example, risk in stark language).[7]

The contention of this article is that the above tests are relevant both to complex investment products, such as the Minibonds, and also to investment products generally. The objective behind the tests is not to prescribe results, but instead to establish criteria against which the effectiveness of written risk disclosure in prospectuses and other disclosure documents can be more reliably assessed.[8] These tests are also useful for assessing the adequacy of legislative provisions and regulatory guidelines on risk disclosure.

In addition to applying these tests to conventional disclosure documentation, such as prospectuses, product summaries and marketing material, this article recommends the adoption of a stand-alone risk awareness statement for retail investment products, an example of which is contained in the Schedule. The objective of this statement is not to provide a comprehensive outline of the risks associated with such product. Instead, the objective is to draw attention to the underlying sources of risk in respect of an investment product in such a way that investors are better able to make the threshold decision as to whether the product is suitable for them. It is for this reason that it is called a 'risk awareness statement' and not a 'risk disclosure statement'. An additional benefit is that it would provide a basis on which financial advisers could better align their product advice with the disclosure documents and more effectively personalise the advice for individual clients.

It is appropriate to note that neither the concept of a stand-alone risk awareness statement nor the example contained in the Schedule has been subject to any rigorous empirical testing or analysis. It is essentially an attempt to look beyond, and supplement, the conventional plain language approach that has applied to date in respect of disclosure documentation. Despite any shortcomings that this attempt might have, it will hopefully contribute to the ongoing debate about plain language risk disclosure and assist in the formulation of policies and guidelines by policymakers and productissuers alike.

This article has nine parts. Part II outlines the development and application of plain language techniques in respect of investment products as a means of providing a frame of reference for the analysis that follows. Parts III, IV and V examine the background to the Minibonds crisis, including the nature of the product, how it was sold, whether the documentation was expressed in plain language and what went wrong with the product. Part VI undertakes a review of the plain language requirements in Hong Kong, Australia and the United Kingdom for the comparative light that it throws on regulatory developments. Part VII considers each of the four tests proposed by this article with reference to

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7 All of these propositions are interrelated.

8 It is also in line with the call by the SFC for disclosure standards to 'be developed covering offering documents and marketing materials for investment products that are publicly offered'. See the SFC Lehman Report, above n 4, [4.3.1].

the applicable regulations and policies in the subject jurisdictions. Part VIII explains the benefits behind the adoption of a risk awareness statement and Part IX closes with some concluding comments.

II WHAT IS PLAIN LANGUAGE?

The plain English or plain language phenomenon first arose in the area of consumer contracts as a means of stripping contracts of the legalistic and archaic language that was traditionally found in legal documents. It was subsequently embraced by parliaments when drafting legislation[9] and by lawyers when drafting commercial contracts.

In the area of disclosure in securities regulation, plain language made its debut in the United States ('US') when the US Securities and Exchange Commission ('SEC') published a handbook in August 1998 entitled 'A Plain English Handbook: How to Create Clear SEC Disclosure Documents' ('SEC Handbook').[10]

It is useful to consider the principles set out in the SEC Handbook, since they highlight both the benefits and limitations of the plain language approach. The SEC Handbook stated its objectives clearly. These included the need to 'start writing disclosure documents in a language investors can understand' and 'to help speed and smooth the transition to plain English'.[11]

The SEC Handbook started by defining a 'plain English' document:

> 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.[12]

Implicit in the above is the reality that the use of plain English provides no guarantee that investors will understand the complex information in disclosure documents or that they will be able to make an informed investment decision. This reality underpins much of the argument in this article. The main benefit of plain English lies in the 'orderly and clear presentation of complex information'.[13]

The SEC Handbook goes on to state:

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9 See, for example, Australian Government Office of Parliamentary Counsel, *Plain English Manual* <http://www.opc.gov.au/about/html_docs/pem/contents.htm> at 23 August 2009.

10 US Securities and Exchange Commission ('SEC'), *A Plain English Handbook – How to Create Clear SEC Disclosure Documents* <http://www.sec.gov/pdf/handbook.pdf > at 23 August 2009.

11 Ibid 3–4.

12 Ibid 5.

13 As Professor Butt has put it, 'Plain language may not be able to simplify concepts, but it can simplify the way in which concepts are expressed. Used properly, plain language clarifies complex concepts.' See Peter Butt, 'Legalese versus plain language' (2001) 35 *Amicus Curiae* 28, 30. See also Brady Coleman, 'Are Clarity and Precision Compatible Aims in Legal Drafting' (1998) *Singapore Journal of Legal Studies* 376.

> Knowing your audience is the most important step in assuring that your document is understandable to your current or prospective investors. To write understandable documents, you need to gauge the financial sophistication of your investors.[14]

Questions that are relevant in knowing your audience include the following: 'How familiar are they with investments and financial terminology?' and 'What investment concepts can you safely assume they understand?'[15] The need to take account of the financial sophistication of investors is also reflected in the following comments:

> If you are writing for financially unsophisticated investors, your document's overall organization may take an educational approach. You may need to explain industry terms or concepts where they first appear.[16]

As an example of the challenges that arise in this regard, the SEC Handbook notes the abstractions (namely, complex abstract concepts) that 'abound in the financial industry'.[17] It refers to research indicating that readers often make an abstract concept understandable by relating it to a scenario in which people are performing actions; in other words, by using an example involving an investor.[18] The underlying principle is that it is possible to increase a reader's ability to comprehend complex concepts by replacing abstract terms with concrete terms and examples that the reader can relate to personally.[19] It is important to understand, however, that there is no guarantee that all investors will understand the information sufficiently to make an informed decision. This ultimately depends on the financial literacy of each investor.

Many of the principles outlined in the SEC Handbook were formally adopted in Rule 421(d),[20] which requires issuers to use plain English principles in the organisation, language, and design of the front and back cover pages, the summary, and the risk factors section of a prospectus. In addition, issuers must comply substantially with six basic principles:

- Short sentences;
- Definite, concrete, everyday language;
- Active voice;
- Tabular presentation or bullet lists for complex material, whenever possible;

14 SEC Handbook, above n 10, 9.
15 Ibid.
16 Ibid 16.
17 Ibid 23.
18 Ibid. The example that is given is an explanation as to how a call option works.
19 This relates to the 'risk in context' test, discussed further in Part VII, Section B below.
20 SEC, *Rules on How to Prepare Prospectuses* <http://www.sec.gov/rules/final/33-7497.txt> at 23 August 2009.

- No legal jargon or highly technical business terms;[21] and
- No multiple negatives.

The problem created by the use of technical terms and industry jargon is a constant theme that runs through the analysis and arguments in this article. Mindful of this problem, the SEC commentary on Rule 421(d) states that when product issuers 'use many highly technical terms, the investor must learn the issuer's dictionary of terms to understand disclosure. If technical terms are unavoidable, [issuers] should make every effort to explain their meaning the first time [they] use them'.[22]

In relation to risk factors, the SEC commentary on Rule 421(d) states as follows:

> If you include a risk factors section in your prospectus, you must write the risk factors in plain English and avoid 'boilerplate' risk factors. We believe a discussion of risk in purely generic terms does not tell investors how the risk may affect their investment in a specific company. You should place any risk factors in context so investors can understand the specific risk as it applies to your company and its operation.[23]

Implicit in this guideline is the need for issuers to explain risks in terms that enable investors to understand how the risks arise in relation to the investment product and to relate it to their own situation.

The effectiveness of plain language has been the subject of continuing debate ever since the initiative was first introduced in the US. In particular, critics argue that the SEC has placed too much reliance on the 'readability' of prospectuses and neglected the reality that many investors are not capable of understanding them in the first place.[24] In other words, even though plain language enhances readability and is an important part of improving financial literacy, it does not guarantee understanding for people who do not have the relevant level of financial literacy.[25] By necessity, it assumes a certain level of technical expertise.

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21 Interestingly, the HK handbooks, see below Part VI, Section A, do not expressly state the need to avoid technical language. Although this may just indicate a difference in emphasis, it may also reflect a different understanding of 'plain language' and the extent to which it should be measured by the use of lay language instead of technical language.

22 SEC, *Rules on How to Prepare Prospectuses*, above n 20.

23 Ibid.

24 This is part of the wider debate about the purpose and target audience of disclosure and whether conventional disclosure documents are too sophisticated for the retail investor. See Kenneth B. Firtel, 'Plain English: A Reappraisal of the Intended Audience of Disclosure under the Securities Act of 1933' (1999) 72 *Southern California Law Review* 851. See also Janis Sarra, 'Disclosure as a Public Policy Instrument in Global Capital Markets' (2007) 42 *Texas International Law Journal* 875. The argument that has been made by some commentators is that only financial experts are capable of reading and understanding a prospectus.

25 For concerns about the limitations of financial literacy education and the inability of investors to understand financial products, see Lauren Willis, 'Evidence and Ideology in Assessing the Effectiveness of Financial Literacy Education', Legal Studies Paper No 2008–6, (October 2008) <http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1098270> at 23 August 2009. See also Lauren Willis, 'Against Financial Literacy Education' (2008) 94 *Iowa Law Review* 197, 201, where the author argues that 'rules of thumb are not useful for decisions about complex products in a volatile market'. The author also argues that it is socially inefficient to require consumers to act as their own financial experts.

It may achieve 'risk disclosure' from an issuer liability perspective; however, it does not achieve 'risk awareness' from an investor understanding perspective.

This in turn raises the question as to the purpose of disclosure. In theory, disclosure performs the dual purpose of protecting the issuer against liability concerns and also informing investors of the product and the associated benefits and risks. However, as noted in the HKMA Lehman Report, '[documentation] is often designed more for the protection of the issuer than for the enlightenment of the customer'.[26]

Another weakness with the plain language approach is the use of the term 'plain language' and the implicit assumptions that it involves; namely, if something has been expressed in accordance with plain language principles, the meaning will be clear. In this writer's view, this has led to a situation where drafters are often more intent on implementing the steps and techniques recommended by the plain language experts than on reviewing the result to determine whether the objectives of plain language have in fact been achieved.

A review of developments in the United Kingdom ('UK') and Australia concerning product disclosure reveals two trends: (1) the adoption of short-form product summaries and key fact statements;[27] and (2) greater emphasis on explaining technical terms and concepts to enhance investor understanding. These have been accompanied by efforts to increase the financial literacy of retail investors generally.

This article argues that although product summaries and key fact statements are an improvement on the conventional long-form prospectus approach, they are subject to the same concerns as outlined above. In other words, they increase readability but do not guarantee understanding for people who do not have the relevant level of financial literacy.[28] In addition, there is a continuing tendency to underestimate the difficulties that retail investors face in understanding technical concepts, technical terms and industry jargon, particularly in the case of complex retail investment products such as the Minibonds. The contention of this article is that a stand-alone risk awareness statement would assist to advance the objectives of risk disclosure, particularly in the face of market volatility and financial crisis.

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26 The HKMA Lehman Report, above n 4, [8.8]. See also Asian Institute of International Financial Law, 'The Global Financial Crisis and the Future of Financial Regulation in Hong Kong' (Working Paper No 4, AIIFL, 2009), 68 <http://www.aiifl.com/> at 23 August 2009.

27 A similar trend is emerging in Hong Kong and Singapore. See Part V, Section C below, for the SFC recommendations in respect of Hong Kong.

28 See the AIIFL Working Paper, above n 26, 69, where the authors query whether such a simplified approach could in substance achieve the objective of enhanced understanding and suggest that it might 'instead have the effect of creating a false sense of appreciation of risk'.

III WHAT WERE THE MINIBONDS AND HOW WERE THEY SOLD?

'Minibonds'[29] was the name given to an unlisted investment product arranged by a company within the Lehman Brothers Group called Lehman Brothers Asia Limited.[30] The issuer (namely, the company that issued the Minibonds) was a company called Pacific International Finance Limited ('Pacific International'). Pacific International was established for the sole purpose of issuing the Minibonds.

The Minibonds were 'credit-linked' to seven companies known as the 'reference entities'. This meant that the returns on the Minibonds (namely, the amounts payable to investors) were linked to, or dependent on, the financial condition of each reference entity and its ability to avoid certain events defined as 'credit events'. The credit events included the bankruptcy of a reference entity or its failure to repay its debts over a specified amount. In essence, by purchasing Minibonds the investors were speculating on the future financial condition of each reference entity and were assuming the risk that a credit event would occur.

Pacific International used the amounts that investors had paid for the Minibonds to acquire a package of financial assets known as the 'collateral'. The collateral underpinned the structure of the Minibonds and consisted of collateralised debt obligations, which enjoyed a triple-A credit rating.[31]

At the heart of the structure were various swap agreements that Pacific International entered into with a Lehman company called Lehman Brothers Special Financing Inc ('Lehman Brothers Special Financing'). These agreements provided the basis on which the returns from the Minibonds were generated and on which the relevant amounts were paid to investors.

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29 The information extracted in this outline is taken from the Minibonds Series 36 Prospectus, which is used for illustration purposes in this article. For a copy of this prospectus, see <http://www.sfc.hk/sfc/html/EN/general/general/lehman/lehman_structure_products.html> at 23 August 2009. This outline does not purport to be comprehensive, but is provided solely for the purpose of providing background information for an understanding of the issues discussed in this article.

30 The name has generated some controversy. See the SFC Lehman Report, above n 4, [2.4.2]. It has been suggested that the term 'mini' was used to indicate that the bonds were sold in smaller denomination amounts than the typical denomination amount of bonds. See the AIIFL Working Paper No 4, above n 26, 38. Some commentators have argued that the use of the term 'bond' is misleading as it suggests a product with low risk and stable returns. See Kwong Man-ki, 'Minibond Holders Voice Ire', *China Daily* (Hong Kong), 23 September 2008, <http://www.chinadaily.com.cn/hkedition/2008-09/23/content_7048899.htm> at 23 August 2009. The programme under which the Minibonds were sold was called a 'Secured Continuously Offered Note Programme', and the prospectus used the term 'Notes' for technical disclosure purposes, reflecting the fact that they were a type of credit-linked note. See the AIIFL Working Paper No 4, above n 26, 39.

31 Collateralised debt obligations ('CDOs') are securities that are backed by a pool of different debt obligations, such as loans and bonds, resulting in an exposure to different types of debt and credit risk. The collateral was segregated from the other assets of Pacific International and was held by a trustee (HSBC Bank USA).

In accordance with the terms of the Minibonds, so long as a credit event had not occurred, the investors would receive a fixed coupon on a quarterly basis[32] and full repayment of the principal amount (namely, the purchase price paid by each investor for the Minibonds) at the end of the three-year term.

On the other hand, if a credit event occurred in respect of any reference entity, the investors would instead receive an amount known as the 'credit event redemption amount'. This amount was calculated by reference to the market value of equivalent debt obligations, with a face value equal to the principal amount of the Minibonds, issued by the affected reference entity. Since the occurrence of a credit event was likely to reduce the market value of those debt obligations, it was likely that investors would receive less, and possible significantly less, than the purchase price that they had paid for the Minibonds.

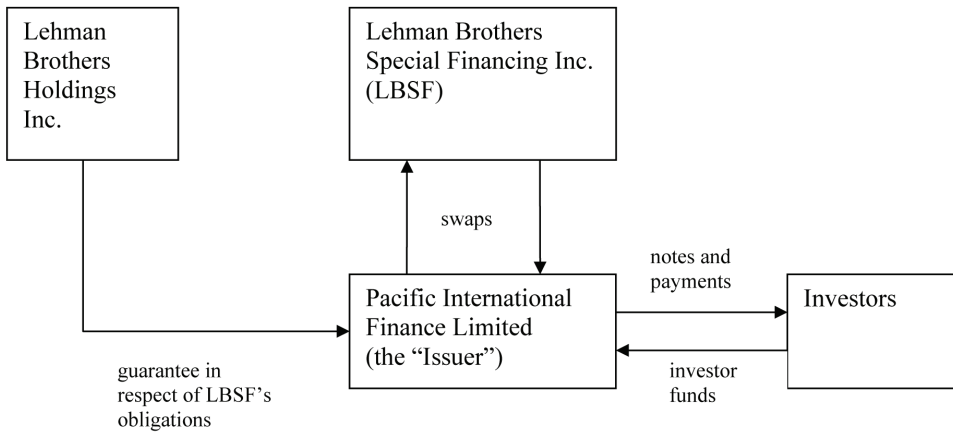
In addition to the risk of a credit event occurring, the investors were subject to the risk that Pacific International would redeem (namely, buy back) the Minibonds prior to their maturity in certain circumstances. These circumstances included the bankruptcy of Lehman Brothers Special Financing. In such circumstances, the swap agreements would be terminated and the collateral would be sold to redeem the Minibonds. If the market value of the collateral had decreased, the proceeds from the sale of the collateral would be less than the principal amount of the Minibonds and, consequently, the investors would receive less, and possible significantly less, than the initial amount that they had paid for the Minibonds.[33]

The obligations of Lehman Brothers Special Financing under the Minibonds structure were guaranteed by Lehman Brothers Holdings Inc.

A simple diagram outlining the parties involved in the structure of the Minibonds appears below.

32 In the case of the Minibonds Series 36, the coupon was 5.50 per cent per annum on the US dollar denominated Minibonds and 5.00 per cent per annum on the Hong Kong dollar denominated Minibonds. According to HKMA, these rates were 'comfortably above the prevailing HIBOR/LIBOR at the time of issue': the HKMA Lehman Report, above n 4, [2.3].

33 This is in fact the scenario that arose in relation to the Minibonds.



The Minibonds were sold by seven distributors in Hong Kong, comprising five banks and two non-bank financial services firms. They proved very popular among retail investors,[34] reflecting a trend towards 'non-traditional investment products', which was due in part to the limited returns on traditional investment products in Hong Kong.[35]

As part of the marketing process, a marketing leaflet was produced[36] and promotional gifts, including supermarket vouchers, audio-visual equipment and cameras, were offered for certain levels of subscription. According to the HKMA:

> These [appeared] to be specifically designed to attract retail investors and to encourage them to subscribe more than they perhaps otherwise would in order to reach the next level of subscription and attain the gift. Arguably, these offers [served] as a distraction from the key facts and from the seriousness of the investment decision being made.'[37]

34 The total amount of Lehman-linked structured products sold by retail banks was HK$20 billion and the number of investment accounts with retail banks holding such products exceeded 48,000. See the HKMA Lehman Report, above n 4, [2.2]. According to the SFC, Lehman Brothers had been a major arranger of this type of structured product since 2002. See the SFC Lehman Report, above n 4, [1.2] and [13.3].

35 See SFC, *Report on Selling Practices of Licensed Investment Advisers* (February 2005) 2 <http://www.sfc.hk/sfc/doc/EN/speeches/public/surveys/05/report_on_selling_practices_of_ia_eng.pdf> at 23 August 2009.

36 For a copy of the marketing leaflet, see the SFC website, <http://www.sfc.hk/sfcCOPro/EN/displayFileServlet?refno=0504&fname=080409_MB36_Take1_eng.pdf> at 23 August 2009.

37 See the HKMA Lehman Report, above n 4, [8.15]. HKMA recommended that consideration be given to placing restrictions on the use of gifts as a marketing tool to promote financial products to investors. See further below in Part VII, Section A, which discusses the problem of 'extraneous' material.

IV WAS THE MINIBONDS DOCUMENTATION EXPRESSED IN PLAIN LANGUAGE?

As one of the conditions imposed by the SFC on the issue prospectus, Pacific International required the distributors to ensure that safeguards were designed so that prospective investors would not be able to make an application without confirming that they had read and understood the offering documentation, including the issue prospectus, in their preferred language version.[38] Accordingly, the distribution agreement that each of the distributors entered into with Pacific required a number of statements to be signed by investors before they could purchase Minibonds. One statement was that the investor 'had read and understood [the] programme prospectus and [the] issue prospectus'.[39]

An examination of the plain language techniques used in the principal documentation for the marketing and sale of the Minibonds (namely, the prospectus and the marketing leaflet) is provided below.

A Minibonds Documentation

A review of the Minibonds prospectus suggests that it had been drafted in compliance with the plain language guidelines in Hong Kong.[40] The relevant plain language features included the following:

- A 'ready-reference' summary of the Minibonds, entitled 'Our notes at a glance', had been placed at the front of the prospectuses and was referred to as 'a ready-reference summary of the main features of our Notes';
- In the sections entitled 'What are our Notes?' and 'How can I buy some Notes?':
  - a reader-friendly 'question and answer' format was used and the questions were expressed in plain language; for example:

    What does credit-linked mean?
    Are our Notes principal protected?
    Who should buy our Notes? Are they suitable for everyone?
    How long is the offer open?
    When will I get my notes?
  - personal pronouns were used (ie 'we' and 'you'),[41] for example:

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38 See *SFC Exemptions Requested by the Issuer in Respect of the Issue Prospectus Dated 14 April 2008*, 3, <http://www.sfc.hk/sfcCOPro/EN/displayFileServlet?refno=0504&fname=ATTP6FKK/ATTP6FKK.pdf> at 23 August 2009.

39 The SFC Lehman Report, above n 4, [2.3.1] explains that

> [d]espite obtaining apparent confirmation that clients had read and understood the relevant prospectus, Intermediaries [i.e. the distributors] were still under an obligation to explain the nature and risks of their product they were selling and ensure that it was suitable [to the investors].

This was pursuant to their obligations under the Code of Conduct.

40 See the SFC Lehman Report, above n 4, [26.1], where the SFC noted that the Minibonds prospectuses had been drafted in plain language.

> Our Notes provide a fixed income investment opportunity. They are credit-linked investments. In return for you taking credit risk on the companies, we pay the following fixed rated interest for our Notes…

  - short sentences were used;
  - active voice and simple grammatical structures were used;
  - a conversational style of expression was used; for example:

> Discuss this with your distributor and shop around if you wish: distributors charge varying fees to open and maintain these accounts and have different arrangements for processing orders.

- The content had been arranged in a logical order;
- In a separate section entitled 'Investment risks', the relevant risks were highlighted and explained, for example:

> Our notes are not principal protected; you could lose part, and possibly all, of your investment.
>
> You are exposed to the credit risk of the reference entities; the reference entities could change in [a] succession event.
>
> Our notes do not have a liquid trading market.

The marketing leaflet for the Minibonds contained the following information in relation to risk:

> Investment involves risk. You must read the issue prospectus dated 14 April 2008 together with the programme prospectus dated 14 April 2008 (together 'Prospectuses') before deciding whether to invest…
>
> The Notes are not principal protected.
>
> There may be a limited trading market for our Notes or no market at all; you should be prepared to hold our Notes to maturity.
>
> Upon the occurrence of a credit event, the credit event redemption amount will likely be less, and could be significantly less, than the principal invested.[42]

In this writer's opinion, although the prospectus and marketing leaflet appear to have complied with the plain language guidelines and the advertising guidelines, the retail investor is still likely to have found it difficult to understand their contents for various reasons, including the following:

- The prospectus adopted the formatting features typical of a conventional prospectus, including the following:
  - The text was fully justified (for example, both the left and the right edges were even);[43]

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41 The logic behind this practice is that the use of personal pronouns makes it easier for investors to identify with (and personalise) the content of the prospectus and reduces the risk that investors will be confused about who does what and, also, which obligations are owed by which parties.

42 See SFC marketing leaflet, above n 36.

43 According to the SEC Handbook, above n 10, 44:

> Research shows that the easiest text to read is left justified, ragged right text…When you fully justify the text, the spacing between words fluctuates from line to line, causing the eye to stop and constantly readjust to the variable spacing on each line. Currently, most disclosure documents are fully justified. This, coupled with a severe shortage of white space, makes these documents visually unappealing and difficult to read.

  - A dense text was used (for example, the text was closely compacted and there was minimal use of white space);[44]
  - The type size was relatively small, which may have made legibility difficult for an elderly audience;[45]
  - The lines were very long and the use of columns was minimal (for example, the lines went from one side of the page to the other);[46]
  - The text did not make any use of graphics or diagrams;[47] and
  - There was minimal variation in terms of the use of type size, typeface and shading to increase the visual appeal of the text.[48]

- Although a plain language structure and a conversational style of expression had been used, the prospectus employed a lot of technical terms, most of which would probably have been difficult for the retail investor to understand.[49] In addition, the prospectus did not provide a glossary of terms to help the reader understand technical terms. Consider, for example, the following statement, which may have been difficult for non-professional retail investors to understand:

  > We intend to issue our Notes in two tranches: a tranche of USD Notes and a tranche of HKD Notes. We will treat each tranche separately. For example, we might call one tranche but not the other tranche.[50]

- The prospectus referred to some features of the Notes without explaining the relevant consequences or implications, for example:

  Is the offer underwritten?

  The offer of our Notes is not underwritten.[51]

- Many of the layout characteristics outlined above in relation to the prospectus were also applicable to the marketing leaflet. For example, the text was very dense, the type size was very small, the lines were very long and there was minimal variation for visual appeal.[52] In addition, the

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44 'Generous use of white space on the page enhances readability, helps to emphasize important points, and lightens the overall look of the document': Ibid.

45 Ibid 42, for comments on type measurement and size.

46 According to the SEC Handbook:

> [a] comfortable line length for most readers is 32 to 64 characters. Any longer than that, and your readers will lose their place when they read from line to line. A safe rule to follow is: the smaller the type size, the shorter the line length … Columns also help your readers to move quickly and easily through large amounts of text.

Ibid 47. In the case of the Minibonds prospectus, some of the lines were 80–90 characters in length.

47 The prospectus used some information boxes but did not represent the information in graphic or diagrammatic form: Ibid 49.

48 Ibid 54.

49 See further in Part VII, Section C, below.

50 Minibonds Series 36 Prospectus, above n 29, 5. Retail investors are likely to have had difficulty in understanding 'tranche' and 'call'.

51 Ibid 14. Cf ibid 9, the explanation given in relation to the question: 'Are our notes principal protected', where the implications were explained in detail.

52 In this writer's view, the features that stood out the most were the free gifts for subscriptions over a certain amount.

marketing leaflet consisted mainly of text that had been lifted from the prospectus.[53]

B How did the Chinese Version Compare with the English Version?

Under section 342(1)(b) of the Companies Ordinance of Hong Kong, a prospectus that is in the English language is required to contain a Chinese translation. Pacific International obtained an exemption from the SFC in respect of this requirement 'on the ground that it [would have been] unduly burdensome for the Issuer to so provide and irrelevant to prospective investors, since a separate Chinese language version of the Issue Prospectus [had] been prepared and [would] be made available simultaneously with the English language version of the Issue Prospectus and a prospective investor [would] decide which language version best [suited] their circumstances'.[54]

The prospectus provided that the English language version would prevail over the Chinese language version in the event of a conflict or discrepancy. It further provided that the English text was the legally binding text. The effect of this was that the English version would be authoritative in matters relating to interpretation.

Some observations in relation to the readability of the Chinese language version are set out below:

- In many respects the text in the Chinese version was consistent with the plain language principles adopted in the English version as outlined above. However, the Chinese version did not use personal pronouns in relation to Pacific International. Instead, the term 'this company' [*ben gongsi*] was used instead of the pronoun for 'we' [*women*]; in addition, an honorific [*gexia*] was used instead of the common pronoun for 'you' [*ni*].[55]
- In general, a higher level of formality was adopted in the Chinese and the expression was less conversational in tone than the English.[56]
- The Chinese version tracked the syntax and structure of the English to the extent possible, reflecting the fact that it was a translation of the English version. Inevitably, this is likely to have detracted from its readability to a Chinese-speaking investor.[57]

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53 As noted in the SFC Lehman Report, above n 4, Appendix 2, [5.5.2], advertisements for debentures under s 38B(2A)(b) or the *Companies Ordinance* must consist of extracts from the related prospectus. This requirement probably reflects concerns about documentation basis risk. See below, n 138, for an explanation of documentation basis risk.

54 See *SFC Exemptions Requested by the Issuer in Respect of the Issue Prospectus Dated 14 April 2008*, above n 38, 1.

55 The use of such terms is consistent with market convention for documents in Chinese.

56 For example, the section entitled 'Our notes at a glance' in English was translated into Chinese as 'Summary of this company's notes'.

57 In this writer's view, this was particularly obvious in the way in which some of the questions had been translated into Chinese.

- The Chinese version of the prospectus and the marketing leaflet mirrored the English in terms of layout.[58]

An analysis of the application of plain language principles to languages other than English – and, in the context of the Minibonds crisis, the extent to which Chinese speakers were at a disadvantage compared with English speakers – is beyond the scope of this article. A review of the Minibonds documentation, however, suggests that the Chinese version was broadly consistent with the plain language approach and that any deficiencies are more likely to be attributable to the fact that it was a translation of the English version.

V WHAT WENT WRONG WITH THE MINIBONDS AND WHAT WERE THE CONSEQUENCES?

A The Bankruptcy of Lehman Brothers

Ironically, the problems in relation to the Minibonds did not arise out of the principal risk outlined above, namely, the occurrence of a credit event in respect of a reference entity.[59] Instead, they were caused by the bankruptcy of the swap counterparty and its guarantor, Lehman Brothers Holdings Inc.[60] This triggered the termination of the swap arrangements and the requirement to sell the collateral and buy back the Minibonds early.[61] The timing for this was not favourable for investors since, in the prevailing market conditions, the value of the collateral had declined significantly. This meant that the amounts that investors stood to recover were substantially less than the purchase price that they had paid for the Minibonds.

The fallout in Hong Kong from the collapse of Lehman Brothers Holdings Inc was considerable and sparked formal investigations by the SFC and the HKMA.[62] It was reported that over 300 investors took to the streets in Hong Kong on 28 September 2008 to protest against the sale of the Minibonds and to call for government intervention, and that their calls had received the support of several political parties in Hong Kong.[63] It was also reported that protests had

58 See above, Section A.

59 Note that there were other products arranged by Lehman in which Lehman Brothers Holdings Inc. was a reference entity. See the HKMA Lehman Report, above n 4, [2.6] for details.

60 Lehman Brothers Holdings Inc. filed for bankruptcy protection under Chapter 11 of the US Bankruptcy Code on 15 September 2008: Ibid [1.1].

61 As it turned out, the trustee was unable to realise the collateral and pay the money to the Minibond investors as a result of the bankruptcy proceedings in the US. See the HKMA Lehman Report, above n 4, 6.

62 For a chronology of events in respect of Lehman Brothers Holdings Inc., its Hong Kong entities and the Minibonds, see the HKMA Lehman Report, above n 4, 5–6.

63 Paul Mozur and Bonnie Chen, 'Anger mounts over Lehman Minibonds', *The Standard* (Hong Kong), 29 September 2008, <http://www.thestandard.com.hk/news_detail.asp?pp_cat=30&art_id=72256&sid=20779304&con_type=1> at 23 August 2009.

occurred on 31 October 2008, with 'angry Hong Kong investors, some banging gongs and others waving banners, [scuffling] outside a bank'.[64]

On 3 October 2008, the SFC issued a circular to issuers of retail investment products ('SFC Circular'). In the SFC Circular, the SFC reminded product issuers 'of their duty to ensure their offering documents continue to be up-to-date and to contain sufficient information necessary for investors to make an informed investment decision given the new circumstances'. The SFC Circular also outlined the requirements in relation to risk disclosure:

> In addition, marketing materials issued must be clear, fair and present a balanced picture *with adequate and prominent risk disclosure* in compliance with all applicable regulations.
>
> Retail investment product issuers should ensure that in their marketing materials, there are *upfront, prominent and adequate warnings of all the risks associated with their products*, including any new risks that may have emerged in the prevailing market circumstances, before these marketing materials are issued or remain in issue.
>
> Going forward, issuers seeking SFC authorisation are urged to conduct a careful review of their applications to ensure that their applications and related offering documents and marketing materials contain *clear upfront explanations of the product and risks with sufficient prominence and clarity*. Those whose applications have been submitted may wish to revise their documents in light of the recent market events.[65] [Emphasis added]

B What were the Complaints from Investors?

Broadly speaking, the complaints from investors revolved around allegations of misselling.[66] In the SFC Lehman Report, the SFC broke down the complaints into the following categories (1) misrepresentation (for example, the products were misrepresented as low risk); (2) complexity (for example, the products were too complex for investors); and (3) suitability (for example, the products were not suitable for the investment profile of investors).[67]

As noted in the SFC Lehman Report,[68] the most common allegations against the banks that distributed the Minibonds included the following:

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64 Bobby Yip and James Pomfret, 'Hong Kong investors protest over Lehman losses', Reuters, 31 October 2008, <http://www.reuters.com/article/ousiv/idUSTRE49U29620081031> at 23 August 2009. It was reported that similar protests had occurred in Singapore and Indonesia.

65 SFC, *Circular to Issuers of Retail Investment Products*, above n 5. The SFC Circular generated a flurry of comments in the media and in professional newsletters. It was reported that fund houses were working on 'the creation of a uniform warning label to be placed prominently in information documents of new funds being launched or portfolios that are being re-launched' and that '[s]ome industry players [had] compared the planned fund warning label to cigarette box warning labels'. See Rita Raagas De Ramos, 'Warning: This Fund May be Hazardous to Your Health', *Asian Investor*, 5 December 2008 <http://www.asianinvestor.net/print.aspx?CIID=130191> at 23 August 2009.

66 See the HKMA Lehman Report, above n 4, [1.5]. The SFC has defined 'misselling' as 'advice in connection with the sale of an investment product which does not meet the standards set down by the statutory and regulatory regime in force'. See the SFC Lehman Report, above n 4, [11.3]. For a further explanation of misselling, see SFC Enforcement Reporter Issue No 60 (October 2008) <http://www.sfc.hk/sfc/doc/EN/speeches/public/enforcement/08/oct_08.pdf> at 23 August 2009.

67 The SFC Lehman Report, above n 4, [2.1.1].

68 Ibid [17.2.2].

- Front line staff proactively induced complainants to turn their matured fixed deposits into investments in Lehman related products for higher returns and other incentives such as free shopping coupons;
- Front line staff failed to consider the complainants' risk profile and personal circumstances when selling products, particularly in the case of the retired, elderly, less educated and less sophisticated, and risk adverse clients;[69]
- Front line staff did not provide product information (for example, term sheets and prospectuses), nor did they explain product features and risks at the point of sales. Some even misrepresented that the products, especially Minibonds, were risk-free, just like fixed deposits;[70]
- Front line staff only highlighted the well-known reference entities of Minibonds, emphasising that the risk of Minibonds was only tied to the credit risk of these reference entities without mentioning the role of and the risk associated with Lehman [Brothers] Holdings; and
- Banks did not respond to complainants' enquiries and complaints after the collapse of Lehman Brothers.

The most common allegations against the financial services firms that distributed the Minibonds included the following:

- Distributors of Minibonds had misrepresented that they were low-risk products; and
- Distributors did not disclose the role of Lehman Brothers.[71]

Significantly, the SFC identifies a common theme of complaints as follows:

> [I]nvestors were not provided with information that they could understand. Whilst the Minibond prospectuses had been drafted in plain language, because of the liability provisions attached to prospectuses, these are lengthy offering documents that may have been difficult for investors to digest without investment advice.[72]

One of the reasons that the Minibonds were difficult to understand was that they did not simply involve 'market risk', as that term might generally be understood, or counterparty risk on Pacific International as the issuer of the Minibonds. They also involved insolvency and counterparty risk on Lehman Brothers Special Financing and Lehman Brothers Holding as the swap counterparty and the guarantor respectively. As a result of the complex risk profile, it is likely to have been very difficult for investors to anticipate that

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69 In other words, investors were sold products that did not match their risk profile and involved a higher level of risk than they were willing or able to assume. This concern was also raised in Singapore. See Francis Chan, '$100,000 Life Savings Gone', *The Straits Times* (Singapore), 16 October 2008 <http://www.straitstimes.com/Breaking%2BNews/Singapore/Story/STIStory_291048.html> at 12 September 2009.

70 The concern that financial intermediaries had misrepresented the risk on the Minibonds was also raised in Singapore: Ibid. According to Chan, many investors and financial advisers did not understand how the product worked and the effect of the 'first-to-default' clause, under which the entire structure would be unwound if one of the reference entities defaulted or went bankrupt. One investor in Singapore was reported as saying, 'What the relationship manager said was, "Don't worry, this is very safe, even if one entity (out of a basket of eight reference entities) fails, you still have seven".' Another investor was also reported as saying, '[M]y relationship manager was already tripping up just trying to explain "credit derivative".'

71 The SFC Lehman Report, above n 4, [17.2.4].

72 Ibid [4.3.5]. The difficulties encountered by investors in understanding risk as a result of lengthy disclosure documents is explored further in Part VII, Section A below.

significant loss could be triggered by the collapse of Lehman Brothers Holdings. The issue was not whether investors could stomach the potential loss had they understood the relevant risk, but whether it would be realistic to expect non-professional retail investors to understand where the risk lay and how it related to the structure of the product. They may have understood the insolvency and counterparty risk on the issuer of the Minibonds. They may even have understood the extent to which the returns on the Minibonds were linked to other companies, known as the 'reference entities'. However, it would have been more difficult for them to understand the implications of the insolvency and counterparty risk on Lehman Brothers Holdings Inc.

The difficulty was compounded by a lack of understanding about the type of product that was involved. Some investors may have seen the Minibonds as akin to a bank deposit. Others may have seen it as a standard corporate bond. In the view of this writer, very few non-professional retail investors would have seen it as a synthetic, derivative-linked product, the operation of which depended on multiple parties and involved a complex risk profile.[73]

In other words, despite the valiant attempts of plain language as reflected in the prospectus, it could not be said that the investors went in to the investment 'with their eyes open'. In the view of this writer, the more synthetic in nature a product is (ie the more its value is linked to the value of another security or the performance of a third party), the less transparent it will be to retail investors, the less easy it will be for them to understand the structure and the nature of the risks[74] and the greater the risk that investors will complain that they were not properly informed of the risks or that they were 'taken by surprise'.

C What did the Regulators Recommend in Terms of Written Disclosure?[75]

In relation to written disclosure, the SFC Report recommended that overall disclosure standards should be developed covering offering documents and marketing materials for publicly offered investment products. This, it suggested, reflected 'a need for clearer product descriptions with prominent disclosure of risks and a common standard across the current broad range of products'. In particular:

> Investors should be provided with a summary explaining the nature of the investment product either in addition to the prospectus or offering document, or

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73 Research conducted in the UK suggests that investment bond buyers are more likely to believe that some or all of their capital and returns are guaranteed. See Financial Services Authority ('FSA'), 'Investment Disclosure Research' (2006) 55 *Consumer Research* 1, 21.

74 Compare this with a plain vanilla corporate bond, where investors take the insolvency risk on one party alone.

75 For press commentary on the SFC Lehman Report and the HKMA Lehman Report immediately after they were issued, see Enoch Yiu and Maria Chan, 'Rethink on Rules for Banks After Minibond Fiasco', *South China Morning* Post (Hong Kong), 9 January 2009, A1; Enoch Yiu, Maria Chan and Paggie Leung, 'Regulators' reports on Lehman Minibonds fiasco fail to satisfy', *South China Morning Post* (Hong Kong), 9 January 2009, B3; Enoch Yiu, Maria Chan and Albert Wong, 'Monetary Authority chief defends regulatory system', *South China Morning Post* (Hong Kong), 10 January 2009, A3.

> part of it. This may present concerns as to prospectus liability for issuers. However, we note that many jurisdictions now require or are introducing rules to require summaries designed to be readily understood by investors.[76]

The SFC report suggested that such summaries should be prepared 'in no more than four pages of plain, concise easily understood language, augmented by charts and diagrams'. They should 'include all key information' and 'facilitate comparisons with other products'.[77]

The HKMA Lehman Report recommended that:

- 'health-warnings' should be attached to retail structured products with embedded derivatives or to retail derivative products generally;[78] and
- Uniform disclosure formats such as simple 'product key facts statements' and 'sales key facts statements' should be required to be produced in respect of such products (and indeed other retail investment products).[79]

The HKMA noted that successful disclosure should be 'clear, concise and comprehensible'.[80] It suggested that uniform disclosure formats

> should be designed to provide balanced disclosure by systematically setting out the nature and risks of a product and giving equal prominence to benefits and risks. Something along the lines of two simple 'Key Facts Statements' (of, say, three pages each maximum) in reasonable-sized print might be appropriate.[81]

Further, the key facts statements should 'stand out clearly among other sales documentation; use concise plain language, supported by good presentation; and [should be] developed with the capability and needs of the customer in mind'.[82]

In the HKMA Lehman Report, the HKMA suggested that more disclosure was not necessarily better disclosure. What was needed, according to the HKMA, was 'customer-friendly prominent disclosure which cannot be overlooked and from which a warning of the riskiness of the product can be swiftly gleaned'.[83]

Following the release of its report, the HKMA issued a letter to all banks asking them to study the report carefully and to implement some of its recommendations.[84] One of the recommendations that HKMA required banks to implement immediately was the attachment of 'health warning' statements, 'printed in reasonable font size, to all existing derivative products and structured products with embedded derivatives that are being sold to investors', together with a requirements for banks to 'draw investors' attention to the "health warning" statement when selling such products to them'.

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76 See the SFR Lehman Report, above n 4, [4.3.6].

77 Ibid [26.6].

78 The HKMA Lehman Report, above n 4, [8.14]. See further in Part VII, Section D, below (risk in stark language).

79 Ibid.

80 Ibid [8.9]. This is similar to the legislative standard adopted in Australia. See Part VI, Section B, below.

81 Ibid [8.10].

82 Ibid [8.11].

83 Ibid [8.14].

84 See HKMA, 'HKMA Urges Authorised Institutions to Study its Report on Issues Concerning the Distribution of Structured Products Connected to Lehman Group Companies', (Press Release, 9 January 2009), <http://www.info.gov.hk/hkma/eng/press/index.htm> at 23 August 2009.

Apart from the adoption of health warnings, which is consistent with the call in this article for risk warnings to be expressed in stark language,[85] the recommendations of the SFC and the HKMA are based on the perceived need to explain the nature of the investment product more effectively to investors. A key component of this is the adoption of summaries and key fact statements as a means of highlighting the benefits and risks for investors. Although consistent with the trend in other jurisdictions such as Australia and the UK, this article will argue that there are inherent limitations in this approach. The comparative analysis in Part VI below outlines the conventional plain language approach as a prelude to highlighting these limitations and the relevance of focusing on risk awareness.

VI PLAIN LANGUAGE REQUIREMENTS: HONG KONG, AUSTRALIA AND THE UNITED KINGDOM COMPARED

A review of the plain language requirements in Hong Kong, Australia and the UK suggests that each jurisdiction has adopted an approach that is consistent with the plain language principles as outlined above. However, there are certain differences in terms of emphasis and also the extent to which the practice in each jurisdiction accommodates the needs of retail investors. This section overviews the plain language requirements in each jurisdiction and makes some observations by way of comparison.

A Hong Kong

Hong Kong recognises two public offering regimes for investment products. As noted by the SFC, '[c]ollective investment schemes are authorised under section 104 of the Securities and Futures Ordinance ('SFO') while the offering documents and marketing materials of retail investment products are authorised either under section 105 of the SFO or authorised for registration under the Companies Ordinance'.[86]

The SFC has issued guidelines on use of offer awareness and summary disclosure materials in offerings of shares and debentures under the Companies Ordinance.[87] These apply to all publicity materials and disclosure materials issued to the public in Hong Kong in connection with a proposed offer of shares

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85 See below Part VII, Section D, in relation to stark language.

86 See SFC, *Circular to Issuers of Retail Investment Products*, above n 5. See also the SFC Lehman Report, above n 4, [8.1] – [8.4] for an explanation of how the different products are regulated. The SFC recommended in the SFC Lehman Report at [25.4.3] that 'for consistency one overall disclosure standard should be specified for all offering documents that seek to describe an investment sold to the Hong Kong public' and that it should 'revisit the issue of whether Hong Kong should retain two public offering regimes for investment products'.

87 SFC, *Guidelines on Use of Offer Awareness and Summary Disclosure Materials in Offerings of Shares and Debentures Under the Companies Ordinance*, <http://www.sfc.hk/sfcRegulatoryHandbook/EN/displayFileServlet?docno=H204> at 23 August 2009.

or debentures in Hong Kong by a prospectus and require the materials to be in 'plain and clear language'.

In Hong Kong, the use of plain language in the context of securities disclosure was formally launched in March 1997 when the SFC established the Working Group on Plain Language, comprising representatives from the SFC, the Stock Exchange and leading market practitioners ('Working Group').[88] The Project on the Use of Plain Language was undertaken in two phases. The first phase was aimed at improving the way listed issuers present information in public announcements to investors and resulted in a handbook entitled 'How to create clear announcements'. The second phase was aimed at improving the format, language and content of prospectuses and resulted in a handbook entitled 'How to create a clear prospectus'.

In 'How to create a clear prospectus',[89] the Working Group suggested that prospectuses could be improved in the following ways:

- simplifying the first page of a prospectus so it contains only essential and important information;
- drafting a useful summary of the information in the prospectus;[90]
- arranging the content into a logical order;
- grouping like information together under descriptive headings;
- where like information cannot easily be grouped together, using cross-references to guide readers;
- eliminating unnecessary repetition, and
- writing in plain language.[91]

A plain language sample prospectus was created to help the market to incorporate these improvements into a prospectus.

In terms of the use of technical terms, the handbook on creating a clear prospectus states that:

> Where possible, the meaning of a word or term should be plain from the context in which it appears. Readers do not like to have to constantly refer to a definition section in order to understand what they are reading.

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88 See SFC, 'Project on the Use of Plain Language' (Press Release, 12 January 1998), <http://www.sfc.hk/sfcPressRelease/EN/sfcOpenDocServlet?docno=120198A> at 23 August 2009.

89 SFC, *How to Create a Clear Prospectus* (January 1988) ('the Handbook'), 2–3, <http://sfc.hk/sfcRegulatoryHandbook/EN/displayFileServlet?docno=H050> at 23 August 2009. This document is available only in English.

90 Ibid 8: The Handbook quotes the comments in the US Securities and Exchange Commission's draft Plain English Handbook concerning the purpose of a summary: 'A summary should orient the reader, highlighting the most important points that are presented in greater detail in the prospectus. Many summaries now seem as long as the prospectus itself and merely consist of selected paragraphs copied straight from the body of the prospectus. Reading the same material two or three times can bore and even trouble readers. Most readers skip over paragraphs if they think they've read them before…'

91 The Handbook does not expressly define 'plain language'.

> If your company's business involves a technical process, and your readers need to understand that process before they can make an informed investment decision, it may be useful for this section to include a glossary of technical terms. As with definitions, a glossary should not be used more than is necessary. You should try to explain any technical terms in context.[92]

The handbook 'How to create clear announcements' also sets out plain language features.[93] These include the following:

- use commonsense names and abbreviations;
- don't use excessive definitions;
- use shorter sentences;
- prefer the active voice;
- avoid hidden verbs;
- use simple, common words, not jargon and legalese;
- prefer the positive to the negative;
- design your document with your reader in mind.

In relation to risk factors, the handbook stated that

> [i]f the risks are many, you should take care to point out the most significant ones, or present them in order from the most to the least important. You should not bury a real risk among many trivial ones.[94]

The approach to plain language as reflected in the handbooks is broadly consistent with the approach adopted in other jurisdictions such as Australia and the UK. However, it does not appear to be as responsive to the needs of retail investors as the approach in those jurisdictions. For example, it does not place as much emphasis on the use of summaries and the associated need to avoid technical terminology and industry jargon. In addition, it does not emphasise the need to explain the practical implications of investment products to retail investors. In view of this, and also the increasing complexity of retail investment products since the handbooks were published, the current review by the SFC and HKMA appears timely.

B Australia

Like Hong Kong, Australia has separate regimes in respect of regulated securities (ie those that are sold using a prospectus) and financial products other than securities (ie those that are sold using a product disclosure statement).

Unlike Hong Kong, however, Australia has established a legislative standard in relation to plain language. Section 715A of the *Corporations Act 2001* (Cth) ('*Corporations Act*') concerns the presentation of disclosure documents in

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92 The Handbook, above n 89, 9.

93 SFC, *How to Create Clear Announcements* (July 1997) <http://www.sfc.hk/sfcRegulatoryHandbook/EN/displayFileServlet?docno=H052> at 23 August 2009. A Chinese language version of this handbook is available. Although it is a translation of the English, many of the plain language principles are also applicable to the Chinese version.

94 See Part VII, Section A, below on the difficulties in establishing the relative significance of risks.

respect of debentures and provides that '[t]he information in a disclosure document must be worded and presented in a clear, concise and effective manner'.

On 8 February 2006, the Australian Securities and Investment Commission ('ASIC') released draft guidelines for issuers and advisers on the preparation of prospectuses.[95] Entitled 'Better prospectus disclosure', the draft guidelines give guidance on, among other things, how to word and present a prospectus in a clear, concise and effective manner.[96]

In terms of using plain language and avoiding jargon, the draft guidelines provide as follows:

> [PS no 44] You should use language that is as plain as possible in a prospectus. Expression should not be legalistic or over-complex.
>
> [PS no 45] If you must describe an important contract (e.g. a trust deed, joint venture agreement, licence or supply contract), use plain language. Rather than merely summarising the contract, you should emphasise its implications for investors and practical effect. If you cannot avoid using legal or industry jargon, you should clearly explain the meaning of the terms. But you should avoid lengthy glossaries as a primary means of communicating information.

The above emphasises the importance of explaining the practical implications of the product and, to this extent, goes further than the guidelines in Hong Kong. As stated by ASIC, '[I]ssuers should explain the practical implications of what is being offered, rather than presenting a mass of legal and financial detail'.[97]

Further, the draft guidelines state (in PS no 49) that the phrase 'clear, concise and effective' should be read as a compound phrase and that each word in the phrase qualifies the operation of the other words. This is likely to be interpreted as requiring each word to be understood by reference to the dictates of the other words.[98]

As in Hong Kong, debentures in Australia are subject to advertising standards. These include the following standards:

- To avoid common misconceptions about the risk profile of debentures, all advertisements for debentures that are offered to retail investors should include a prominent statement to the effect that investors risk losing some or all of their principal investment;

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95 ASIC, *[Draft PS] Better Prospectus Disclosure* (February 2006) <http://www.asic.gov.au/asic/pdflib.nsf/LookupByFileName/better_prospectus_disclosure_draft.pdf/$file/better_prospectus_disclosure_draft.pdf> at 23 August 2009. For background information on the guidelines, see ASIC, '06-027 ASIC Releases Draft Guidance on Shorter, Better Prospectuses' (Press Release, 8 February 2006) <http://www.asic.gov.au/asic/asic.nsf/byheadline/06-027+ASIC+releases+draft+guidance+on+shorter%2C+better+prospectuses?openDocument> at 23 August 2009.

96 When the draft guidelines were issued, ASIC stated that

> issuers and their advisers [had] not yet fully adopted the "clear, concise and effective" style', and that this requirement demanded that 'issuers and advisers re-think the whole craft of prospectus writing.

See ASIC press release, above n 95. Although still in draft form as at the date of writing, the guidelines are likely to reflect the policy of ASIC in relation to best practice.

97 Ibid.

98 See *Story v National Companies and Securities Commission* (1988) 13 NSWLR 661, where the Supreme Court of New South Wales considered the compound phrase 'efficiently, honestly and fairly'.

- Advertisements for debentures should state that the debenture is not a bank deposit. They should *also* not suggest that:
  - the debenture is, or compares favourably to, a bank deposit; or
  - there is no or little risk of the investor losing their principal or not being repaid.[99]

The above emphasises the importance of distinguishing debentures from bank deposits, a concern that was reflected in the SFC Lehman Report.[100]

Under section 1013C(3) of the *Corporations Act*, product disclosure statements are also subject to the requirement for information to be worded and presented in a 'clear, concise and effective manner'.

ASIC Regulatory Guide 168[101] sets out six Good Disclosure Principles for product disclosure statements ('PDS'), including the principle that 'disclosure should promote product understanding.' In terms of plain language, the guide states as follows:

> Where possible, product issuers should try to avoid using industry and legal jargon in a PDS. If this cannot be avoided, then they should explain its meaning. Product issuers should use plain language and, if necessary, illustrate explanations by providing simple examples.[102]

The approach adopted in Australia is interesting for three reasons. First, it imposes a legislative standard in respect of plain language and goes further than other jurisdictions in terms of prescribing the result that plain language is intended to achieve. Secondly, it highlights the importance of avoiding technical terminology and industry jargon, and explaining the practical implications of the investment product. Thirdly, it emphasises the importance of distinguishing the product from other products in advertising materials, a theme that is explored further in Part VII, Section D below.[103]

C The United Kingdom

In the UK, the content of a prospectus is governed by the *Financial Services and Markets Act 2000*, section 87(5) and (6) of which provide as follows:

> (5) The prospectus must include a summary (unless the transferable securities in question are ones in relation to which prospectus rules provide that a summary is not required).
>
> (6) The summary must, briefly and in non-technical language, convey the essential characteristics of, and risks associated with, the issuer, any guarantor and the transferable securities to which the prospectus relates.

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99 ASIC Regulatory Guide 156, 5, <http://www.asic.gov.au/asic/pdflib.nsf/LookupByFileName/rg156.pdf/$file/rg156.pdf> at 23 August 2009.

100 The SFC Lehman Report, above n 4, [26.6].

101 ASIC, *Disclosure: Product Disclosure Statements (and Other Disclosure Obligations)*, Regulatory Guide 168 (May 2007) <http://www.asic.gov.au/asic/pdflib.nsf/LookupByFileName/ps168.pdf/$file/ps168.pdf> at 23 August 2009.

102 Ibid [168.50].

103 Interestingly, ASIC has recently turned its attention to risk awareness – the focus of this article – with the launch of its 'swimming between the flags' campaign, under which financial products are classified as 'between the flags' or 'outside the flags'.

The prospectus regime is also governed by the Simplified Prospectus Instrument 2005. This was issued pursuant to The Undertakings for Collective Investments in Transferable Securities Directive ('UCITS Directive'),[104] which requires simplified prospectuses for UCITS funds. These provide that an operator of a simplified prospectus scheme must be satisfied on reasonable grounds that each simplified prospectus that it produces:

(a) includes all such information as is necessary to enable an investor to make an informed decision about whether to acquire units in the scheme;

(b) does not omit any key item of information;

(c) wherever possible is written in plain language which avoids technical language and jargon; and

(d) adopts a format and style of presentation which is clear and attractive to the average reader, so that it can be easily understood by him.

Like the approach in Australia, the Financial Services Authority ('FSA') Conduct of Business sourcebook requires firms 'to avoid using technical, or industry specific, terms whenever that is reasonably possible (if a *firm* cannot reasonably avoid using such terms, it should explain, in plain language, what those terms mean)'.[105]

In recent years, the FSA has reviewed the product disclosure regime in relation to 'packaged products',[106] including those products that are subject to the simplified prospectus regime. The main focus of the review was 'to develop point-of-sale information that consumers [would] recognize and be better motivated to read, and which, when read, [would be] well understood'.[107]

Underpinning the review was the recognition that 'one of the key problems in the current regime is that many consumers do not read the information (specifically the Key Features Document ('KFD') that firms give them at the time of the sale)'.[108] As part of the review, the FSA considered a number of proposals, including the following:

- replacing the KFDs with concise and jargon-free documents called 'Key Facts' and 'Examples'; and
- requiring the Key Facts to follow a 'question and answer' format and to include a 'KeyFacts Quick Guide' highlighting the most important factors consumers should think about before buying a product.[109]

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104 UCITS Directive, 2001/07/EC.

105 FSA, *With-Profits Governance (Amendment No 2) Instrument 2005*, 5, <http://fsahandbook.info/FSA/handbook/LI/2005/2005_5.pdf> at 23 August 2009.

106 FSA, *Investment Product Disclosure: Proposals for a Quick Guide at the Point of Sale*, Consultation Paper 05/12 (July 2005) <http://www.fsa.gov.uk/pubs/cp/cp05_12.pdf> at 23 August 2009. This describes packaged products as including 'life policies with an investment element, personal pensions including stakeholder pension schemes, units or shares in collective investment schemes and investment trust savings schemes'.

107 Ibid 3.

108 Ibid.

109 Ibid 4.

The KeyFacts Quick Guide proposal was prompted by previous FSA research, which suggested that consumers tend not to read KFDs for the following reasons:

- Uncertainty about the exact role of the documentation;
- Failure of much of this material to stand out and identify itself as being important;
- A perception that it appears boring and impenetrable.
- The reliance that many consumers have on advice delivered verbally by the adviser.[110]

The aim of the initiative was 'to encourage more consumers to engage with product disclosure documentation at some level'.[111]

Ultimately the FSA decided not to implement the above proposals; instead, it proposed 'to simplify [the] current requirements and implement a number of measures to improve the standard of KFDs and to encourage greater stand-out and readership'.[112] In deciding against the adoption of the disclosure reforms in the UK, the FSA pointed to research showing 'that the new disclosure package [did] not increase consumers':

- knowledge and understanding of the product they are buying; and
- likelihood to monitor the performance of their investment on an ongoing basis.[113]

In terms of plain language, the FSA has stated that it expects 'consumer documents to be written and presented clearly and in plain language'.[114] Originally, the FSA proposed to give guidance on what this meant. Subsequently, it adopted a less prescriptive approach, deciding instead to '[keep] the high-level plain language requirement but without detailed guidance'.[115] In explaining this approach, the FSA provided the following comments:

> As noted from our research, consumers prefer simple, easy to understand language rather than documents full of jargon and legal terms. So, we think it is the responsibility of firms to consider the needs of their customers in producing these documents.[116]

It is interesting to note that the UK considered the adoption of jargon-free key fact documents, but ultimately abandoned the proposal because it was not perceived to go any further than the existing documentation. In this writer's view, this reflects the inherent limitations with product disclosure summaries and highlights the need to focus more on building risk awareness, particularly in relation to complex investment products, than on explaining technical terms and concepts. Also of interest is the decision not to provide specific guidance on plain

110 FSA, 'Key Facts Quick Guide: Research Findings' (2005) 41 *Consumer Research* 1.

111 Ibid.

112 FSA, *Point of Sale Investment Product Disclosure: Feedback on CP170 and CP05/12*, Feedback Statement 06/5 (November 2006), [1.9] <http://www.fsa.gov.uk/pubs/cp/fs06_05.pdf> at 23 August 2009.

113 FSA, above n 73, 5.

114 FSA, above n 106, [2.35].

115 Ibid.

116 FSA, above n 112, [2.44].

language and, instead, to leave it to firms to achieve this objective based on the needs of their customers. This probably reflects the difficulties in prescribing the objective of plain language, and makes for an interesting point of comparison with the legislative standard in Australia.

VII THE FOUR TESTS

As outlined in the introduction, this article proposes four tests to determine the adequacy of risk disclosure in respect of investment products. This Part considers each of these four tests in turn.

A Risk in Isolation

This test considers whether risk disclosure has been effectively isolated from other information concerning the investment product. It is based on the proposition that retail investors will pay due regard to risk only if it is isolated from other information.

The SFC Circular[117] reminds retail investment product issuers of their duty to 'ensure that in their marketing materials, there are upfront, prominent and adequate warnings of *all the risks associated with their products…*' and urges issuers seeking SFC authorisations to 'ensure that their applications and related offering documents and marketing materials contain clear upfront explanations of the products and risks *with sufficient prominence and clarity*.' [Emphasis added]

In short, this appears to be a call for issuers to ensure that risk disclosure in their offering documents is clear, complete and prominent. Leaving aside the problems associated with limited financial literacy on the part of retail investors, the requirement for risk disclosure to be clear and complete was arguably satisfied in the Minibonds documentation, at least in a technical sense. The requirement for risk disclosure to be prominent, however, is more difficult to satisfy and raises the following two questions:

- Should equal prominence be given to all risks, or should certain risks be given greater prominence than other risks on the basis that those risks are more likely to occur?
- Does the requirement of prominence mean that risk should be disclosed more prominently than other information, or only that it should be given equal prominence with other information?[118]

In relation to the first question, giving greater prominence to certain types of risk is problematic, since this is likely to diminish or detract from the significance of other risks. In addition, it is often only with the benefit of hindsight that the

117 SFC, *Circular to Issuers of Retail Investment Products*, above n 5.

118 Experience to date suggests that the primary concern of regulators has been to ensure that equal prominence is given to risks and benefits. See ASIC Regulatory Guide 168, above n 101, [168.66].

significance of certain risks can be accurately determined.[119] This was certainly the case with the Minibonds, where the bankruptcy of Lehman Holdings Inc, coupled with the occurrence of a global financial crisis, would have been considered to be a very remote risk at the time the Minibonds were sold.

One of the complaints against the Minibonds marketing materials was that 'undue prominence was given to the reference entities without balancing it with upfront risk disclosures about risks relating to Lehman Brothers'.[120] The Minibonds marketing leaflet did in fact refer to the risk on Lehman Brothers Holdings Inc in the marketing leaflet under the 'Disclaimer' heading as follows:

> To the extent due payment of amounts fails to be made under the underlying securities or Lehman Brothers Holdings Inc. is unable to procure due payment of amounts under the swap arrangements, Pacific International Finance Limited will be unable to make the corresponding payments due under the Notes and the recourse of investors in the Notes is limited to realization of the underlying securities plus or minus (as the case may be) the termination payment due to or payable by (as the case may be) Pacific International Finance Limited under the swap arrangements.

It might be argued that this risk was buried within other information and that the risks in general were not highlighted in a sufficiently prominent manner. However, in this writer's view, it could not be said that the disclosure of this risk was less prominent than other risks in the marketing leaflet. For those investors who did in fact read this information, any difficulties that they experienced in understanding the risk are likely to have been attributable more to the technical terminology used and the length of the sentence, which runs to 93 words, than to a failure to highlight this risk with equal prominence.[121]

In relation to the second question (namely, should risk be disclosed more prominently than other information?), the reference by the SFC to 'upfront, prominent and adequate warnings of all the risks' is not clear. If the requirement is simply for risk to be given equal prominence with other information, this was arguably satisfied in relation to the Minibonds prospectus and marketing leaflet.

Irrespective of how the arguments are resolved in relation to prominence, it is impossible to escape the reality that many investors will simply not read the information concerning risk in the prospectus and the marketing material. The failure of investors to read all of the relevant information can be attributed to various factors, including (as previously discussed) limited financial literacy on

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119 The original proposal of the FSA proposed that 'providers determine where and how to disclose risks bearing in mind that the "Key Facts Document" should highlight only the most significant risks.' See FSA, Feedback Statement 06/5, above n 112, [2.12]. In response to requests from respondents for clarification on what FSA considered to be the 'most significant risks', the FSA expressed the view that 'firms are best placed to determine the "most significant risks" of their products … [i]t is also important that firms disclose such risks in [a] way that consumers can access and understand'. See FSA, Feedback Statement 06/5, above n 112, [2.14].

120 SFC Lehman Report, above n 4, [28.1.2].

121 Arguably, this risk was given less prominence in the prospectus where the bankruptcy of the swap counterparty was one of several reasons for which the Minibonds would need to be redeemed and was not highlighted to the same extent as the consequences of a credit event.

the part of retail investors and also what could be described as 'information overload'.

Information overload can be caused by a number of factors, including the following:

- The inclusion of extraneous information, which means that the investor is distracted from the key messages that disclosure is intended to convey;
- Simply too much information for investors to absorb.

In relation to the issue of extraneous information, the impact of this in the marketing materials for the Minibonds has already been considered in the context of promotional gifts.[122] Concerns about the impact of extraneous information in product disclosure statements have also been voiced by ASIC, particularly where such information includes advertising or promotional material or 'immaterial benefits associated with the acquisition of a product':

> If a product issuer includes extraneous material in a PDS, there are risks that:
>
> (a) consumer may not read, or may disregard or not understand the importance of, other information in the PDS; and
>
> (b) a consumer might otherwise be misled or deceived.[123]
>
> To diminish these risks, we expect product issuers will consider methods to ensure that extraneous material in a PDS is:
>
> (a) clearly distinguishable from other information; and
>
> (b) no more prominent than other information.[124]

In relation to the second factor outlined above (ie too much information for the investor to absorb), concerns about the length of prospectuses appear to be behind the recommendation by SFC for summaries to be provided to investors, either in addition to the prospectus or offering document, or as part of it.[125] Similar concerns about lengthy product disclosure statements have been voiced by ASIC:

> [P]roduct issuers who produce lengthy PDSs need to ensure that a PDS is not so lengthy that it impedes a consumer's ability to extract the information needed to make an informed decision about the financial product on offer.
>
> ASIC has observed that there are some very complex products being marketed to retail customers. Compliance with the content requirements relating to disclosure of significant benefits, significant risks, the cost of the product and significant characteristics or features is more onerous when the product or products on offer

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122 See above, Part III.

123 ASIC, Regulatory Guide 168, above n 101, [168.56]

124 Ibid [168.57].

125 See the SFC Lehman Report, above n 4, [4.3.6]; see also [26.1] and [26.2]. This issue has also been considered in the context of consumer contracts. See Jeffrey Davis, 'Protecting Consumers from Oversdisclosure and Gobbledygook: An Empirical Look at the Simplification of Consumer-Credit Contracts' (1977) 63 *Virginia Law Review* 841. Davis analyses the impact of information load based on the simplification of consumer credit contracts. Davis' research suggests that 'although reduced disclosure is desirable, it is a less effective aid to acquisition than is simplification via redrafting' (887). This adds support to the proposition that the problem stems from difficulties in understanding legalese rather than from the length of documentation. See also Shmuel I. Becher, 'Asymmetric Information in Consumer Contracts: the Challenge that is Yet to be Met' (2008) 45 *American Business Law Journal* 723.

> are complex. This necessarily contributes to the length of the PDS, since the consumer needs to be informed about all of these matters in sufficient detail to understand the product.[126]

Implicit in the above comments is the inherent tension between the need for short product disclosure statements and the need to achieve comprehensive product disclosure. This tension becomes greater as products become more complex, such as in the case of the Minibonds and highlights the challenges for risk disclosure as identified in this article.

In the UK, one of the main objectives behind the Quick Guide initiative in the UK was 'to minimise the risk of information overload for consumers'.[127] However, the benefits of this initiative were considered to be limited as a result of the volume of literature that investors receive at the point of sale.[128]

Invariably, this writer argues, the impact that information on risk has on retail investors is likely to be compromised by its inclusion with other material in the same document. This is bound to affect its prominence and, consequently, to diminish its impact on the retail investor. Although designed to be more accessible to retail investors than the formal disclosure documentation, short-form summaries and key fact statements also have the effect of burying risk within other information. It is for this reason that this article suggests the adoption of a stand-alone risk awareness statement that highlights the sources of risk at a high level of generality and places it within the context of the specific investment product.[129]

B Risk in Context

This test considers whether risk has been contextualised sufficiently to enable consumers to understand how the risk arises in relation to the investment product and to relate it to their own situation. This is based on the proposition that retail investors will understand the nature and extent of risk only if they understand how it arises in relation to the investment product and are able to relate it to their own situation.

There are at least four reasons why investors have difficulty contextualising the risk. First, risk is often expressed in standardised terms, which gives the investors the impression that it is just 'bumph' and makes it difficult for them to

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126 ASIC, 'IR 04-71 ASIC Issues Guidance on PDS Disclosure' (Press Release, 21 December 2004) <http://www.fido.gov.au/asic/asic.nsf/byheadline/IR+04-71+ASIC+issues+guidance+on+PDS+disclosure?openDocument> at 23 August 2009. As this article has previously argued, the ability of consumers to understand complex products turns more on financial literacy than on whether they have been given 'sufficient detail'.

127 FSA, Consultation Paper 05/12, above n 106, [2.4].

128 FSA, above n 73, 6.

129 See Section B below for risk in context.

relate to it in any meaningful way.[130] For example, the statement that 'investment involves risk' is trite almost to the point of being meaningless.

The second reason is that information about risk often does not explain the implications of the risk and the impact that it might have on investors. For example, the implication in the statement 'the Notes are not principal protected' – namely, that investors could lose part, and possibly all, of their investment – was included in the prospectus but not in the marketing leaflet.

The third reason is that risk is often expressed in technical terms, which are often impenetrable to the retail investor.[131] The fourth reason is that retail investors often do not have a sufficient understanding of the product to understand how it gives rise to the relevant risks.

There are limited solutions to these problems in terms of modifying the prospectus and the marketing material, largely as a result of the range of information that these documents must include and the general difficulties that retail investors face in understanding complex investment products.

In this writer's view, retail investors are likely to get lost in the technical detail of the formal disclosure documents. The concepts involved and the extent of detail act as a significant impediment to understanding the product. The more detail retail investors are given, the less likely they will understand the product sufficiently to appreciate the risk. The benefit of a risk awareness statement is that it would only provide as much detail in relation to risk as necessary for the investor to form a view as to whether the product might be suitable. In addition, it could be expressed in a more personalised format than the prospectus and the marketing material, which would make it easier for investors to relate the risk to their own situation.[132]

C Risk in Lay Language

This test considers whether the risk has been explained in lay language. It is based on the proposition that retail investors will understand the nature and extent of the risk only if the product and the associated risks are explained in lay language.

A threshold question in this regard is how the term 'lay language' should be defined. For the purposes of this analysis, 'lay language' is understood to mean language that a lay person would use with minimal reference to technical terms or industry jargon. Ideally, it would exclude any reference to technical terms or

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130 In consumer research prepared for the FSA on the proposed KeyFacts Quick Guide, DVL Smith commented that 'previous research had shown that what the documentation looks like will immediately impact on the consumer. It needs to be engaging, not marketing 'bumph', not 'government like' but still important': See FSA, above n 110, 4.

131 See Section C below in relation to lay language.

132 The benefits of providing information in personalised terms have been recognised by ASIC:

> Research has generally found that personalised information is more widely read and retained by consumers because it is seen as more important and relevant. An example of personalised information is using customer-specific information as a basis for projections associated with life insurance products.

See ASIC, Regulatory Guide 168, above n 101, [168.75].

industry jargon; however, this objective has to take account of the practicalities, which often require that some technical terms and industry jargon be used.

It is likely that the use of technical terms and industry jargon would have been a significant factor behind the inability of many Minibond investors to appreciate the nature and extent of the risks involved.

There appears to be little doubt that the use of technical terminology creates a barrier to understanding.[133] Regulators have acknowledged the difficulties that arise when complex products are offered to retail investors. As noted by ASIC:

> Where possible, product issuers should try to avoid using industry and legal jargon in a PDS. If this cannot be avoided, then they should explain its meaning. Product issuers should use plain language and, if necessary, illustrate explanations by providing simple examples.[134]

ASIC has also acknowledged that '[e]ven where product issuers present information in plain language, the complexity of what is being described may create a barrier to consumers' understanding'.[135] 'In some extreme instances, a product issuer may need to consider simplifying the item or system being described, as well as how information about it is disclosed.'[136]

Ultimately, there are limits on the strategies that can be adopted to make a prospectus easier for retail investors to understand. By necessity, a prospectus must use technical terms and industry jargon when referring to the way in which a product works and its benefits and risks. There is some scope for mitigating the difficulties, including the greater use of lay language to explain the meaning of technical terms and industry jargon and to explain the implications of risk. For example, consider the following suggested insertions (underlined) in the statement in the Minibonds prospectus set out below:

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133 Note the comment in the SEC Plain English Handbook, above n 10, that '[a]bstractions abound in the financial industry.' In terms of similar difficulties that arise in the context of legal or technical jargon in consumer credit contracts, see Becher, above n 125.

134 ASIC, above n 101, [168.50]. In Australia, case law has suggested that a PDS 'should be intelligible to reasonable members of the class to whom it is directed': *Fraser v NRMA Holdings Ltd* (1995) 15 ASCR 590 at 603. See ASIC, above n 101, [168.97].

135 Ibid [168.51].

136 Ibid [168.54]. Similar thoughts have been expressed by the Monetary Authority of Singapore ('MAS'): 'Some areas we may need to review include … simpler descriptions of the features and risks of products so that they can be more readily understood.' See MAS Approach in Dealing with Recent Developments Concerning the Sale of Structured Products' (Press Release, 2 October 2008) <http://www.mas.gov.sg/news_room/press_releases/2008/MAS_Approach_in_Dealing_with_Recent_Developments_Concerning_the_Sale_of_Structured_Products.html> at 23 August 2009. MAS has released a consultation paper entitled 'Review of the Regulatory Regime Governing the Sale and Marketing of Unlisted Investment Products'. See <http://www.mas.gov.sg/resource/publications/consult_papers/2009/MAS%20consult%20paper%20structured%20pdt%20review.pdf> at 23 August 2009. Included in the proposals is the requirement for issuers to prepare a Product Highlights Sheet to supplement the prospectus. This will be required to disclose key information in plain language in a 'Question & Answer' format and its length will be capped at four pages. Interestingly, MAS proposes that the document be written and presented in a 'clear, concise and effective manner', which is the same as the legislative standard adopted in Australia. The Product Highlights Sheet will be treated as part of the prospectus for statutory liability purposes.

> We intend to issue our Notes in two tranches (i.e. two batches): a tranche of USD Notes and a tranche of HKD Notes. We will treat each tranche separately. For example, we might call (i.e. buy back) one tranche but not the other tranche.

Another approach that has been suggested is to replace technical terminology with terms that 'more accurately reflect what they mean to the general public'.[137] However, the concern remains that one form of jargon is simply replaced with another form of jargon and that documentation basis risk will arise as a result.[138]

In this writer's view, some of the limitations inherent in a prospectus could be overcome in a stand-alone risk awareness statement that explains complex products in lay language and at a higher level of generality than is possible in the prospectus. This would accommodate a broader range of financial literacy. It would also reverse the conventional approach, which proceeds on the assumption that an understanding of the product is gained only through an explanation of the risks.[139]

In addition to increasing the likelihood that investors will understand the product and the associated risks, a lay language risk awareness statement would also make it easier for investment advisers to understand the product themselves and explain the risks to their customers. As previously noted,[140] there are valid concerns over whether investment advisers have a sufficient understanding of the prospectus to explain the product and its associated risks to clients. Even if advisers have a sufficient understanding, they often find it challenging to find the right language to explain the product to customers.[141]

D Risk in Stark Language

This test considers whether the risk warnings have been expressed in stark language, namely, in language that is direct and unambiguous. It is based on the proposition that retail investors will pay due regard to risk warnings only if they have been expressed in a direct and unambiguous manner.

A threshold question arises as to the definition of 'direct and unambiguous'. For the purposes of this test, these adjectives denote language that relates the warning directly to the product in question and does not allow any ambiguity in terms of the consequences of risk.

The SFC Circular stated that

137 Richard Mazzochi, Scott Farrell and Abigail Rath, 'Tailoring Structured Notes to the Hong Kong Public' (2004) 23 *International Financial Law Review* 43. This article notes at 44 that in some transactions, 'the term credit default swap has been replaced with portfolio agreement or credit transfer agreement. Similarly, reference entity may become portfolio company and credit event could become company event'.

138 Documentation basis risk arises where inconsistent language is used in contracts that relate to a transaction. Mazzochi, Farrell and Rath, ibid 43, acknowledge this risk, but suggest that it should be 'managed as part of the price of a retail offering'.

139 The conventional approach is reflected in the comments of ASIC Regulatory Guide 168, above n 101, [168.46(d)]: 'In general, complex products that are not well understood need sufficient explanation of their risks to ensure consumers understand how the product works.'

140 See Part V, Section B, above.

141 This is a challenge facing all professionals.

> retail investment product issuers should ensure that in their marketing materials, there are upfront, prominent and adequate warnings of all the risks associated with their products, including any new risks that may have emerged in the prevailing market circumstances, before these marketing materials are issued or remain in issue.[142]

The call for 'upfront, prominent and adequate' risk warnings appears consistent with the thinking behind this test. As previously noted,[143] the Lehman Minibonds prospectus contained various warnings. Some of these related to specific risks, for example: 'Our Notes are not principal protected. You could lose part, and possibly all, of your investment.'[144]

Other warnings did not refer to specific risks but instead warned investors in general terms about the appropriate action to take. For example:

> If you are in any doubt about any of the contents of this issue prospectus *you should obtain independent professional advice.*
>
> We cannot give you investment advice: *you must decide for yourself, after taking professional advice if you deem appropriate, whether our Notes meet your investment needs*.[145]
>
> Our Notes are credit-linked to seven reference entities. We have no special access to information about the reference entities. *You must rely on publicly available information about them in deciding whether to buy or hold our Notes.*[146] [Emphasis added]

In addition, the prospectus included disclaimers; namely, statements that disclaim responsibility for certain outcomes. The following is an example of a disclaimer in the Minibonds prospectus:

> You can find information about each reference entity and its operations and financial condition on the websites listed in the table below…*The information on these websites is not part of our issue prospectus and we and the arranger accept no responsibility for that information, including whether that information is accurate, complete or up-to-date.*[147] [Emphasis added]

The requirement for the language to be direct and unambiguous also applies to disclaimers.[148]

In its report, the HKMA recommended that 'health-warnings' should be attached to retail structured products with embedded derivatives or to retail derivative products generally.[149] This would 'reduce any confusion with plain

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142 SFC, above n 5. See the SFC Lehman Report, above n 4, Appendix 2, [5.5.4] for the standard warnings that must be included in marketing materials for debentures. ASIC has also adopted the adjective 'prominent' to describe the required warning statements: see ASIC, above n 99, [156.17–156.18]. See also ASIC, above n 101, [168.66].

143 See above, Part IV, Section A.

144 Minibonds Series 36 Prospectus, above n 29, 15.

145 Ibid 2.

146 Ibid 6.

147 Ibid.

148 For the requirement for disclaimers to be prominent, see ASIC, above n 101, [168.100]:

> Disclaimers about statements may not be effective if they are not sufficiently prominent to clearly counterbalance the effect of a misrepresentation clearly made. A disclaimer should generally be able to be seen and understood by those who otherwise might be misled.

See also *Lezam Pty Ltd v Seabridge Australia Pty Ltd* (1992) 35 FCR 535.

149 HKMA, above n 4, [8.14].

vanilla debt securities' and would '[alert] readers to the inherent risk'. For example, '[t]his is a structured product which involves derivatives. Do not invest in it unless you fully understand and are willing to assume the risks associated with it'.[150]

Such warning statements would introduce an element of consistency into the documentation for investment products. However, it is important to bear in mind that they are not a complete solution to the lack of understanding on the part of retail investors in view of their standardised nature.[151] In addition, there is a concern that the overuse of standardised risk warnings might dilute their impact.

As noted above,[152] one trend that has emerged in jurisdictions such as Australia is that risk warnings should not only warn investors about the inherent risks in the product on offer; they should also clearly distinguish the product from other products with which it might be confused. A corollary to this is that terms or adjectives that might be associated with bank deposits (such as 'secure', 'secured', 'guaranteed', 'safe', 'deposit') should be avoided in advertisements for debentures.[153]

VIII RISK AWARENESS STATEMENT

The risk awareness statement contained in the Schedule is an attempt to produce a stand-alone document that goes some way towards achieving the objectives of the four tests outlined above. The primary benefit of such a statement is its potential to filter out retail investors for whom the product is clearly not suitable.

The benefits of adopting a stand-alone risk awareness statement are supported in research commissioned by the FSA in the UK, which suggests that 'having the "more important" information in a separate document was felt by some respondents to help make it stand out and reinforce its importance, which may in turn increase the likelihood of it being read and/or kept for reference'.[154]

The risk awareness statement obviously falls well short of a comprehensive outline or summary of the product itself and, for this reason, could not act as a substitute for the product prospectus or the short-form summaries or key fact statements. Its purpose, however, would be to provide investors with an awareness of the risks associated with the product. As previously noted, it would

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150 Ibid [8.12]. The HKMA and the HKAB have since followed up with a requirement in respect of the specific wording of the health warning: See HKMA, *Implementation of Recommendations in the HKMA's Report on Issues Concerning the Distribution of Structured Products Connected to Lehman Brothers* (2009) <http://www.info.gov.hk/hkma/eng/guide/index.htm> at 23 August 2009.

151 Interestingly, ASIC has stated that its approach is not to

> [prescribe] "boilerplate" or standardised warning statements. It is the responsibility of the issuer to ensure that their advertisement is not misleading or deceptive and that the warning statements…are effective.

See ASIC, above n 99, [156.17] – [156.18]. See also ASIC, above n 101, [168.66].

152 See Part VI, Section B, above.

153 ASIC, above n 99, [156.20] – [156.22].

154 FSA, above n 73, 11.

also provide a basis on which financial advisers could better align their product advice with the disclosure documents and more effectively personalise the advice for individual clients.

This would reduce the risk that written disclosure is undermined by inaccurate financial advice and limit the tendency for investors to downplay the importance of the disclosure documents.[155]

Further, the statement is not a comprehensive outline or summary of the *types* of risks associated with the product. Instead, its focus is on the underlying *sources* of risk, particularly counterparty risk. This is consistent with the following comments made by the HKMA in its report:

> In any case, it is not strictly necessary for the investor to be fully conversant with all of the technical financial engineering of the product: what matters is that he should be aware of the underlying sources of risk, particularly where there is exposure to entities unrelated to the issuer.[156]

Certain features of the statement are relevant in terms of the issues discussed in this article. First, the statement takes the form of a letter and is addressed to the customer, albeit on an impersonal basis. The purpose behind this is to increase the likelihood that customers will read it and that it will stand out from the other product documentation.

Secondly, information about the product has only been included to the extent that it is relevant to risk.

Thirdly, to the extent possible, technical concepts are expressed in lay language and risk warnings are expressed in stark language.

Fourthly, the statement adopts a Q&A format and is designed around the following four questions that, in the writer's view, are essential to enable retail investors to make the threshold decision as to whether the product is suitable for them:[157]

- What is the product?
- Who is responsible for the product?
- How risky is the product?
- How easily can I sell the product?

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155 This problem has been identified in research in the UK, which suggests that many investors see the key facts document as a pre-adviser document and rely heavily on explanations given by their adviser: Ibid 5.

156 HKMA, above n 4, [8.4].

157 This approach has been inspired by the 'Ask me 3' program adopted by the National Patient Safety Foundation in the US. This 'promotes three simple but essential questions that patients should ask their providers in every health care interaction': (1) What is my main problem? (2) What do I need to do? (3) Why is it important for me to do this? See National Patient Safety Foundation, 'What is Ask me 3?' <http://www.npsf.org/askme3/PCHC/what_is_ask.php> at 23 August 2009. A similar approach has been adopted by the Monetary Authority of Singapore in its financial education initiative called 'MoneySENSE': Securities Investor Association, 'Ten Important Questions Investors Should Ask Before Buying A Structured Product' Money Sense <http://www.moneysense.gov.sg/publications/quick_tips/Consumer_Portal_10Qns.html> at 23 August 2009.

IX CONCLUSION

The stand-alone risk awareness statement attempts to plug some of the gaps created by prospectuses and product summaries. In this writer's view, it reflects the following realities:

- It is unrealistic to expect that the majority of retail investors will read a prospectus or a product summary in relation to a complex investment product and understand the product sufficiently to make an informed investment decision about the risks involved and its suitability.[158]
- It is also unrealistic to expect that all intermediaries (for example, financial advisers and distributors) will fully understand the contents of a prospectus, particularly as they relate to the mechanics of complex products such as derivatives.[159]
- In the case of retail investors, risk awareness cannot be achieved simply via the mechanism of comprehensive disclosure as contained in the prospectus or product summary. By isolating risk (for example, risk in isolation) and explaining the general features of the product for this purpose only (i.e. risk in context), there is a greater chance that investors will be able to make the threshold decision as to whether the product is suitable for them and whether the risks are of a type that they are willing to assume.
- References to technical terminology and technical concepts in a prospectus or product summary inevitably undermine risk awareness. For this reason, it is essential to explain risk in terms that the retail investor will understand (for example, risk in lay language).
- Although important, the adoption of standardised risk warnings alone is insufficient. Risk warnings must also be given in language that relates the warning to the product in question and highlights the risks involved (for example, risk in stark language).

Of course, all written disclosure has its limitations, irrespective of the language used and the way in which information is presented. The Lehman Minibonds crisis is a timely reminder that risk disclosure depends on the interplay of three essential factors: (1) written disclosure; (2) investor advice; and (3) financial literacy. Although written disclosure is just one of these factors, it is of critical importance since it is the only factor that is constant and the only factor over which product-issuers and regulators have complete control. Furthermore, its importance increases as investment products become more complex, since the complexity of products like the Minibonds increases the difficulties that investment advisers face in explaining risk to their clients, and also makes financial education for retail investors more difficult to achieve.

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158 As previously noted, one of the main obstacles is the technical nature of risks associated with products such as the Minibonds, particularly counterparty and bankruptcy risk.

159 For comments in support of this proposition, see AIIFL, above n 26, 68.

The Minibonds crisis reflects the ongoing debate in relation to the role and effectiveness of plain language risk disclosure. As this article has argued, the conventional plain language approach has its limitations. This is reflected in the fact that even though the Lehman prospectus had been written in accordance with the plain language guidelines, it was arguably still not capable of being understood by retail investors.

SCHEDULE

Dear Customer

Minibonds – Risk Awareness Statement

We have prepared this risk awareness statement to help you understand the risks associated with the purchase of Minibonds.

Investment involves risk. Before buying any Minibonds, you must be aware of all of the relevant risks, details of which are contained in the prospectus.

If you are in any doubt about this product, get independent professional advice.

What are Minibonds?

The Minibonds are a 'derivative-linked' product. The return on the Minibonds (namely, what you get back on your investment) is linked to the financial condition of seven companies as identified in the prospectus.

In effect, by purchasing Minibonds, you are speculating on the financial condition of the seven companies.

Your investment will be at risk if the financial condition of any of the seven companies deteriorates.

If you are unable to form a view as to the financial condition of the seven companies, then you should not purchase Minibonds.

Which companies are responsible for the Minibonds?

- Pacific International Finance Limited – this company will issue the Minibonds.
- Lehman Brothers Special Financing Inc – this company will enter into agreements called 'swap agreements' with Pacific International Finance Limited. The swap agreements are an integral part of the Minibonds structure.
- Lehman Brothers Holding Inc – this company will guarantee the obligations of Lehman Brothers Special Financing Inc under the swap agreements.

Your investment will be at risk if any of the above companies fails to perform its obligations in respect of the Minibonds.

How risky are the Minibonds?

You could lose part, and possibly all, of your investment.

This product is not a bank deposit and is not guaranteed. It is a structured product that involves derivatives. Do not invest in it unless you fully understand and are willing to assume the risks associated with it.

How easily can I sell my Minibonds?

There is no active market for the sale and purchase of the Minibonds. They cannot be traded on any stock exchange

This means that it may be difficult or impossible to sell your Minibonds.

Yours faithfully

Pacific International Finance Limited