Shifting from Financial Jargon to Plain Language

Advantages and Problems in the European Retail Financial Market*

*Francesco De Pascalis***

Abstract

The purpose of this paper is to discuss the European regulatory efforts to guarantee investors a proper understanding of the characteristics of the products being offered in the retail financial market. In particular, the analysis emphasises the proposal to introduce plain language as a mandatory requirement for drafting pre-contractual documents relating to retail financial products.

The 2007-2009 financial crisis brought to attention the importance of providing investors with more information on financial products to help them make informed investment decisions. However, more disclosure alone is not enough. The quantity and quality of information to be disclosed must go hand in hand with the way the information is communicated.

Plain language is seen as an adequate tool to make information more transparent and understandable to the average investor. However, to make plain language a valuable instrument, it is necessary to enhance the ability of those who have the responsibility to apply it, that is, the financial products' issuers and distributors.

This aspect deserves proper consideration; otherwise, the benefit of plain language will remain on paper.

Keywords: financial markets, financial information, PRIPs/KIIDs, financial jargon, plain language.

A. Introduction

Investors need information on the specificities and risk characteristics of financial products offered to them. Information enables them to evaluate the profitability of a proposed investment. The task of providing information falls on the sellers of the products. To this end, regulation can specify which details the

* Special thanks go to the editors and reviewers of the *EJLR* for their insightful comments. All errors and omissions remain the author's.

** The author obtained an LLM degree in Banking and Finance Law at Queen Mary University of London in October 2010 and is admitted as a barrister to the Verona Bar Society. Currently, he is doctoral candidate at the Institute of Advanced Legal Studies, University of London.

investors should be provided with. Nonetheless, optimal disclosure does not exclusively depend on the amount of information circulated but on clarity and comprehensibility. These aspects pertain to the language through which information is disclosed.

The financial industry is characterised by technical terms and jargon. This sometimes makes the financial language incomprehensible to potential investors because of varying levels of financial literacy. Experienced investors deal with the complexities of language normally used to describe financial products, while others, less sophisticated, may encounter several difficulties in understanding such language. This impairs their ability of knowing what they are investing in. Before the outbreak of the 2007-2009 financial crisis, complex financial products were sold worldwide. These products carried a high degree of sophistication so that even professional investors struggled to understand their features and risk characteristics.[1] Significantly, the turmoil brought to attention the necessity to provide investors with essential product information.[2] This has been one of the main concerns in the European Union (EU) where investor confidence in the retail financial products collapsed in the wake of the crisis.[3] Hence, disclosing more information on financial products is a step in the right direction. However, this is only the first step. Information must be also comprehensible to the average investor. Plain language is regarded as the next step which will serve this purpose.[4]

The aim of this paper is to take stock of the legislative initiatives which introduce the use of plain language in the financial arena. In particular, attention will be devoted to the pre-contractual documents relating to financial products offered in the European retail market. In this sector, a wide variety of complex products are offered to investors.[5] The present contribution supports the view that plain language is an adequate instrument to enhance the investor understanding of the products. Also, due consideration is to be given to the capability of issuers and distributors of products to apply plain language properly. Enhancing their plain language literacy will be crucial for the effectiveness of the European post-crisis efforts to guarantee adequate disclosure and clarity in the financial context.

The remainder of this paper is organised as follows. Section 2 gives some background by providing basic information on the nature of the financial system and its participants. This part will constitute the basis with which to understand

1 R.J. Rosen, 'Investors Behaviour before the 2007-2009 Financial Crisis', *in* J.R. La Brosse, R. Olivares Caminal & D. Singh (Eds.), *Managing Risk in the Financial System*, Cheltenham, Edward Elgar 2011, pp. 4-13.

2 Commission Staff Working Document Accompanying the Communication from the Commission to the European Parliament and the Council-Packaged Retail Investment Products Impact Assessment, SEC (2009) 556, Brussels, 2009.

3 *Ibid.*

4 Proposal for a Regulation of the European Parliament and of the Council on Key Information Documents for Investment Products, COM (2012) 352 final, Strasbourg, 2012.

5 Communication from the Commission to the European Parliament and the Council-Packaged Retail Investment Products, COM (2009) 204 final, Brussels, 2009.

the importance of providing investors with essential information. Also, it will clarify the reasons why they were not adequately equipped with clear details against the (toxic) products that they purchased during the pre-crisis period. Section 3 links these problems to the European initiatives which make plain language mandatory in the pre-contractual documents for retail financial products. Based on these reforms, Section 4 discusses some difficulties that issuers and distributors of financial products may encounter in the use of plain language. Section 5 is the conclusion.

B. Financial Markets and Market Participants

I. Financial Systems and Economic Growth

In the Shakespeare's play *The Merchant of Venice*, the title character, Antonio, is a wealthy businessman whose life is built around some fundamental questions: What projects can be suitable for me? Where can I find money for them? Who will finance the project and on what terms? To what extent can I profit from such investments?[6]

The existence of a financial system can answer all these questions. A world without financial institutions, financial markets, and financial assets may be regarded as a car with no engine. In such a world, most, if not all, of the opportunities available now would be impossible. For instance, financing education, borrowing or saving money for a house, and conducting business would be extremely difficult.[7] The existence of financial systems is the answer to all these needs. Financial systems help create links and thus facilitate the transfer of money from those who have it (lenders) to those who need it most (borrowers).[8] By directing real resources to their ultimate uses, financial systems are an essential conduit for the allocation of resources in economies; in other words, they are crucial to economic growth.[9] To this end, some scholars have identified five critical functions which a financial system performs: (1) production of ex ante information about possible investments; (2) monitoring of investments and implementation of corporate governance; (3) management of risk, including risk diversification through trading; (4) mobilization and pooling of savings, which widen access to finance; and (5) facilitation of economic (exchange) transactions.[10] Such functions are, in

6 Spremann refers to this as the first financial paradigm, *see* K. Spremann, 'Old and New Financial Paradigm', *in* G. Eilenberger *et al.* (Eds.), *Current Challenges for Corporate Finance: A Strategic Perspective*, Berlin, Heidelberg, Springer-Verlag 2010, pp. 7-26.

7 D. Valderrame, 'Financial Development, Productivity and Economic Growth', *FRBSF Economic Letter*, No. 18, June 2003, pp. 2-3, available at: <www.frbsf.org/economic-research/publications/economic-letter/2003/june/financial-development-productivity-and-economic-growth/el2003-18.pdf>, accessed on 3 July 2013.

8 T. Beck, 'The Role of Finance in Economic Development: Benefits, Risks, and Politics', European Banking Center Discussion Paper, No. 38, December 2011, pp. 6-16.

9 A. Crockett, 'What Financial System for the 21st Century?', Per Jacobsson Lecture, Basel, June 2011.

10 E. Avgouleas, 'Financial Markets and Financial Crisis', *in Governance of Global Financial Markets, the Law, the Economics, the Politics*, Cambridge University Press 2012, pp. 23-24.

turn, possible through three fundamental pillars: intermediaries, markets, and infrastructures.[11]

Intermediaries such as commercial banks, insurance companies, broker-dealers, mutual funds, and pension funds stand between lenders and borrowers to facilitate the channelling of funds.[12] Markets are the places where buyers and sellers exchange assets such as equities, bonds, currencies, and derivatives.[13] Then, infrastructures, broadly defined, include all institutions, information technologies, rules, and standards that enable the interaction between intermediaries and markets.[14] Though separate, these components are interrelated. Without infrastructure, intermediaries cannot exchange claims securely, and without markets they cannot hedge risks inherent in their intermediation activities.[15] As mentioned above, the presence and interaction of the three components are essential to facilitate the allocation of resources between borrowers and savers. In this context, borrowers range from investors, entrepreneurs, and various economic agents such as domestic households, governments, and businesses with limited financial resources, while lenders include domestic households, businesses, and governments.[16]

II. Financial Markets and Information Problems

As can be seen from the above, the three components of a financial system are necessary for the allocation of resources between savers and borrowers. Markets are places where the exchange and allocation of resources is set in motion. In essence, markets are institutions where buyers and sellers can gather and exchange goods, services, and resources. These institutions cannot be static; they must move with the times, that is to say, they must adapt to the consumers' taste and to the new goods and services, which progress and technology create.[17] In one word, markets must be dynamic.

Further, markets generate income and stimulate competition. In fact, where the price of goods or services rises, firms will produce and supply consumers with more items. At the same time, other firms will be stimulated by increased demand to enter the market to produce the same item.[18] Within the global economic system, three types of markets can be identified and distinguished: factor markets in which factors of production such as labour, capital, and land are pur-

11 S. Valdez & P. Molineaux, *An Introduction to Global Financial Markets*, 6th edn., London, Palgrave 2010.

12 *Ibid.*

13 *Ibid.*

14 M. Miller, N. Milenko & S. Sankaranarayanan, 'Financial Infrastructure, Building Access through Transparent and Stable Financial System', *The World Bank and the International Finance Corporation, Financial Infrastructure Policy and Research Series*, Washington, DC, 2009, pp. 2-20.

15 Crockett 2011.

16 K. Pilbeam, *Finance and Financial Markets*, 3rd edn., London, Palgrave 2010.

17 C.P. Duncan, 'Consumer Market Beliefs: A Review of the Literature and Agenda for Future Research', *in* M.E. Goldberg, G. Gorn & R.W. Pollay (Eds.), *NA-Advances in Consumer Research*, Vol. 17, Association for Consumer Researcher, Provo, UT, 1990, pp. 729-736.

18 D. Gerber, *Global Competition: Law Markets, and Globalization*, Oxford University Press 2010.

chased and sold;[19] product markets in which only finished goods are traded;[20] and financial markets for the channelling of funds from individuals and institutions in surplus to individuals and institutions in deficit. In the financial markets, players trade financial claims in accordance with fixed rules of conduct. Depending on the nature of the claims being traded, financial markets can be classified into money markets, bond markets, equity markets, derivative markets, commodity markets, and the foreign exchange market.[21] Financial markets attract and allocate funds and set interest rates and the price of the financial claims. Thus, they are centre stage in the global economic system.[22]

Financial markets are, by definition, imperfect because they are characterised by information asymmetry problems. These occur when one party to a financial contract does not have enough information about the other party to make accurate investment decisions.[23] Asymmetric information prevents financial markets from operating perfectly and can result in adverse selection and moral hazard problems. Adverse selection can be identified before a transaction takes places, and it is concerned with the lenders' inability to distinguish between good and bad credit risk projects.[24] In other words, when allocating funds, lenders are unable to select between trustworthy and untrustworthy borrowers as to the repayment of the debt due to incomplete information. In this context, as Mishkin notes, 'those who want to take on big risks are likely to be the most eager to take out a loan because they know that they are unlikely to pay it back'.[25] Consequently, those individuals who are likely to produce an undesirable (adverse) outcome are most likely to be selected.[26] To avoid this possibility, lenders might refrain from entering into any loan transaction, and this can lead to market freezes and liquidity hoarding.[27] As opposed to adverse selection, moral hazard arises after a transaction takes place. Moral hazard is concerned with the danger that the borrower applies the granted funds to different purposes than those agreed on with the lender.[28] For instance, the borrower might decide to invest the

19 B. Van Bavel, T. De Moor & J.L. Van Zanden, 'Introduction: Factor Markets in Global Economic History', *Continuity and Change*, Vol. 24, special issue, No. 1, Cambridge University Press 2009, pp. 9-21.

20 European Commission, 'Product Markets', available at: <http://ec.europa.eu/economy_finance/structural_reforms/product/index_en.htm>, accessed on 15 July 2013.

21 Valdez & Molineaux 2010.

22 W.F. Duisenberg, 'The Role of Financial Markets for Economic Growth', *BIS Review*, No. 48, 2001.

23 R.N. Bebczuk, *Asymmetric Information in Financial Markets, Introduction and Application*, Cambridge University Press 2003.

24 J. Eatwell, M. Milgate & P. Newman (Eds.), *Allocation, Information and Markets, The New Palgrave*, Macmillan, London 1989.

25 F.S. Mishkin, 'Financial Market Reform', *Economic Policy Reform: What We Know and What We Need to Know*, Center for Research on Economic Development and Policy Reform, Stanford University, 17-19 September 1998; *see* also G. Akerlof, 'The Market for Lemons: Quality Uncertainty and the Market Mechanism', *Quarterly Journal of Economics*, Vol. 84, 1970, pp. 488-500.

26 *Ibid.*

27 K. Kirabaeva, 'Adverse Selection and Financial Crises', *Bank of Canada Review*, Winter 2010-2011, pp. 11-17.

28 Bebczuk 2003.

borrowed funds in projects which are different and more risky than the one for which the funds were granted. This may jeopardise the possibility to repay the debt if the project fails. Again, lenders might refrain from lending, and the functioning of financial markets will be hampered consequently.[29]

Both phenomena can be minimised. Adverse selection can be reduced by requiring lenders to screen between good and bad borrowers, while moral hazard can be mitigated by requiring lenders to impose restrictions on borrowers with regard to the use of the funds. Furthermore, lenders should monitor the details of the restrictions and enforce them in case of violation by the borrowers.[30] However, such activities are costly and, above all, may be discouraged by another impediment to the functioning of the financial markets: free-rider problem. With respect to financial markets, free-rider problems can be understood by referring to the 'public good' characteristic of information. Information is a public good to the extent that it is both non-excludable and non-rivalrous, that is to say, individuals cannot be excluded from using information, and its use to one individual does not reduce its availability to others.[31]

Where people do not request and pay for collecting information but take advantage of the information other people have paid for, a free-rider problem arises.[32] Within a financial system, free-rider problems increase information asymmetries and can cause herd behaviours in that, once identified the free rider, other market participants may emulate it. As a result, the demand and supply of information decreases proportionately to the increase of the number of free riders. Free-rider problems hamper the efforts to reduce adverse selection and moral hazard. For example, from a moral hazard perspective, where investors know that others are monitoring compliance with the restrictions, they might be free riding on them. Once the others know that they can do the same and avoid the monitoring costs, they will stop monitoring as well so that, ultimately, not adequate resources will be devoted to monitoring and enforcement.[33]

III. *Tackling Information Problems: Financial Intermediaries and Government Regulation*

Information problems can be tackled through financial intermediation or government regulation. Financial intermediaries are specialised in providing information on borrowers. To this end, banks play a fundamental role by channelling funds from savers to investors.[34] Banks have the necessary resources to collect

29 Mishkin 1998.

30 S. Ross, R. Westerfield & J. Jaffe, *Corporate Finance*, 4th edn., New York, Irwin 1996.

31 B.J. Bates, 'Information as an Economic Good: A Re-Evaluation of Theoretical Approaches', *in* B.D. Ruben & L.A. Lievrouw (Eds.), *Mediation, Information, and Behaviour*, New Brunswick, Transaction 1990, pp. 379-394.

32 F.S. Mishkin, 'Policy Remedies for Conflict of Interest in the Financial System', *Macroeconomics, Monetary Policy and Financial Stability: A Festschrift for Charles Freedman*, Ottawa, Bank of Canada 2004, pp. 217-240.

33 *Ibid.*

34 D. Heremans & A.M. Pacces, 'Regulation of Banking and Financial Markets', *in* R. Van Den Bergh & A.M. Pacces (Eds.), *Regulation and Economics*, Cheltenham, Edward Elgar 2012, pp. 559-603.

information on borrowers and to guarantee an efficient monitoring of their behaviour after a loan has been entered into. Moreover, bank loans are private, they are not traded in an open market, and this helps to avoid other traders free riding on the information collected by banks.[35]

Banks are not the only financial intermediaries which can help alleviate information problems. Investors and market participants also rely on the production and sale of information by credit rating agencies (CRAs), which offer information and monitoring services on the creditworthiness of bond issuers in financial markets.[36] The information service is concerned with an assessment of the probability that an issuer of a debt instrument is defaulting in the repayment of its obligation to investors, while monitoring services are performed after the credit rating is made public. These are concerned with the outlook and watch list procedures to urge the issuer to take all the necessary corrections and, thus, avoid possible downgrades.[37]

Finally, government intervention in the operation of financial markets finds its reasons in asymmetric information problems which create risk of fraud, negligence, or incompetence.[38] Regulation is regarded as complementary to financial intermediaries, depending on their ability to overcome free-rider problems in the production of information. In fact, while CRAs help mitigate information asymmetries, free-rider problems remain to the extent that credit ratings, once issued, are public good information available to everybody.[39] Consequently, government intervention is needed where financial intermediaries are not sufficient to tackle information failures. Furthermore, while financial intermediaries contribute to mitigate information problems, their operation may be affected by information and monitoring problems. The financial institutions' regulatory and supervisory intervention is supposed to deal with these issues as well.[40]

IV. Market Failures in Assessment and Production of Information: The 2007-2009 Financial Crisis

Financial intermediaries such as banks and CRAs play a fundamental role in the financial markets for the reduction of information asymmetries. Their services

35 F.S. Mishkin, *The Economics of Money Banking and Financial Markets*, 9th edn., Boston, MA, Pearson, Addison-Wesley 2010.

36 F. Amtembrink & J. De Hann, 'Credit Rating Agencies', *DNB Working Paper*, No. 278, January 2011.

37 *Ibid.*

38 Heremans & Pacces 2012.

39 Originally, CRAs were paid by investors under the subscriber-pays model. In the 1970s, CRAs shifted from the subscribers-pay model to the issuers-pay model. According to the latter, they receive their revenues from the entities they rate. The change was motivated by the fact that advances in reproduction and distribution technologies increased the free-rider problem. In fact, information bought by investors could be easily accessed by others for free. By providing rating services to issuers, free-rider problems are reduced. However, nowadays, technological progress makes the transmission of information even easier. Therefore, the risk of free riding can be of concern even under the issuers-pay model, *see* R.G. Alcubilla & J.R. Del Pozo, *Credit Rating Agencies on the Watch List-Analysis of European Regulation*, Oxford University Press 2012.

40 Heremans & Pacces 2012, p. 568.

help investors make informed investment decisions. However, their screening and monitoring services failed during the years leading up to the recent financial crisis. This happened in relation to structured finance products backed by subprime mortgages. Some background information will help clarify actors and responsibilities. The US President's Working Group on Financial Markets identified five causes of the 2007-2009 financial crisis: (1) a breakdown in underwriting standards for subprime mortgages and questionable lending practices to less qualified homebuyers, (2) erosion of market disciplines by parties to the mortgage securitization process, (3) flaws in CRAs' assessments of subprime mortgages, (4) risk management weaknesses at large financial institutions, and (5) failure by financial institutions to mitigate these risk management weaknesses.[41]

To begin with, it is widely accepted that the recent financial turmoil was an accident waiting to happen.[42] Before the outbreak of the crisis, there was great prosperity almost worldwide. In the USA, the economic boom was mainly fuelled by a large quantity of foreign savings being deposited in the major banks and financial institutions.[43] As a result, credit could be easily obtained by the Americans.[44] More loans to distribute meant more profit to generate. Along with low interest rates, the early part of the 2000s witnessed a surge in the housing market.[45] Among others, mortgages were also granted to borrowers with high probability of default in the repayment of their debt and, for this reason, were defined as subprime borrowers.[46] The subprime mortgage market was thus the segment of the US financial markets from which the crisis originated. Lending to subprime borrowers was poor lending not only because of the borrowers' riskiness but also because of the lenders' laxness in the appraisal of the borrowers' capacity to repay.[47] To put it more simply, lenders were not incentivised to perform adequate controls. This was due to a number of reasons. Firstly, there was the wrong assumption that house prices would continue to increase and thus liquidity would remain available for everyone. Secondly, banks and other financial institutions

41 The President's Working Group on Financial Market Developments, 'Policy Statement on Financial Market Developments', March 2008, available at:<www.treasury.gov/resource-center/fin-mkts/Documents/pwgpolicystatemktturmoil_03122008.pdf>, accessed on 21 July 2013.

42 C.A.E. Goodhart, 'The Background to the 2007 Financial Crisis', *International Economics and Economic Policy*, Vol. 4, No. 4, 2008, pp. 331-346.

43 B.S. Bernanke, 'Four Questions about the Financial Crisis', Morehouse College, Atlanta, Georgia, April 2009.

44 P. Krugman, 'Revenge of the Glut', *The New York Times*, March 2009.

45 J. Holt, 'A Summary of the Primary Causes of the Housing Bubble and the Resulting Credit Crisis: A Non Technical Paper', *The Journal of Business Inquiry*, Vol. 8, No. 1, 2009, pp. 120-129.

46 Subprime mortgages were issued as adjustable rate mortgages (ARM), that is, with a fixed interest rate for two or three years followed by a higher rate; *see* R.W. Kolb, *The Financial Crisis of Our Time*, Financial Management Association Survey and Synthesis Series, New York, Oxford University Press 2011, p. 53.

47 US Financial Crisis Inquiry Commission, *The Financial Crisis Inquiry Report*, 2011, available at: <http://fcic-static.law.stanford.edu/cdn_media/fcic-reports/fcic_final_report_full.pdf>, accessed on 10 August 2013.

had the possibility of getting rid of the risk inherent to the subprime mortgages they originated through securitization techniques.

Generally speaking, if lenders keep the loans they originate until maturity, they will bear the loss in the event of a borrower's default. On the other hand, if they sell them, the risk shifts to the buyer. Putting things into a securitization perspective, the process can be simplified as follows. In the crisis context, banks or mortgage companies sold the subprime loans they originated to other financial institutions or government-sponsored entities (GSE).[48] These pooled the loans and sold them as securities called mortgage-backed securities (MBS) to institutional investors worldwide. MBS are financial products whose value derives from the underlined pool of mortgages.[49] In practice, MBS purchasers do not buy the mortgage but a promise to receive the return that the pool of loans will generate. In other words, when borrowers pay monthly part of their debt and the interest rate, that money will pass through to the MBS investors.[50] These will ultimately bear the borrowers' risk of default.

There is nothing illegitimate in these techniques which allow to move and distribute the risk from the originators to others, as long as they are conducted responsibly. However, seen from the crisis angle, such practices explain why lenders granted mortgages so easily, in particular, to subprime borrowers. They knew that they would finally transfer the risk of default to others. Undoubtedly, the risk taken was not managed and distributed properly, if only because the financial products resulting from the securitization process were backed by risky subprime mortgages. Furthermore, MBS were mixed with other safer and stable instruments to create more complex and risky products, the so-called collateralised debt obligations (CDOs).[51] Again, these products were bought by institutional investors worldwide. CRAs were actively involved in the process.[52] They underestimated the risk associated with a large quantity of structured products backed by risky

48 These were Fannie Mae, Freddie Mac, and Ginnie Mae, *see* K. Brandlie, 'Promoting Homeownership in the United States: The Rise and Fall of Fannie Mae and Freddie Mac', University of Iowa, College of Law, Center for International Finance and Development, April 2011, p. 4.

49 A.B. Ashcraft & T. Schuermann, 'Understanding the Securitization of Subprime Mortgage Credit', *Federal Reserve Bank of New York Staff Report*, No. 318, 2008.

50 G. Walden, 'Make More with Mortgage Backed Securities', excerpt from, *If Not Stocks, What?*, New York, London, McGraw-Hill 2004, available at: <www. allstarstocks. com/ gpage1. html>, accessed on 13 August 2013.

51 Before the outbreak of the financial crisis, the subprime market was worth $500bn. Up to a quarter of this ($125bn) was estimated to go into a default. This 'bad' debt was mixed with safe and stable instruments through structured finance techniques. Consequently, the financial products resulting from the process were toxic because they were infected by 'bad' debts which nevertheless infected the structured finance market, *see* G.A. Walker, 'Credit Crisis, Bretton Woods II and a New Global Response: pt 2', *Butterworths Journal of International Banking and Financial Law*, Vol. 24, No. 2, January 2009, pp. 77-84.

52 C.M. Mulligan, 'From AAA to F: How the Credit Rating Agencies Failed America and What Can Be Done to Protect Investors', *Boston College Law Review*, Vol. 50, No. 4, 2009; L.J. White, 'The Credit Rating Agencies: Understanding Their Central Role in the Sub-Prime Debacle of 2007-2008', Stern School of Business, 2009.

subprime mortgages.[53] Their rating methodologies proved to be inadequate in relation to the complexity of the rated products.[54] Besides, CRAs were accused of inflating the structured product rating because of conflict of interest with the issuers.[55] Regulators could have helped to prevent these practices if they had exercised tougher prudential supervision on financial intermediaries and institutions.

However, the chain was soon broken. In the third quarter of 2006, when interest rates were raised, house prices began plummeting in the USA. As a result, borrowers' default increased exponentially.[56] Large financial institutions which invested in MBS or CDO products experienced huge liquidity problems. Due to the interconnection of financial markets, the crisis spread worldwide. From a subprime crisis, it developed into a liquidity crisis which finally ended up in a global recession in 2009.[57] As explained, the debacle was caused by the interplay of several actors. The US Financial Crisis Inquiry Commission aptly summed up the issue:

> [T]he crisis was the result of human action and inaction, not of Mother Nature or computer models gone haywire. The captains of finance and the public stewards of our financial system ignored warnings and failed to question, understand, and manage evolving risks within a system essential to the well-being of the American public. Theirs was a big miss, not a stumble. While the business cycle cannot be repealed, a crisis of this magnitude need not have occurred.[58]

Investors paid a high price. As purchasers of 'toxic' products, they suffered significant losses once the products declined in value. Due to the high level of sophistication and complexity, it was hard for investors to have a proper understanding of the type and risk characteristics of the structured products they were buying.[59] In fact, potential buyers need to understand the credit risk of the underlining

53 C.A. Hill, 'Why Did Rating Agencies Do Such a Bad Job Rating Sub-Prime Securities?', *University of Pittsburgh Law Review*, No. 20, 2010, pp. 10-18.

54 H. McVea, 'Credit Rating Agencies, the Subprime Mortgage Debacle and Global Governance: The EU Strikes Back', *International and Comparative Law Quarterly*, No. 59, 2010, pp. 701-730.

55 *Ibid.*, as to conflict of interest, the author underlines that: "with many institutions embedding ratings within their operating procedures, or with minimum ratings thresholds contained within investment mandates, issuers were heavily reliant on ratings to maximize the pool of potential purchasers of their securities. As a result, there was pressure on issuers to secure, and an incentive for rating agencies to award, over-inflated ratings".

56 *See* 'President's Bush Speech to the Nation on the Economic Crisis', *The New York Times*, September 2008, transcript available at: <www.nytimes.com/2008/09/24/business/economy/24text-bush.html?_r=2&pagewanted=1&oref=slogin>, accessed on 20 August 2013.

57 Walker 2009.

58 US Financial Crisis Inquiry Commission, *supra* note 47.

59 Opacity was due to the concentration of RMBSs into CDOs and combination of them with derivative products such as credit default swap (CDS). In addition, more subprime loans were repackaged, co-mingled with other securities, and sold worldwide, *see* B.I. Jacobs, 'Tumbling Tower of Babel: Subprime Securitization and the Credit Crisis', *Financial Analyst Journal*, CFA Institute, March/April 2009, pp. 17-27.

assets, the legal structure, and the process according to which a structured product is created.[60] High product complexity and the inadequacy of investors to have the resources and expertise to conduct a proper product analysis made them overreliant on the information provided by the CRAs. Their overreliance was summarised as follows: "Its [the structured product] AAA rated so it's safe, valuable, and liquid".[61]

This conduct can be seen from two different angles. On the one hand, it may denote investors' imprudence in that they took at face value the rating assigned to the structured products without performing any due diligence or credit assessment complementary to the credit ratings. On the other hand, individual due diligence and credit assessment were difficult even for the most prudent investor. This can be traced back not only to the products' complexity but also to the unavailability of sufficient information on them provided by issuers and distributors. Only later, at the outset of the crisis, did investors discover that the highly rated structured products they bought had liquidity characteristics which were different from traditional debt instruments. Above all, these products were 'toxic' because they were backed up by subprime mortgage bonds.[62]

C. European Post-Crisis Strategies to Restore Investors' Confidence: The Introduction of Plain Language

I. *The European Retail Financial Market: Characteristics and Products*

Risks have to be taken into account when investment decisions are made. During adverse market conditions, the exposure to losses is a natural consequence of the risks investors undertake.[63] However, the financial crisis revealed the extent to which sometimes the gravity of the risks investors undertake may not be fully perceived by them.[64] As seen in the years preceding the 2007-2009 financial crisis, investors did not have sufficient information on the type and risk characteristics of the structured products they purchased. This was also due to poor public disclosure by issuers and financial intermediaries.[65] Consequently, at the end of the crisis, authorities at the national, international, and regional levels discussed

60 M. Bennet, 'A Global Issuer Perspective on Structured Products', *The Euromoney International Debt Capital Markets Handbook*, 2013.

61 Committee of European Securities Regulators (CESR), *CESR's Second Report to the European Commission on the Compliance of Credit Rating Agencies with the IOSCO Code and the Role of Credit Rating Agencies in Structured Finance*, Ref: CESR/08-277, 2008.

62 International Organization of Securities Commissions (IOSCO), *Report of the Task Force on the Subprime Crisis-Final Report*, May 2008, available at: <www. iosco. org/ library/ pubdocs/ pdf/ IOSCOPD273.pdf>, accessed on 5 August 2013; *see* also K.M. Bianco, 'The Subprime Lending Crisis: Causes and Effects of the Mortgage Meltdown', *CCH Mortgage Compliance Guide and Bank Digest*, No. 6, 2008, pp. 2-21.

63 J. Glisovic & X. Reille, 'Microfinance Investors Adjust Strategy in Tougher Market Conditions', Consultative Group to Assist the Poors, October 2010, pp. 2-3.

64 Impact Assessment, *supra* note 2.

65 As highlighted in many post-crisis reports, where information was disclosed, this often happened in a not easily and usable accessible way, *see* Financial Stability Forum (FSF), *Report of the Financial Stability Forum on Enhancing Market and Institutional Resilience*, 2008.

appropriate strategies to restore investors' confidence in the soundness of markets, financial institutions, and financial products.[66] In the EU, regulators had to face a dramatic decline in the investors' trust in financial services. In particular, the financial crisis badly dented the investors' confidence in the products sold in the European retail financial market.[67]

Providing a definition of the retail financial market is not easy due to the wide variety of financial products being offered in that sector. To begin with, some background information is given about the buyers of retail financial products. A line must be drawn between institutional or professional investors and small, less sophisticated investors, also referred to as retail investors. Institutional investors hold resources, education, and investment experience, and, thus, they are supposed to be capable of making informed, independent investment decisions.[68] In contrast, small or less sophisticated investors do not have the resources, experience, and economies of scale to make informed investment decisions.[69] Information intermediaries such as CRAs are vital to this category, so that retail investors can be helped to have the information needed to evaluate the credit quality of the financial products they would like to invest in.

As already mentioned, many products are exchanged in the retail financial market. These products facilitate retail investors' access to financial markets and are considered essential for efficient capital markets which, in turn, help fund EU economic growth.[70] Even though the retail financial market is characterised by different types of products, these instruments are all defined as packaged retail investment products (PRIPs). PRIPs are investment products marketed directly to retail customers. To better understand these products, the terms 'investment' and 'product' should be analyzed separately.

Firstly, as investments, they expose potential buyers to risks: the investor provides capital and expects returns on this capital.[71] Secondly, as products, PRIPs are manufactured by financial service intermediaries to take different legal forms, so that they can be offered across different industry sectors and satisfy specific investment goals.[72] Their manufacture makes the products different from each other, and, therefore, retail investors can choose among several investment options. Despite different characteristics, PRIPs serve the same purpose, that is to say, providing retail investors with the prospect of capital accumulation over the medium long term.[73]

66 M. Dailami & P.R. Masson, 'Measures of Investors and Consumer Confidence and Policy Actions in the Current Crisis', *The World Bank PRWP*, No. 5007, July 2009, pp. 7-9.

67 European Investors Working Group, 'Restoring Investor Confidence in European Capital Market', *Final Report*, 2nd edn., March 2010.

68 C.E. Fletcher III, 'Sophisticated Investor under the Federal Securities Law', *Duke Law Journal*, No. 6, December 1988, pp. 1085-1147.

69 *Ibid.*

70 Communication, *supra* note 5.

71 Commission Staff Working Document Impact Assessment Accompanying the Document Proposal for a Regulation of the European Parliament and of the Council on Key Information Documents for Investment Products, SWD (2012) 187, Brussels, 2012.

72 *Ibid.*

73 *Ibid.*

Having clarified these aspects, the key types of PRIPs identified in the retail financial market are (1) funds, (2) investment packaged as life insurance policies, (3) retail structured products, and (4) structured term deposits.[74] It is estimated that up to € 10 trillion was invested at the end of 2007 in different types of retail investment products such as investment funds, structured securities, unit-linked life insurance policies, and structured term deposit. However, at the end of 2008, asset write-downs and investor withdrawals caused a significant decline in assets invested in these products, from € 10 to € 8 trillion.[75] Hence, restoring investors confidence and promoting effective retail engagement with the financial markets are among the most important objectives on the European institutions' agenda.

II. Disclosing More Information on Financial Products: The First Step

When retail investors decide to invest in products that address capital accumulation needs, PRIPs are the type of instruments that financial intermediaries or product manufacturers propose to them. PRIPs are complex products, and the high level of sophistication which characterises them increases the information asymmetries between investors and distributors.[76] Retail investors encounter several difficulties in understanding how a PRIP works and what risks it carries so that it is hard for them to make informed, independent investment decisions. To this end, the work of information intermediaries, such as CRAs, is fundamental but not exclusive. Their work should be regarded as complementary and not as the substitute for the investors' duty to perform their own due diligence and credit assessment.[77] Investors remain ultimately responsible for their investment decisions. The financial crisis brought to attention these issues since retail investors lost money through investments carrying risks which were not sufficiently transparent or gauged by them. Therefore, the problem lies in how to effectively enhance retail investors' financial literacy, meant as "the capability of consumers and small business owners to understand retail financial products with the view to making informed investment decisions".[78]

Public authorities have sought solutions to this problem by promoting financial education, improving the regulation of the products and of those financial institutions that originate and distribute them, strengthening the control on the process through which products are sold or advised on, and requiring more disclosure on the characteristics of the products which will be proposed to retail investors.[79] This last requirement is central to the present analysis.

74 This list is provisional since new investment products are constantly emerging, *see* Communication, *supra* note 5.

75 Retail Financial Services Report, Special Eurobarometer 373, 2012, available at: <http://ec.europa.eu/public_opinion/archives/ebs/ebs_373_en.pdf>, accessed on 26 August 2013.

76 Communication, *supra* note 5.

77 Moody's Investors Service Inc, 'Rating Symbol and Definitions', September 2013, available at: <www.moodys.com/researchdocumentcontentpage.aspx?docid=PBC_79004>, accessed on 13 January 2014.

78 Invitation to tender no. MARKT/2006/26/H, Annex I, available at: <http://ec.europa.eu/dgs/information_society/evaluation/data/pdf/studies/s2008_03/ts.pdf>, accessed on 26 August 2013.

79 Impact Assessment, *supra* note 71.

1. *Ensuring Investors' Understanding of Information Through the Use of Plain Language: The Second Step*

Compelling firms to disclose more information on the characteristics of the products offered in the retail investment market was one of the main zeitgeists within the post-crisis regulatory debate.[80] Providing more information is vital to enable small, less sophisticated investors to understand the specificities of the products they want to buy, how they work, and the risks they carry. To put it more simply, the more the information they have, the more they can take independent investment decisions.

In the PRIP market, where complex, highly sophisticated products are exchanged, requiring more disclosure as well as specifying which piece of information has to be disclosed is a necessary step to enhancing the investors' understanding of their potential investments. However, more disclosure, per se, is not the panacea.[81] Problems are not only related to the quantity and quality of the information to be disclosed but also to the way details are disclosed. In essence, one can disclose the most important piece of information, and yet it may remain incomprehensible because it has not been communicated clearly. Consequently, 'what' you disclose cannot be disjointed from 'how' you disclose. This interplay is crucial in the PRIP market. Disclosure of key details concerning the specificities and risk of PRIPs is required, but, where retail investors are still unable to comprehend what is being proposed, 'more disclosure' will remain an abstract watchword.

Existing disclosure requirements for PRIPs provide evidence that simply requiring firms to disclose more information does not serve the purpose of making retail investors better equipped in their financial decisions. In fact, it has been argued that documents (contractual and pre-contractual) for retail investors were written using jargon that was comprehensible only to professional counterparts rather to an average reader.[82] Financial concepts were expressed in an overly technical language which did not facilitate any comparison with the information in other products.[83] Furthermore, retail investors complained about the impossibility of identifying key information because documents were overloaded with details so that it was hard to pinpoint essential details.[84] What is more, disclo-

80 FSF 2008, pp. 22-30.

81 F. Hache, 'Towards Suitable Investment Decisions? Improving Information Disclosure for Retail Investors. A position Paper on Key Information Disclosure for Investment Products', *Finance Watch*, 2012. According to the author, improving disclosure alone is not enough to protect retail investors because: (a) retail investors exhibit a low level of financial literacy; (b) many financial advisors do not understand all the risks involved in the products that they sell, while there is evidence that retail investors rely heavily on advice; (c) behavioural economic shows that investors are more influenced by psychological than informational factors; and (d) understanding how a financial product works is different than being able to assess the risks it carries.

82 *See* N. Charter, S. Huck & R. Inderst, 'Consumer Decision-Making in Retail Investment Services: A Behavioural Economic Perspective', *Final Report*, No. 8, 2010, available at: <http://ec.europa.eu/consumers/strategy/docs/final_report_en.pdf>, accessed on 28 August 2013.

83 *Ibid.*

84 Financial Service Authority (FSA), 'Investment Disclosure Research', *Research Report Prepared for the FSA by IFF Research LtD*, March 2006.

sures were mainly concerned with reducing legal risk for the manufacturer of the PRIPs, rather than providing an effective communication about the product in a form that the potential investors were able to understand and use.[85]

All things considered, disclosed information on PRIPs must be transparent to be comprehensible and enable retail investors to make informed investment decisions. Adequate transparency, in turn, is guaranteed through a language which is not too technical and full of financial jargon. To this end, as Sloan underlines:

> [D]isclosure is when you bury information in widely separated places in a 400-word document filled with small type. Transparency is when you tell people what they need to know in simple terms in readable type on the cover of a document or within the first few pages.[86]

To achieve the goal of restoring confidence in the European retail financial market and, above all, to enable investors to make informed investment decisions, the use of plain language may be the key instrument through which 'more disclosure' can be workable in practice.

2. Plain Language Is Necessary: The Case of KIIDs

The European Commission (Commission) has understood that plain language is a necessary tool to guarantee adequate transparency in the disclosure of information relating to PRIPs. Specifically, plain language is to be utilised in the Key Information Investment Document (KIIDs) for PRIPs.

KIIDs are pre-contractual documents providing information with regard to the characteristics and risks of the products being traded in the retail investment market.[87] In 2009, KIIDs were introduced as information document under Directive 2009/65/EC relating to undertakings for collective investment in transferable securities (UCITS IV).[88] One of the most innovative features of the UCITS KIIDs was the requirement to write them in plain language. In fact, the aim was to shorten, streamline, and focus information to the greatest extent possible and ensure comprehensibility of information to the average retail investors.[89] To this end, the use of plain language was regarded as essential.

Consistent with the post-crisis drive to provide clearer information to investors about the financial products, the Commission addressed the possibility of extending the introduction of KIIDs to all retail products classified as PRIPs. The purpose was again to enable European retail investors to receive short, comparable, and standardised information written in plain language for all types of products on offer. Currently, the Commission has formulated its proposal for a regula-

85 Impact Assessment, *supra* note 71.

86 *See* <http://blog.smu.edu/maguireethics/2011/11/01/the-difference-in-transparency-and-disclosure-from-allan-sloan-of-fortune/>, accessed on 28 August 2013.

87 CICERO, 'European Commission Proposal for a Regulation on Packaged Retail Investment Product', *A Cicero Consulting Special Report*, July 2012, pp. 3-13.

88 Under UCITS IV, KIIDs were introduced with a view to replacing the simplified prospectus which has failed to provide clear and simple investment information to investors.

89 OJ L 302, 17.11.2009, 32.

tion of KIIDs for PRIPs.[90] KIIDs developed for UCITS are the base on which the KIIDs for PRIPs are to be elaborated and finalised in future regulation. At the present stage of development of the new EU regulation, the main features of the KIIDs for PRIPs can be summarised as follows. KIIDs are mandatory, that is, they must be provided to retail investors, not offered. Providers can be either the manufacturer in case of direct sale or the distributor before an investment decision is taken. The responsibility to draft and present the KIIDs is on the manufacturers of the products.[91] The meaning of the term manufacturers is twofold: it is referred not only to those who produce an investment product but also to those who alter the risk or cost structure of an existing investment product in such a way that the product can be considered as remanufactured.[92]

The essential elements of the investment product to be described in the KIIDs are then clearly spelt out in the proposal: the type of product and its manufacturer; the nature and the main features of the product, including whether the investors might lose capital; its risk and reward profile; and the costs and past performance as appropriate.[93] Moreover, the Commission recommended that the document must include minimum essential information so as to avoid KIIDs being too complicated for retail investors. The Commission encouraged a standardised 'look and feel' of the KIIDs through a common format with contents designed to keep investors focussed on key information and facilitate the comparability between different investment products.[94] Finally, information is to be communicated in plain language. Accordingly, the requirement of plain language is satisfied when the document is written in a concise style which avoids financial jargon and technical language so that it can be understandable to the average retail investor.[95] The proposed format and, above all, the use of plain language are regarded as adequate tools to help investors undertake informed investment decisions. Also, through pre-contractual documents written in a simple language, investors should be able to use the credit risk assessment services provided by other intermediaries only as a source of information complementary to their own analysis, rather than as an exclusive source.

D. Promoting and Guaranteeing an Effective Use of Plain Language in the Financial Context

As mentioned earlier, plain language was first introduced as a requirement for KIIDs related to UCITS products. Through the illustrated proposal, the Commission aims to extend KIIDS and to promote the use of plain language to all the other products traded in the retail financial market. At the time of writing, the regulation has not yet been finalised. However, plain language is now an essential

90 Art. 5 of the Commission Proposal.
91 Arts 12 to 13.
92 Art. 4.
93 Art. 8(b).
94 Arts 6 to 11.
95 Art. 6(b).

requirement. This will remain a key component of the final version of the regulation of KIIDs for PRIPs as it will result from the trialogue between the Commission, the European Parliament (EP), and the Council of the European Union (CE).

The use of plain language as a tool to guarantee transparency in the disclosure of information on PRIPs is worth considering in greater detail. Plain language will be of benefit to retail investors since they are no longer meant to struggle with complex financial language which is full of jargon and technical words. Simple language will enhance their financial literacy so that they should be able to make more informed and independent investment decisions. This is the rationale behind the introduction of plain language as a writing style for PRIPs pre-contractual documents.[96] The proposal makes it clear that issuers of PRIPs have the responsibility to draft the KIIDs using a simple language. This aspect is fundamental, as it raises the question of whether they have sufficient plain language knowledge. In practice, it is necessary to verify their ability to write KIIDs in plain language and identify any difficulties they may face in using plain language.

Referring to some surveys on the use of plain language for UCITS KIIDs can be of help in answering these questions.[97] Unfortunately, outcomes are all but encouraging. Recently, a survey looked into the use of plain language among KIIDs prepared by asset managers.[98] The survey examined 100 KIIDs from 29 asset managers based in four languages (English, French, German, and Italian).[99] The study highlighted that asset managers do not make proper use of plain language within their KIIDs. This is due to several reasons. Back in 2010, when the introduction of plain language in UCITS KIIDs started to be discussed as a necessary requirement, the Committee of European Securities Regulators (now replaced by the European Securities and Markets Authority (ESMA)) issued a set of guidelines. These should have helped asset managers draft and produce their KIIDs in a simple language.[100] However, the instructions relating to the use of plain language were not sufficiently clear. The survey revealed that most of the KIIDs which were drafted under the CESR guidelines were still a mixture of technical terms and jargon, simply written in short sentences.[101] Besides this, asset managers were found to apply the concept of plain language quite subjectively.[102]

These problems can be traced back to the fact that the section of the guidelines related to the use of plain language was too generic. To start with, a defini-

96 Proposal, *supra* note 4.

97 UCITS are allowed to continue using KIIDs in accordance with the Directive 2009/65/EC for five years from the entry into force of the future regulation on PRIPs KIIDs. Then, the provisions on KIIDs under Directive 2009/65/EC might be replaced or considered equivalent to the provisions of the future regulation on PRIPs KIIDs, *see* Art. 25 Commission Proposal.

98 The survey was jointly conducted by Kneip and Ebsylon.

99 C. Allen, 'KIIDs not being completely accurately, study shows', December 2011, available at: <www.investmenteurope.net/investment-europe/news/2132692/kiids-completed-accurately-study>, accessed on 17 January 2014.

100 CESR, 'CESR's Guide to Clear Language and Layout for the Key Investor Information Document', CESR/10/1320, December 2010.

101 Out of 100 KIIDs examined, 97 were found to use technical terms, while 87 of them used jargon, *see* B. Aboulian, 'KIIDs Fail on Use of Plain Language', *Financial Times*, December 2011.

102 *Ibid*.

tion of plain language is borrowed by Martin Cutt's definition in the Oxford Guide to Plain Language. Then, some suggestions on how to deal with jargon are listed as alternatives so that asset managers could choose the one they thought was most suitable.[103] When the guidelines were issued, it was not taken into consideration the possibility that asset managers might lack sufficient plain language literacy, that is, a proper understanding of what plain language is and the ability to apply it efficiently. On the whole, asset managers are aware that plain language is a requirement they have to comply with; on the other hand, they are not familiar with the use of plain language within the KIIDs. This is the main problem, and it will take time for them to become experienced in the use of that since they have always regarded themselves as an 'industry of jargon'[104]. Their failure ultimately stems from their inability to write the required details in plain language. Given this problem, the benefit of plain language might remain on paper. Retail investors risk dealing with short, descriptive documents but written in a language which is still too complex. This problem has been in relation to the UCITS KIIDs but should also be of concern in relation to the proposed extension of plain language to all other retail products.

E. Conclusions

The financial arena is an environment in which many different players interact with each other. The language of this context has always applied a high degree of technicality and jargon.[105] In the EU, the introduction of plain language as a mandatory requirement is a turnaround which nobody could have ever envisaged before the financial crisis. Important reforms are now under way in the European retail financial market through the requirement to use plain language in the explanatory documents related to PRIPs.

As illustrated, ensuring more disclosure on financial products was the post-crisis zeitgeist. This was considered a necessary step to improve investors' understanding of financial products and thus facilitate a sound investment decision. Disclosing more information, however, cannot be separated from the way details are communicated. To guarantee adequate transparency in the disclosure of financial information, plain language should be regarded as the instrument through which essential product details can be understood by investors. In the proposal for regulation on KIIDs, the Commission set out the structure, the content, and the style through which the pre-contractual documents have to be written. Issuers of PRIPs have to comply with these requirements. In particular, they will have to simplify their documents according to a style which will no longer be technical or full of financial jargon.

103 For instance, it is suggested to explain jargon in brackets after its use or to explain jargon in a footnote to the section or the page, *see* CESR's Guide 2010, Part. 2, pp. 6-7.

104 Aboulian 2011.

105 H. Wilson, 'How Financial Jargon Changed Over the Decade', December 2009, available at: <www.efinancialnews.com/story/2009-12-31/how-financial-jargon-changed-over-the-decade>, accessed on 17 January 2014.

As seen above with regard to the use of plain language in UCITS KIIDs, issuers are experiencing difficulties in their shift from an 'industry of jargon' to an 'industry of plain language'. Though restricted to the UCITS sector where the use of plain language is already effective, these problems may also be experienced in KIIDs which the future European regulation will introduce for PRIPs. Issuers' lack of capability to convey information in plain language should be of concern in relation to the goal of helping investors make informed investment decisions. Where documents are simplified in structure and contents but not in the language, this goal cannot be achieved. European institutions are therefore responsible for enhancing issuers' plain language literacy by improving existing guidelines. This will guarantee more uniformity in the application of plain language. Moreover, the subjectivity which seems to characterise the use of plain language in the KIIDs concerning UCITS products will be reduced.

All things considered, the overall strategy to facilitate retail investors' understanding of complex product and rebuild confidence in the retail market has to be based on a two-pronged approach: ensuring more transparent information on financial products through the use of plain language and improving issuers' education on plain language. This interplay is crucial so that transparency can be regarded as the watchword and plain language be at the heart of change.[106]

106 D. Burns, 'Financial Sector Reporting is about to Get Much Clearer', April 2011, available at: <www. write. co. nz/ Resources/ Plain+English+articles/ Financial+sector+reporting+is+about+to +get+much+clearer.html>, accessed on 22 January 2014.