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## Articles

# Should Japan Adopt a Plain Language Rule?\*

Susumu Miyazaki\*\*

### INTRODUCTION

Before the Securities and Exchange Commission (SEC) adopted the plain English rule in 1998, if individual investors had been asked whether they had ever read a prospectus prior to making an investment decision, many might have answered “no.”<sup>1</sup> Although prospectuses were then (and are still) important as tools that provide essential information to investors,<sup>2</sup> the SEC believed that, prior to adoption of the plain English rule, lay investors did not rely on prospectuses because they were incomprehensible.<sup>3</sup> Simply put, the complex and legalistic language kept lay-individual investors away from prospectuses; the plain English rule was codified in order to curb this tendency.<sup>4</sup> The question remains, however, whether the plain English rule accomplishes its goal of furthering disclosure of information to

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1. See *World Accounting Report*, THE FIN. TIMES, June 14, 1994, at 1.

2. See JAMES D. COX ET AL., SECURITIES REGULATION CASES AND MATERIALS 4 (3d ed. 2001).

3. HOMER KRIPKE, THE SEC AND CORPORATE DISCLOSURE: REGULATION IN SEARCH OF A PURPOSE 15 (1979).

4. Plain English Disclosure, 63 Fed. Reg. 6370 (Feb. 6, 1998).

lay investors, or whether there are ways to better achieve that goal. The purpose of this article is to examine precisely that question. Specifically, this article aims to demonstrate that the Japanese version of the plain English rule (the plain language rule) offers added investor protection by working together with other Japanese laws, and that the plain language rule alone does not sufficiently protect lay investors.

This article will accomplish this task by first discussing the historical background, structures, strengths and shortcomings of the plain English doctrine. This article will then outline Japan's current situation and its regulation regarding disclosure as an alternative solution. Finally, this article will discuss the new movement to introduce a plain language doctrine in Japan and the effects of the combination of current regulation and the plain language rule on the financial system.

## I. PLAIN ENGLISH DOCTRINE

### A. BACKGROUND

A prospectus is a document that details the nature, purpose, and risks of a security.<sup>5</sup> Through prospectuses, investors can achieve an understanding of their investment targets; thus, prospectuses are extremely important for investment decisions.<sup>6</sup> However, because of the technical terms traditionally used to write a prospectus, detailed prospectuses tend to be too difficult for lay-individual investors.<sup>7</sup> In order to narrow the gap between disclosure requirements and the need for clear, understandable prospectuses, the SEC devised and adopted the plain English rule in 1998.<sup>8</sup>

The plain English doctrine is not a new concept in the legal world.<sup>9</sup> Beginning with guidelines published in the mid 1940s

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5. Generally, a prospectus is defined as "[a] printed document that describes the main features of an enterprise . . . and that is distributed to prospective buyers or investors; esp., a written description of a securities offering." BLACK'S LAW DICTIONARY 1238 (7th ed. 1999).

6. See COX ET AL., *supra* note 2, at 5.

7. See Plain English Disclosure, 63 Fed. Reg. 6370 (Feb. 6, 1998).

8. The proposed plain English rule was released by the SEC on January 21, 1997. Plain English Disclosure, 62 Fed. Reg. 3152 (Jan. 21, 1997). On January 22, 1998, the Plain English Rule was codified at 17 C.F.R. § 230.421.

9. Andrew T. Serafin, *Kicking the Legalese Habit: The SEC's "Plain English Disclosure" Proposal*, 29 LOY. U. CHI. L.J. 681, 683 (1998); see also Michael G. Byers, *Eschew Obfuscation—The Merit of the SEC's Plain English Doctrine*, 31 U. MEM. L.

that were intended to make writing more understandable,<sup>10</sup> the preference for expression in simple, ordinary, and plain language began to take root.<sup>11</sup>

## B. HISTORY OF THE PLAIN ENGLISH DOCTRINE

Rudolph Flesch was one of the first intellectuals who promoted the importance of clear, understandable writing.<sup>12</sup> In 1946, Flesch published *The Art of Plain Talk*, and advocated that all types of writing should be clear and readable.<sup>13</sup> He devised both quantitative and qualitative formulas to measure readability, and insisted that writers consider the differences in ability to understand among readers due to their diverse backgrounds.<sup>14</sup>

The plain English doctrine began to be used during the 1950s, but was not widely applied to many types of legal writing until the 1960s.<sup>15</sup> In 1963, for instance, David Mellinkoff suggested ways to clarify “wordy,” “unclear,” “pompous,” and “dull” legalese.<sup>16</sup> In the 1970s, insurance policies written in complicated legalese led to significant social problems, a fact that further contributed to the use of plain English in legal writing.<sup>17</sup> During this period, consumer movements pushed for readable and understandable legal documents.<sup>18</sup> As a result of these movements, President Carter issued an executive order and became the first President to require that government regulations be written in plain English.<sup>19</sup>

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REV. 135, 138 (2000).

10. See generally RUDOLF FLESCH, *THE ART OF PLAIN TALK* (1946).

11. *Id.* at 2.

12. See Serafin, *supra* note 9, at 683.

13. See FLESCH, *supra* note 10, at 1.

14. RUDOLF FLESCH, *THE ART OF READABLE WRITING* 147-56 (1949); see also FLESCH, *supra* note 10, at xii. This formula determined readability with such quantitative elements as fewer words per sentence and fewer syllables per word. FLESCH, *supra* note 10, at 105. Flesch also devised a qualitative formula. *Id.* Flesch recommended that writers not use “rhythm,” “periodic sentences,” “rhetorical questions,” “metaphors without an explanation,” “contrasts without an explanation,” or “irony.” *Id.*

15. See Serafin, *supra* note 9, at 686-87.

16. *Id.* at 686 (citing DAVID MELLINKOFF, *THE LANGUAGE OF THE LAW* 24 (1963)).

17. See Kenneth B. Firtel, *Plain English: A Reappraisal of the Intended Audience of Disclosure under the Securities Act of 1933*, 72 S. CAL. L. REV. 851, 852 (1999). More than half of the states now have statutes which require insurance companies to simplify the language of their policies. *Id.*

18. *Id.*

19. *Id.* (referring to Exec. Order No. 12,044, 3 C.F.R. 152 (1978)).

### C. THE SEC'S VIEW OF DISCLOSURE

The SEC is of the opinion that one of the best ways to protect every investor is full disclosure of information.<sup>20</sup> The Securities Act of 1933, which regulates the SEC, arose as a result of securities fraud in the 1920s that was partially caused by misleading information and insufficient disclosure.<sup>21</sup> One of the objectives of this Act was to enable all investors to read and understand the prospectuses of their investment instruments and, thereby, to understand all material information about the issuer.<sup>22</sup> However, this expectation was far from realized, and the gap between difficulty of prospectuses and comprehension by lay-individual investors remained.<sup>23</sup>

### D. THE SEC AND THE PLAIN ENGLISH RULE

In the early 1990s, the SEC began to develop the plain English rule, but steps toward introducing this rule were not actually taken until 1996, when Arthur Levitt became chairman of the SEC.<sup>24</sup> Levitt's belief in the importance of investor education led to the introduction of the plain English rule.<sup>25</sup> In 1996, the SEC started a pilot program in which public companies used plain English for two disclosure documents: a mutual fund prospectus and a joint proxy statement.<sup>26</sup> This pilot program was a success. In particular, Bell Atlantic's experience demonstrated that even large companies listed on the New York Stock Exchange could successfully write documents in plain English.<sup>27</sup> This success promoted the utility of the plain English rule.<sup>28</sup>

In 1995, under Levitt's lead, the SEC established a task force to incorporate the principles of the plain English doctrine

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20. Plain English Disclosure, 62 Fed. Reg. 3152 (Jan. 21, 1997).

21. See COX ET AL., *supra* note 2, at 3-4.

22. *Id.* at 5.

23. See Byers, *supra* note 9, at 142-44 (discussing the finding of an SEC Task Force).

24. *Id.* at 141-42.

25. *Id.* at 142.

26. George Hathaway & Kathleen Gibson, *The Word from the Securities and Exchange Commission: Put it in Plain English*, 75 MICH. BUS. L. J. 1314 (1996).

27. Plain English Disclosure, 62 Fed. Reg. 3152, 3154 (Jan. 21, 1997). Bell Atlantic is currently Verizon communications. Verizon, *The History of Verizon Communications*, at <http://investor.verizon.com/profile/history/> (last visited Nov. 9, 2003). Verizon Communications (NYSE: VZ), formed by the merger of Bell Atlantic and GTE, is one of the world's leading providers of high-growth communications services. *Id.*

28. See Serafin, *supra* note 9, at 696.

into securities regulations.<sup>29</sup> This task force issued a report which recommended changing some of the SEC's regulations regarding the writing of, and disclosures in, prospectuses.<sup>30</sup> The SEC recognized that disclosure is not accomplished where investors lack understanding; prospectuses that contain convoluted language and thereby frustrate investor understanding do not provide proper disclosure.<sup>31</sup> The task force, therefore, recommended that the SEC "develop a 'plain English' introduction to the prospectus to enhance its readability for individual investors, eliminat[e] boilerplate 'legalese' and require[] a summary of key information."<sup>32</sup> As for disclosure of risk, the task force recommended that the SEC "clarify that disclosure regarding the risks of the offering pursuant to Item 503 of Regulation S-K must be set forth in full in the forepart of the prospectus and cannot be incorporated by reference from other filings or portions of the document."<sup>33</sup> The task force also recommended the inclusion of a summary, with common questions written without technical and legal jargon, to prevent the prospectus from becoming too lengthy.<sup>34</sup>

#### E. ADOPTION OF THE PLAIN ENGLISH RULE

Based on the activities of the task force, the SEC released a draft of the plain English rule in January 1997.<sup>35</sup> The proposal was highly controversial in the business world.<sup>36</sup> In particular, the following two concerns were typically raised by financial industries: first, using plain English made full disclosure less complete than it had been before; and second, an issuer's litigation risk would increase.<sup>37</sup> The SEC, citing Mellinkoff, countered the first concern in an official release: "[t]he disclosure obviously must be correct, but plain English often is more precise than the obscure and complex writing style that is prevalent in prospectuses, [even though] legal terms like 'hereafter,' 'herein-

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29. Byers, *supra* note 9, at 142.

30. U.S. SEC. & EXCH. COMM'N, REPORT OF THE TASK FORCE ON DISCLOSURE SIMPLIFICATION, available at <http://www.sec.gov/news/studies/smpl.htm> (Mar. 5, 1996).

31. *Id.*

32. *Id.*

33. *Id.*

34. *Id.*

35. Plain English Disclosure, 62 Fed. Reg. 3152 (Jan. 21, 1997).

36. See Byers, *supra* note 9, at 147-48.

37. *Id.* at 148-49.

after,' and 'herein' may give a legal flavor to writing."<sup>38</sup> The SEC argued that "[f]irst, the rule proposals do not reduce the substantive information that must be given to an investor; plain English does not mean leaving out anything important or material. Second, we know of no case that has held anyone liable under Section 11 for clearly disclosing material information to investors."<sup>39</sup> The SEC adopted the plain English rule on January 22, 1998.<sup>40</sup>

## F. CONTENTS OF THE PLAIN ENGLISH RULE

The plain English rule<sup>41</sup> is composed of four sections outlining elements of clear prospectuses. 17 C.F.R. § 230.421(b) and (d) give specific guidelines on how to express detailed information, while subsections (a) and (c) discuss conceptual matters.<sup>42</sup>

38. *Id.*; see also Plain English Disclosure, 62 Fed. Reg. 3152, 3155 (Jan. 21, 1997).

39. See Byers, *supra* note 9, at 149.

40. 17 C.F.R. § 230.421 (1998).

41. *Id.*

42. *Id.* This section of the regulation provides that:

(b) You must present the information in a prospectus in a clear, concise and understandable manner. You must prepare the prospectus using the following standards:

(1) Present information in clear, concise sections, paragraphs, and sentences. Whenever possible, use short, explanatory sentences and bullet lists;

(2) Use descriptive headings and subheadings;

(3) Avoid frequent reliance on glossaries or defined terms as the primary means of explaining information in the prospectus. Define terms in a glossary or other section of the document only if the meaning is unclear from the context. Use a glossary only if it facilitates understanding of the disclosure; and

(4) Avoid legal and highly technical business terminology.

17 C.F.R. § 230.421(b). A later section provides that:

(d)(1) To enhance the readability of the prospectus, you must use plain English principles in the organization, language, and design of the front and back cover pages, the summary, and the risk factors section.

(2) You must draft the language in these sections so that at a minimum it substantially complies with each of the following plain English writing principles:

(i) Short sentences;

(ii) Definite, concrete, everyday words;

(iii) Active voice;

The note to 17 C.F.R. § 230.421(b) provides examples of inappropriate expressions of information.<sup>43</sup>

In sum, 17 C.F.R. § 230.421(b)(1) and (2) tell issuers how to correctly present information, and 17 C.F.R. § 421(b)(3) and (4) and the note to 17 C.F.R. § 230.421(b) show types of disclosure that should be avoided.<sup>44</sup> Similarly, 17 C.F.R. § 230.421(d) shows the devices that make a prospectus more readable and understandable.<sup>45</sup> In particular, 17 C.F.R. § 230.421(d)(2) gives specific affirmative instruction to issuers.<sup>46</sup> The Instructions to 17 C.F.R. § 230.421 similarly provide guidance by referring issuers to the “Securities Act Release No. 33-7497 for information on plain English principles.”<sup>47</sup> In this release, the SEC gives detailed information about how to write a prospectus using 17 C.F.R. § 230.421(d).<sup>48</sup> According to this section, an issuer must “prepare the front portion of the prospectus in plain English” and “use plain English principles in the organization, language,

(iv) Tabular presentation or bullet lists for complex material, whenever possible;

(v) No legal jargon or highly technical business terms; and

(vi) No multiple negatives.

(3) In designing these sections or other sections of the prospectus, you may include pictures, logos, charts, graphs, or other design elements so long as the design is not misleading and the required information is clear. You are encouraged to use tables, schedules, charts and graphic illustrations of the results of operations, balance sheet, or other financial data that present the data in an understandable manner. Any presentation must be consistent with the financial statements and non-financial information in the prospectus. You must draw the graphs and charts to scale. Any information you provide must not be misleading.

17 C.F.R. § 230.421(d).

43. 17 C.F.R. § 230.421. The Note to § 230.421(b) prohibits the use of:

1. Legalistic or overly complex presentations that make the substance of the disclosure difficult to understand;

2. Vague “boilerplate” explanations that are imprecise and readily subject to different interpretations;

3. Complex information copied directly from legal documents without any clear and concise explanation of the provision(s); and

4. Disclosure repeated in different sections of the document that increases the size of the document but does not enhance the quality of the information.

44. 17 C.F.R. § 230.421(b).

45. 17 C.F.R. § 230.421(d).

46. See Plain English Disclosure, 63 Fed. Reg. 6370, 6371-72 (Feb. 6, 1998).

47. 17 C.F.R. § 230.421.

48. See Securities Act Release No. 33-7497.



and design of the front and back cover pages, the summary, and the risk factors section.”<sup>49</sup> Also, the SEC requests that issuers comply with the six basic principles enumerated in 17 C.F.R. § 230.421(d)(2).<sup>50</sup>

## II. THE STRENGTHS AND SHORTCOMINGS OF THE PLAIN ENGLISH DOCTRINE

### A. THE STRENGTHS OF THE PLAIN ENGLISH DOCTRINE

#### 1. *The Plain English Rule Makes Risks Clear*

17 C.F.R. § 230.421(d) requires issuers to use plain English in the risk factor section.<sup>51</sup> Plain English, rather than legalese or technical terms, enables lay investors to better understand the risks of investing in a security. For example, the *Morgan Stanley Dean Witter Balanced Growth Fund* prospectus, dated March 12, 2001, describes “principal risk.”<sup>52</sup> In the section, the prospectus indicates that “[t]here is no assurance that the Fund will achieve its investment objective. When you sell Fund shares, they may be worth less than what you paid for them and, accordingly, you can lose money investing in this Fund.”<sup>53</sup>

Each sentence in the Morgan Stanley prospectus is short, uses concrete, everyday words, and active voice.<sup>54</sup> The prospectus contains no legal jargon, no wordy sentences, and no multiple negatives, thereby conforming to the principles enumerated in at least 17 C.F.R. § 230.421(d)(2)(i), (ii), (iii), (v), and (vi).<sup>55</sup> In this prospectus, subsection (iv), which requires “[t]abular presentation or bullet lists for complex material, whenever possible,”

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49. See Plain English Disclosure, 63 Fed. Reg. 6370, 6371 (Feb. 6, 1998).

50. *Id.* The SEC requests that issuers “comply substantially with six basic principles . . . when drafting the language in these front parts of the prospectus.” *Id.* At the same time, as a general caution about writing a prospectus, this release says “[an issuer] must design the cover page, summary, and risk factors section to make them easy to read. [An issuer] must format the text and design the document to highlight important information for investors. The rule permits you to use pictures, charts, graphics, and other design features to make the prospectus easier to understand.” *Id.*

51. 17 C.F.R. § 230.421(d).

52. MORGAN STANLEY DEAN WITTER, BALANCED GROWTH FUND 2 (2001).

53. *Id.*

54. *Id.*

55. 17 C.F.R. § 230.421(d).

is used to show the relationship between interest rate and price, past performance, returns on each class, and the cost of the fund.<sup>56</sup> A reading of the entire "principle risk" section does not reveal any "legalese" expressions like those used in federal code. Also, since cautions appear in only one place, investors do not have to search through the entire prospectus to find all the risk factors. On the whole, the principles enumerated in 17 C.F.R. § 230.421(d)(2) are useful for making risks clear.

## 2. *The Plain English Rule Promotes Equal Information Sharing*

Fundamentally, the SEC believes that the best way to protect investors is full disclosure to every investor.<sup>57</sup> The prospectus plays an important role in such disclosure. However, even if the same prospectus is given to every investor, an investor's ability to read a prospectus and understand what it says will vary because the investment community includes both lay-individual investors who have no professional investment experience and professional investors who are trained to read prospectuses written in technical language. It is, however, difficult for lay-individual investors to read and understand such complex documents. If issuers continue to write prospectuses using difficult terms and jargon, lay investors will become increasingly reluctant to read them. In short, the more difficult a prospectus becomes, the larger the qualitative difference of information recognized by each investor becomes. Indeed, a significant reason to create the plain English rule was that many investors made investment decisions without reading the prospectus.<sup>58</sup>

The plain English rule establishes a standard for writing prospectuses that purports to close the gap of understanding between lay investors and professional investors.<sup>59</sup> If prospectuses are written in plain English, theoretically any investor can read and understand them. The SEC's intent was to ensure that every investor would have access to the same information before investing.<sup>60</sup>

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56. See MORGAN STANLEY DEAN WITTER, *supra* note 52, at 3-6.

57. See Plain English Disclosure Rule, 62 Fed. Reg. 3152 (Jan. 21, 1997).

58. *Id.* at 3153.

59. *Id.*

60. *Id.* (explaining that most written disclosures are too long and complicated to be of practical use to anyone other than a securities lawyer or expert investor).

### 3. *The Plain English Rule Helps To Provide Education To Investors*

The plain English rule can help to educate lay investors.<sup>61</sup> Many lay investors lack a substantial amount of knowledge regarding finance and investment.<sup>62</sup> Investors should, however, know about investment targets in financial markets because it is almost impossible for lay investors to make intelligent investment decisions without investment knowledge. Specifically it is important for investors to study "the issuer's financial condition, products and markets, management" and other important factors which may affect their investments because these factors are very important for assessing an investment target's risk and return.<sup>63</sup>

A situation in which every investor can read a prospectus and make an investment decision by himself is best for financial markets because it places investors on nearly equal footing.<sup>64</sup> Lay investors who make investment decisions without sufficient knowledge run the risk of buying securities that are overpriced or worthless.<sup>65</sup> Investors, then, may receive significant returns, but it is also likely that they will lose money.

If lay investors lose substantial sums of money, they may abandon their ventures in financial markets and deposit their money in neighborhood banks rather than spend it on high-risk gambling. This is undesirable not only for lay investors, but also for financial markets, because the growth of financial markets will slow without an influx of newcomers into markets.<sup>66</sup> The plain English rule can help to resolve this problem. If a prospectus is written in understandable language, lay investors can gather important information about securities and markets. Hence, in order to create "an informed layman," it is indispensable to write a prospectus in plain language.

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61. See Firtel, *supra* note 17, at 895-96; see also Byers, *supra* note 9, at 142.

62. See generally Homer Kripke, *The Myth of the Informed Layman*, 28 BUS. L.J. 631 (1973).

63. COX ET AL., *supra* note 2, at 1.

64. *Id.* at 5.

65. *Id.*

66. *Id.* at 1.

#### 4. *The Plain English Rule Enables Investors To Invest Without Assistance.*

The SEC has opined that where the prospectus is understandable, an investor need not necessarily be advised to seek advice from a financial advisor. The SEC theorizes:

that in the selection of investments from the numerous offerings of this very intricate merchandise, a simple readable prospectus on one company will enable the man in the street to make a wise choice between one company and the thousands of others about which no one may be telling him anything.<sup>67</sup>

It follows from this theory that all investors should be able to make investments without professional assistance, and each investor ought to be required to face the consequences of his investment decisions. Security fraud litigation will thus decrease because there is no middleman to blame.

### B. SHORTCOMINGS OF THE PLAIN ENGLISH RULE

#### 1. *Complex Concepts May Not Be Clear Even When Using Plain English*

Financial technologies are constantly evolving. For example, consider complicated mutual funds. These complicated mutual funds use futures and options transactions for hedging market risk and for leverage in promoting return; they make complicated investment decisions assisted by computers and investment theories using complicated pricing models such as the Black-Scholes model.<sup>68</sup>

It is possible that there are no plain English equivalents to explain such high-tech financial activities. Even if issuers could explain technical terms using plain English, there is no guarantee that they could explain the financial terms of the future. To explain complex terms, prospectuses will necessarily have to become lengthy. Even now, for example, Morgan Stanley Dean Witter uses more than 900 words to explain only two risk factors: foreign securities and how to make a portfolio.<sup>69</sup> Foreign

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67. Kripke, *supra* note 62, at 633.

68. See Black & Scholes, *The Pricing of Options and Corporate Liabilities*, 81 J. POL. ECON. 637 (1973).

69. MORGAN STANLEY DEAN WITTER, MORGAN STANLEY COMPETITIVE EDGE FUND "BEST IDEAS" PORTFOLIO 2 (2001).

securities include such factors as stock price volatility, liquidation risk, default risk, and currency risk<sup>70</sup>—issues which are difficult to explain in few words.

The SEC insists that the plain English doctrine does not diminish the amount of information an issuer is required to give to investors.<sup>71</sup> If this is true, the number of pages in prospectuses will continue to increase as technical jargon increases and becomes more complex. And the more pages the prospectus has, the less likely lay investors will read it in its entirety.

## *2. The Plain English Rule Creates A Double Standard For Lay Investors And For Professionals*

The SEC requires that issuers must “use plain English principles in the organization, language, and design of the front and back cover pages, the summary, and the risk factors section.”<sup>72</sup> Accordingly, issuers may ignore the plain English rule in all other sections of the prospectus.<sup>73</sup>

In unrestricted portions of the prospectus, the issuer may use the usual technical financial terms,<sup>74</sup> thus creating an imbalance between the amount of information imparted to lay-individual investors and the amount of information imparted to professionals. Professional investors are trained, after all, to read and understand the entire prospectus; lay individual investors are likely to understand only the parts written in plain English. The summary and risk factors are not the only information that investors should be able to understand in order to make wise investment decisions. Ideally, the issuer should use plain English throughout the prospectus, but, in doing so, the prospectus may become overwhelmingly lengthy. The directive that the front and back cover pages, the summary, and the risk factor sections be written in plain English seems to be a compromise for bridging the gap between the ideal of the plain English rule and the reality of how much lay investors are willing to read. However, it seems unfair that the professional investor can understand all the information while the lay individual investor may be able to understand only the simplified parts.

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70. *Id.*

71. *See* Plain English Disclosure Rule, 62 Fed. Reg. 3152, 3155 (Jan. 21, 1997).

72. *See* Plain English Disclosure Rule, 63 Fed. Reg. 6370, 6371 (Feb. 6, 1998).

73. *Id.*

74. *Id.*

### 3. *The Plain English Rule Robs Lay Investors Of The Opportunity To Use New Financial Technology*

When financial technology becomes too complex to explain using plain English, issuers are faced with tough decisions. In such situations, one solution to the problem is to avoid using such complicated financial technologies for lay-individual investors and reserve them for professional investors. Indeed, this tendency may be desirable for lay investors because such high-level financial technology may include unanticipated high risks. Avoiding use of complicated financial technologies, however, robs lay investors of investment opportunities. Even if the high-level financial technology is too complicated for the current investment environment, the complication may not always exist in the future. Some professional investors use new financial techniques when they first emerge, and later their use spreads over general financial products for individuals. However, this movement from professionals to individuals may shrink as a result of the plain English rule because of the possibility that issuers will oversimplify and mistranslate new financial techniques. Since this is undesirable for individual investors, new financial techniques, which could enhance individuals' investments, may not be used because of the imposition of the plain English rule.

### 4. *The Plain English Rule May Compromise The "Black-Box" Technique*

If emerging financial technologies become too complicated to explain using plain English, another alternative is to use a "Black-Box" technique, whereby explanations of complicated terms are omitted.<sup>75</sup> For example, a mutual fund which invests in several investment options like stocks, bonds, and currency, makes sophisticated investment decisions assisted by complex computer calculations.<sup>76</sup> The computer program decides how to allocate the fund to investment options.<sup>77</sup> Using sophisticated

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75. See, e.g., Interview by John Bollinger, Financial News Network Technical Analyst, with Lou Mendelsohn, President, Market Technologies Corp. (Sept. 5, 1986), at [http://www.day-trading-commodities.com/john\\_bollinger\\_library.asp](http://www.day-trading-commodities.com/john_bollinger_library.asp) (last visited Oct. 25, 2003) [hereinafter Mendelsohn Interview].

76. *Id.*

77. *Id.* See also FUJI INVESTMENT MANAGEMENT CO., LTD, FUJI GLOBAL BALANCE OPEN 2-3 (June 2003), at <http://www.mizuhobank.co.jp/saving/fund/info/e26311995.html> (last visited Oct. 17, 2003).

mathematical models, the computer decides on the prospect of each market as well as whether each investment option is overvalued.<sup>78</sup> Since it may be difficult to explain these processes in plain English, the issuer could limit the explanation as follows: “[i]n the process of making an investment decision, the front-computer model chooses the best portfolio.” Such an omission can be referred to as a “Black-Box” omission. Lay-individual investors may or may not be able to understand such complicated computer models, even if the prospectus could explain them in plain English. Additionally, professional investors may not understand what goes on inside the “Black-Box” because the explanation of the “Black-Box” mechanism does not appear in the prospectus. Moreover, once a loophole like the “Black-Box” option is adopted, such omissions may become rampant. When the prospectus deals with high-level financial terms, either exceedingly long explanations or excessive omissions are likely to occur.

### III. SECURITIES AND FINANCES IN JAPAN

In Japan, the same issue exists regarding how to bridge the gap between investor understanding and the difficulties of reading prospectuses.<sup>79</sup> In order to resolve this problem, Japan established the Law on Sales of Financial Products (LSFP), which imposes the burden of explaining material information about securities on financial product sellers or broker-dealers. The LSFP may be a more important tool in investor protection than the Japanese version of the plain English. This section will discuss the Japanese regulatory system; the market situation, and legal mechanisms, including the LSFP, will be discussed.

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78. See Mendelssohn Interview, *supra* note 77.

79. KINYU-CHO KINYU SEIDO SHINGIKAI KINYU BUNKAKAI DAI ICHI BUKAI [THE FINANCIAL SERVICES AGENCY OF JAPAN, THE FIRST SUBCOMMITTEE MEETING OF THE FINANCIAL SYSTEM COUNCIL] (Nov. 29, 2001) at [http://www.fsa.go.jp/singi/singi\\_kinyu/gijiroku/kinyu/dai/20011129\\_roku.html](http://www.fsa.go.jp/singi/singi_kinyu/gijiroku/kinyu/dai/20011129_roku.html) (last visited Mar. 5, 2002) [hereinafter First Subcommittee Meeting].

## A. SECURITIES REGULATORS IN JAPAN

### 1. *The Financial Service Agency*

In the United States, the SEC has extensive responsibilities in the administration of securities regulations.<sup>80</sup> The SEC's primary responsibilities include: 1) administering the disclosure requirements articulated in federal securities laws; 2) overseeing the operation of secondary trading markets; 3) administering the Investment Company Act and Investment Advisers Act; and 4) undertaking enforcement actions such as investigations and prosecutions.<sup>81</sup> In Japan, the Financial Service Agency (FSA) is responsible for such activities.<sup>82</sup> The FSA operates through four bureaus: the Planning and Coordination Bureau, the Inspection Bureau, the Supervisory Bureau, and the Executive Bureau;<sup>83</sup> it is primarily responsible for policymaking concerning financial systems and the securities market, as well as inspection and supervision of private-sector financial institutions.<sup>84</sup>

The establishment of the FSA was a complex process. Until 1998, the Ministry of Finance (MOF) carried out administration of securities regulations.<sup>85</sup> In the early 1990s, the opinion that

80. See COX ET AL., *supra* note 2, at 11.

81. *Id.*

82. FINANCIAL SERVICES AGENCY, FINANCIAL SERVICES AGENCY PAMPHLET 4 (2002), at [http://www.fsa.go.jp/info/infoe/pamphlet\\_e.pdf](http://www.fsa.go.jp/info/infoe/pamphlet_e.pdf) (last visited Apr. 3, 2002) [hereinafter PAMPHLET].

83. *Id.*

84. *Id.* at 4. The FSA is responsible for:

- 1) planning policymaking concerning financial system,
- 2) inspection and supervision of banks, securities companies, insurance companies and other private-sector financial institutions,
- 3) establishment of rules for trading in securities markets,
- 4) establishment of business accounting standards and other planning and policymaking concerning corporate finance,
- 5) supervision of certified public accountants and audit firms,
- 6) participation in activities on financial issues of international organizations and bilateral and multi-lateral financial discussions for furtherance of internationally harmonious financial administration, and
- 7) surveillance of compliance of rules governing securities markets.

*Id.*

85. JAPAN INSTITUTE FOR SECURITIES INFORMATION AND PUBLIC RELATIONS, INC., SHOKEN SHIJO 2001 [SECURITIES MARKET 2001] 55 (2000) [hereinafter SECURITIES MARKET 2001].



surveillance of financial institutions and planning of financial systems should be separated from the MOF became widespread.<sup>86</sup> In 1998, the Financial Supervisory Agency was established as an external organ of the Cabinet Office (then the Prime Minister's Office). The responsibilities for inspection and supervision of financial institutions and securities transactions were transferred from the MOF to the Financial Supervisory Agency.<sup>87</sup>

In 2000, the FSA was established as one of the reorganizations of the Financial Supervisory Agency.<sup>88</sup> The FSA took over the work of the Financial Supervisory Agency, and undertook the planning of financial systems.<sup>89</sup> With these reorganizations, the MOF lost all responsibility regarding securities regulations and financial system planning except for financial system stabilization planning;<sup>90</sup> the FSA became the main agency responsible for securities regulation.<sup>91</sup>

## 2. Local Finance Bureaus

A local finance bureau is an external organ of the MOF; its main responsibilities are oversight of budget execution, observation of companies' financial situations, and management of national properties.<sup>92</sup> The FSA also requires local finance bureaus to inspect securities registration documents and monitor securities transactions.<sup>93</sup> In fact, securities registration documents

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86. SHOKEN TORIHIKI TOU KANSHI IINKAI, SOSHIKI JIMUGAIYOU [THE SECURITIES AND EXCHANGE SURVEILLANCE COMMISSION, ORGANIZATIONS AND FUNCTIONS], at [http://www.fsa.go.jp/sesc/aboutsesc/about\\_work.htm](http://www.fsa.go.jp/sesc/aboutsesc/about_work.htm) (last visited Apr. 3, 2002).

87. See PAMPHLET, *supra* note 82. See also THE CABINET OFFICE, OVERVIEW OF THE CABINET OFFICE: "FORUM FOR KNOWLEDGE" FOR THE CABINET, available at <http://www8.cao.go.jp/naikakufufu/> (last visited Sept. 9, 2003). The Cabinet Office was established as an important pillar of the recent reform of the central government ministries and agencies in order to strengthen the Cabinet's functions. The Cabinet Office's main responsibilities are to: "[assist] the overall strategic functions of the Cabinet Secretariat, [carry] out planning and overall coordination regarding key Cabinet policy, and [engage] in administrative work deemed suitable for management by the Prime Minister from the standpoint of the government as a whole." *Id.* The FSA is one of the external organs of the Cabinet Office. *Id.*

88. See PAMPHLET, *supra* note 82, at 3.

89. *Id.*

90. *Id.*

91. *Id.*

92. THE MINISTRY OF FINANCE, ZAIMUSHO NO SHIGOTO [RESPONSIBILITIES OF THE MINISTRY OF FINANCE], at <http://www.mof.go.jp/mof/zaimusyod.htm> (last visited Apr. 10, 2002).

93. *Id.*

are still submitted to local finance bureaus<sup>94</sup> notwithstanding the fact that local finance bureaus ceased to have primary responsibility for regulating securities disclosure in 1998.<sup>95</sup>

### 3. *The Securities and Exchange Surveillance Commission*

In Japan, the agency for market oversight is the Securities and Exchange Surveillance Commission (SESC);<sup>96</sup> this agency is sometimes referred to as the Japanese version of the SEC.<sup>97</sup> The SESC was formally established in July of 1992,<sup>98</sup> by which time the creation of such an agency in Japan was long overdue.<sup>99</sup> In 1991 financial scandals, wherein several major securities companies compensated their customers for damages from the bear market, became a social problem.<sup>100</sup> The public demanded the establishment of inspections and monitoring systems over securities brokers and markets.<sup>101</sup> An advisory committee to the Prime Minister recommended that an inspections and surveillance commission be established and that the commission be independent from the supervisory function of the MOF.<sup>102</sup> Based on these recommendations, the SESC was formally established.<sup>103</sup> Organizationally, the SESC was within the MOF at the time of its establishment; now, it is within the FSA.<sup>104</sup>

There are significant differences between the SESC and the SEC. For example, unlike the SEC, the SESC does not have authority to make rules or to prosecute fraudulent transactions. The SESC can neither make rules, issue no-action letters, nor

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94. See Security and Exchange Law, Art. 5-1, translated in INTERNATIONAL SECURITIES REGULATION, BINDER 4, BOOKLET 2: JAPAN (Robert C. Rosen et al. eds., KenTsunematsu (sic) & Shuji Yanese trans., 2000) [hereinafter SEL].

95. SECURITIES AND EXCHANGE SURVEILLANCE COMMISSION, HISTORY AND FUNCTIONS (2001), at <http://www.fsa.go.jp/secsc/english/aboutsecsc01.htm> (last visited Apr. 3, 2002) [hereinafter SESC HISTORY AND FUNCTIONS].

96. *Id.* The SESC is located within the ambit of the FSA. *Id.*

97. *Shokenkensa—"Rule Genshyu" Tokyoku nimo hokosaki* [Securities Inspection: "Strict Observance of Rules" Authorities Also Attacked], NIHON KEIZAI SHIMBUN, Aug. 11, 2003, at [http://bizplus.nikkei.co.jp/colm/colCh.cfm?i=t\\_kawahigashi02](http://bizplus.nikkei.co.jp/colm/colCh.cfm?i=t_kawahigashi02) (last visited Oct. 16, 2003).

98. SESC HISTORY AND FUNCTIONS, *supra* note 95.

99. *Id.*

100. *Id.*

101. *Id.*

102. *Id.*

103. See SESC HISTORY AND FUNCTIONS, *supra* note 95.

104. *Id.*

examine securities registration documents, as the SEC does.<sup>105</sup> The SESC can inspect securities companies and survey financial markets.<sup>106</sup> Based on such inspections, the SESC can only recommend that the FSA take administrative disciplinary action against a securities broker for misconduct and file an accusation with the prosecutor.<sup>107</sup>

## B. THE CHANGING NATURE OF THE JAPANESE FINANCIAL MARKET

The character of Japanese financial markets is changing from a market designed only for professional investors to a market including many individual investors; as a result, individual investment options are becoming more diverse.<sup>108</sup> In order to keep up with such changes, the FSA of Japan has been charged with two tasks: developing investor protections and stimulating financial markets.<sup>109</sup>

The Japanese economy experienced a major stock and real estate boom in the late 1980s with the emergence of the so-called "bubble economy."<sup>110</sup> The balance of trade between the United States and Japan deteriorated because the dollar was strong under the Reagan administration.<sup>111</sup> In order to adjust the imbalance, the Japanese government and the Bank of Japan introduced the expansion of domestic demands by lowering interest rates, increasing the supply of money, and permitting the strengthening of the yen.<sup>112</sup> An unparalleled stock boom resulted, caused in part by the events listed above and in part by low oil prices.<sup>113</sup> In 1988, the total trade volume of the Tokyo Stock Exchange (TSE) exceeded that of the New York Stock Exchange (NYSE) and for the first time the TSE became the most

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105. *Id.*

106. *Id.*

107. *Id.*

108. FINANCIAL SERVICES AGENCY, OUTLINE OF THE PROGRAM FOR STRUCTURAL REFORM OF SECURITIES MARKETS, at <http://www.fsa.go.jp/news/newse/e20010808-2.html> (last visited Oct. 10, 2003).

109. See SECURITIES MARKET 2001, *supra* note 85, at 54.

110. Although there are a variety of definitions for "bubble economy," it is most often defined as a situation in which an expanding monetary economy distances itself from fundamental economic principles. See generally Geoffrey P. Miller, *The Decline of the Nation State and Its Effect on Const. & Int'l Economic Law: Contribution: The Role of a Central Bank in a Bubble Economy*, 18 CARDOZO L. REV. 1053 (1996).

111. See SECURITIES MARKET 2001, *supra* note 85, at 38, 43.

112. *Id.* at 31.

113. *Id.* at 31-32.

active market in the world.<sup>114</sup> In 1989, the total trade volume of the TSE was 2.431 trillion dollars, the total trade volume of the NYSE was 1.542 trillion dollars, and the total trade volume of the London Stock Exchange (LSE) was 477 billion dollars.<sup>115</sup>

Japan's "bubble economy," however, collapsed in 1990, after creating a formidable bear stock market.<sup>116</sup> The Nikkei Stock Average (Nikkei 225), which is a typical index showing movement of the TSE, was 38,130.00 yen in December, 1989, but declined to 15,790.15 yen in August, 1992.<sup>117</sup> The TSE lost about sixty percent of its value in just thirty-two months.

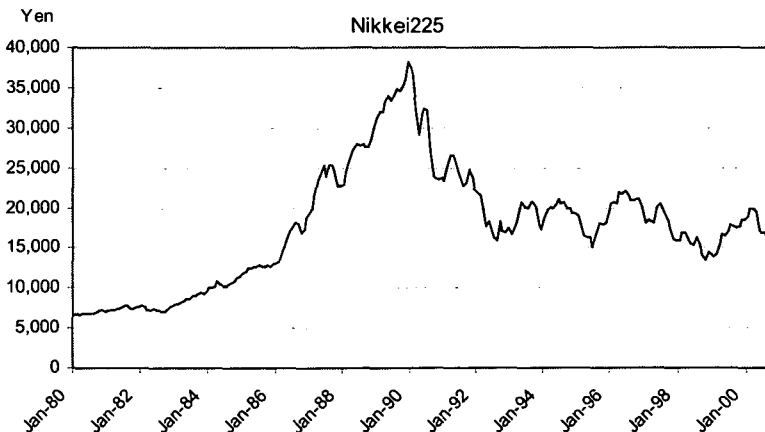
114. *Id.* at 183. See also TOKYO STOCK EXCHANGE, INC., SHUYO TORIHIKIO HIKAKU TOUKEI [INTERNATIONAL STATISTICAL COMPARISON AMONG MAJOR MARKETS] (2000) [hereinafter STATISTICAL COMPARISON].

115. *Id.*

116. THE ECONOMIC PLANNING AGENCY, NENJI KEIZAI HOUKOLU [ANNUAL REPORT REGARDING ECONOMY] (July 28, 1992), at <http://wp.cao.go.jp/zenburn/keizai/wp-je92/wp-je92-00101.html> (last visited Apr. 11, 2002) [hereinafter ANNUAL REPORT REGARDING ECONOMY]. "The Japanese economy strongly expanded from 1987, but its speed started to be reduced at the end of 1990, and it entered into a recession process in the latter part of 1991. . . ." *Id.*

117. NIHON KEIZAI SHIMBUN, CHARACTERISTICS OF THE NIKKEI STOCK AVERAGE, at [http://www.nni.nikkei.co.jp/FR/SERV/nikkei\\_indexes/nifaq225.html](http://www.nni.nikkei.co.jp/FR/SERV/nikkei_indexes/nifaq225.html) (last visited Sept. 13, 2003).

The Nikkei Stock Average is Japan's most widely watched index of stock market activity and has been calculated continuously since September 7, 1950. (Before that date, the Tokyo Stock Exchange calculated the Tokyo Stock Exchange Adjusted Average Stock Price, so index-based measurement of the market actually goes back to May 16, 1949.) The current calculation method, called the Dow Jones method, has been used since 1950. The 225 components of the Nikkei Stock Average are among the most actively traded issues on the first section of the TSE. The index reflects the ex-rights-adjusted average stock price.



This bear market brought financial crisis.<sup>118</sup> Several banks, loan companies, securities companies and life insurance companies started to go bankrupt in 1995 because of asset loss and lagging investment.<sup>119</sup> Citizens rapidly lost trust in the financial system and a tremendous volume of bad loans jeopardized other banks including large money center banks;<sup>120</sup> because of the faltering economy, a number of reforms were implemented.<sup>121</sup> However, many government officers and bank managers believed that the banking problems would resolve themselves once the economy started to recover.<sup>122</sup> Thus, the Japanese government continued to follow the traditional policy based on a philosophy in which an indirect financial system<sup>123</sup> is superior to a direct financial system<sup>124</sup> and did not research and implement a reform of the fundamental financial system until 1996.<sup>125</sup> The United States and the United Kingdom, on the other hand, spurred by competition with foreign markets because of increased investment through telecommunication technology, had already begun to reform their financial markets while Japan continued to struggle.<sup>126</sup> Since the differences in transaction fees and ease of transacting between the TSE and the NYSE became more marked as a result of these changes, high-level financial transactions began shifting out of the TSE into other financial markets. This was due to the fact that broker-dealers could cut transaction costs and issuers could cut issuance costs by leaving the TSE, which remained more expen-

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118. See SECURITIES MARKET 2001, *supra* note 85, at 44-45.

119. *Id.* at 45.

120. Editorial, MAINICHI SHIMBUN, Nov. 6, 2001, at <http://www.mainichi.co.jp/eye/shasetsu/200111/06-2.html> (last visited Oct. 13, 2003).

121. Brian A. Popper, *The Japanese Financial Reform of 1993: Will Reform Spark Innovation?*, 28 CORNELL INT'L L.J. 525 (1995).

122. See SECURITIES MARKET 2001, *supra* note 85, at 45.

123. See *id.* at 46.

124. See ANNUAL REPORT REGARDING ECONOMY, *supra* note 116. In the United States, in the eighteenth and nineteenth centuries, a lot of war bonds were issued, and a bond market that dealt with them was established. *Id.* Because this development of a bond market affected the establishment of the U.S. financial system, commercial banks did not have an important role in lending money to large companies. *Id.* However, in Japan, since the nineteenth century, banks had given long-term loans to companies. *Id.* Therefore, bond markets were not established until the 1970s. *Id.* Because of insufficient development of bond markets and strict regulation of bond issuance, it was difficult for companies to issue bonds for a long time. *Id.* As a result, in Japan, an indirect financial system has been superior to a direct financial system. *Id.*

125. See SECURITIES MARKET 2001, *supra* note 85, at 46.

126. *Id.*

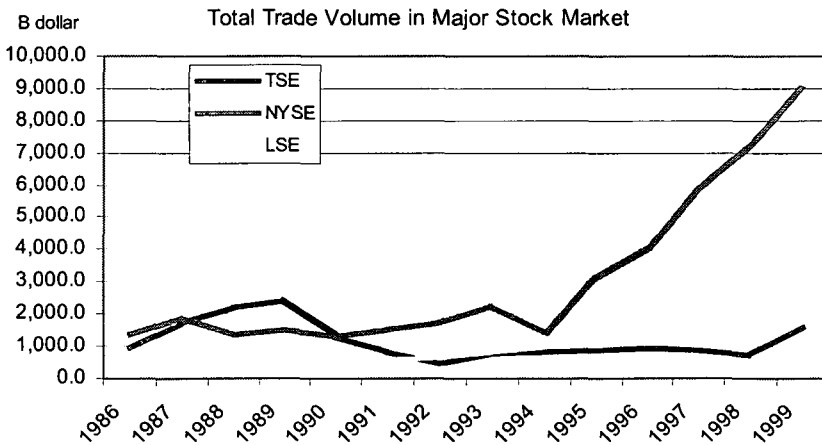
sive due to delay in reforming.<sup>127</sup> In 1996, the total trade volume of the TSE declined to 938 billion dollars; conversely, that of the NYSE increased to 4.063 trillion dollars, and that of the LSE increased to 1.389 trillion dollars.<sup>128</sup>

In November 1996, Ryutaro Hashimoto, then Prime Minister of Japan, initiated a financial market reform whose keywords were “free,” “fair,” and “global.”<sup>129</sup> The Hashimoto administration aimed to (i) increase investors’ investment options, (ii) promote competition among financial institutions, (iii) create an efficient financial market, and (iv) develop fair and transparent rules.<sup>130</sup> The administration aimed to reform not only the Japanese securities industry but also banks and the insurance industry.<sup>131</sup> This was a marked contrast to the United Kingdom, whose reform of financial markets was limited to only the securities industry.<sup>132</sup>

As a result of the aforementioned reforms, financial institutions began to produce many new types of financial products for companies and individuals,<sup>133</sup> the financial products available to

127. *Id.*

128. *Id.*



129. FINANCIAL SERVICE AGENCY OF JAPAN, JAPANESE BIG BANG, at [http://www.fsa.go.jp/p\\_mof/english/big-bang/ebb37.htm](http://www.fsa.go.jp/p_mof/english/big-bang/ebb37.htm) (last visited Sept. 13, 2003).

130. *Id.*

131. See SECURITIES MARKET 2001, *supra* note 85, at 47.

132. *Id.*

133. Minoru Komeda, *Kinyu Big Bang no Impact: Kigyo, Kakeibumon eno eikyowa doumiruka* [The Impact of the Financial Big Bang: How to View the Effect on Corporations and Household Economic Units], COLUMBUS, at <http://www.colum->

investors became more diversified and complicated.<sup>134</sup> At the same time, financial products for individuals and discounting of transaction costs attracted individual investors who had left Japanese financial markets because of the bear market.<sup>135</sup> The ratio of individual investors to the total trading volume of the TSE increased from 15.3% in 1998 to 29.1% in 1999.<sup>136</sup> This was the first increase since the collapse of the “bubble economy.” However, individual investor protection in Japan did not keep pace with the speed of the reform because deregulation and liberalization were implemented prior to the improvement of investor protection.<sup>137</sup>

Although the diversity and complexity of financial products had increased, sufficient investor protections were not in place, and dissonance between broker-dealers and customers increased.<sup>138</sup> The civil code and laws regulating financial institutions were, and are still, insufficient to protect investors against financial losses because the burden of proof in the civil code is too high for individual investors.<sup>139</sup> Under the civil code, plaintiffs bear the burden of proof of showing a causal relationship between the damage the plaintiff sustained and the financial product which the plaintiff has alleged caused the damage.<sup>140</sup> However, in many cases, time and financial constraints limit individual investors’ ability to establish this causal relationship. The National Assembly, recognizing this problem, passed the LSFP. Under the LSFP, the courts will presume a causal relationship between the defendant’s misleading explanation and the plaintiff’s financial damages upon a showing that the defendant’s explanation of the financial product was, in fact, misleading.<sup>141</sup>

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<http://www.columbus.or.jp/jyohooita/1/4.html> (last visited Oct. 16, 2003).

134. See SESC HISTORY AND FUNCTIONS, *supra* note 95.

135. *Kojintoushika Kabushikishiyoni Fukki Net Torihiki Seikyo [Individual Investors Return to the Stock Market: Net Trade Prosperity]*, ASAHI SHINBUN, July 8, 2003, at <http://www.asahi.com/money/kaisetsu/TKY200307080095.html> (last visited Oct. 8, 2003).

136. See SECURITIES MARKET 2001, *supra* note 85, at 182.

137. *Id.* at 54.

138. *Id.*

139. See THE FINANCIAL SERVICES AGENCY, KONO HOURITSU DE DOU KAWARUNO [THE EFFECTS OF THE LAW ON SALES OF FINANCIAL PRODUCTS], at [http://www.fsa.go.jp/notice/noticej/kinyuusyuhin\\_c.html](http://www.fsa.go.jp/notice/noticej/kinyuusyuhin_c.html) (last visited Oct. 27, 2003).

140. *Id.* See also Civil Code of Japan, Art. 709.

141. See THE FINANCIAL SERVICE AGENCY OF JAPAN, THE LAW ON SALES OF FINANCIAL PRODUCTS, available at [http://www.fsa.go.jp/rfer/others/law\\_e/law\\_002.pdf](http://www.fsa.go.jp/rfer/others/law_e/law_002.pdf) (last visited Mar. 17, 2001) [hereinafter LSFP]. Article 2-1 (xiii) of the LSFP provides: “[in this law, the “sale of a financial product” shall mean the] conduct

### C. CURRENT REGULATIONS

In Japan, the Security and Exchange Law (SEL) primarily regulates issuances and exchanges of securities.<sup>142</sup> In 1948, the SEL was established by merging several existing securities regulation rules. These rules introduced the following changes: the disclosure system to issuance markets, the periodic disclosure system to exchange markets, and a rule prohibiting fraudulent transactions in the United States.<sup>143</sup> Most securities regulations are covered by the SEL. The SEL does not define all detailed rules, but rather commissions the Cabinet Office to set such rules.<sup>144</sup> The Cabinet Office issues ordinances; the FSA ensures that these ordinances and the SEL are enforced.<sup>145</sup>

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stipulated by cabinet order as being similar to any of the conduct listed in the above subparagraphs.” *Id.* Article 5-1 of the LSFP provides:

Where a customer demands compensation from a financial product provider, etc. pursuant to Article 4, the amount of the compensation payable shall be presumed to be the amount of the loss of principal that the customer has incurred as a result of the failure of the financial product provider, etc. to explain an important matter.

*Id.* Article 5-2 of the LSFP provides:

As used in paragraph 5.1, “amount of the loss of principal” shall mean the amount that results from adding [a] the total amount of money that the customer (including a third person in the case where the customer instructs that a third person is to receive the money or a thing or right other than money from the sale of a financial product; hereinafter referred to in this paragraph as “customer, etc.”) received or is to receive in the sale of the financial product (in a case where there is a thing or right other than money that the customer, etc. received or is to receive from the sale of a financial product, the amount that results from adding to said total amount received, the total amount of the market prices of said things or rights other than money [if there is no market price, the estimated disposal price]) and [b] the total disposal price of the things or rights other than money that the customer, etc. acquired in the sale of the financial product and which the customer, etc. sold or otherwise disposed of, and then subtracting [c] the total amount of money that the customer paid or is to pay upon the conclusion of the sale of a financial product (in a case where the customer transferred or is to transfer a money equivalent upon the conclusion of the sale of a financial product, the amount that results from adding to said total amount paid, the total amount of the market prices of said money equivalents [if there is no market price, the estimated disposal prices]).

*Id.*; see also THE FINANCIAL SERVICE AGENCY OF JAPAN, OUTLINE OF THE LAW ON SALES OF FINANCIAL PRODUCTS 3, available at [http://www.fsa.go.jp/refer/others/law\\_e/law\\_001.pdf](http://www.fsa.go.jp/refer/others/law_e/law_001.pdf) (last visited Mar. 17, 2002) [hereinafter OUTLINE OF LSFP].

142. WATARU HORIGUCHI, SHOKENTORIHAKIHO HANDBOOK [HANDBOOK OF THE SECURITY AND EXCHANGE LAW] 3 (3d ed. 2000) [hereinafter SEL HANDBOOK].

143. *Id.*

144. *Id.*

145. See PAMPHLET, *supra* note 82, at 4.



### 1. Regulations Regarding Prospectuses

In Japan, a prospectus is defined by Article 2-10 of the SEL.<sup>146</sup> Article 13-1 prescribes when issuers are required to prepare prospectuses;<sup>147</sup> the “Ministerial Ordinance Concerning Disclosure with Respect to Specified Securities” (MO) contains the primary prescriptions for the contents of those prospectuses.<sup>148</sup>

146. See SEL, *supra* note 94, Art. 2-10. Article 2-10 provides:

[T]he term “prospectus” shall mean any document describing the business of the issuer of securities and the other matters which are prescribed by MOF which is furnished to the opposite parties for the purpose of the public offering or secondary distribution of such securities (other than those enumerated in Item (2) of Paragraph 1 of Article 4) or the solicitation from general investors of securities which were directed to qualified institutional investors as provided in Paragraph 2 of Article 4 (other than those falling within the category of a secondary distribution of securities).

*Id.*

147. See SEL, *supra* note 94, Art. 13-1. Article 13-1 provides:

The issuer of securities subject to the principal provisions of Paragraph 1 or 2 of Article 4 with respect to a public offering or secondary distribution of such securities shall prepare a prospectus in connection with such public offering or secondary distribution. The same shall apply to the issuer of securities subject to a secondary distribution (excluding the one whose total selling price is less than one hundred million yen (¥100,000,000) and those otherwise prescribed by MOF Ordinance) where disclosure is made (being a situation where disclosure is made as provided in Item (1) of Paragraph 1 of Article 4; hereinafter in this Chapter the same being applicable) (in the next Paragraph and Paragraph 2 of Article 15 referred to as “securities as to which disclosure is made”).

*Id.*

148. See Ministerial Ordinance Concerning Disclosure with Respect to Specified Securities, Art. 10, *translated in* INTERNATIONAL SECURITIES REGULATION, *supra* note 94 [hereinafter MO]. Article 10 of the MO provides that:

The issuer of specified securities intending to file a securities regulation statement pursuant to the provisions of Paragraph 1 of Article 5 of the [Securities and Exchange] Law shall prepare the following Items depending on the classification of the subject specified securities and file the same with the Director General etc.:

- (1) Domestic investment trust certificates – Form 4;
- (1-2) Foreign investment trust certificates – Form 4-2;
- (2) Beneficial certificates of foreign loans trusts – Form 5;
- (3) Domestic asset-backed securities – Form 5-2;
- (4) Foreign asset-backed securities – Form 5-3;
- (5) Beneficial interests of loans trusts – Form 6; and
- (6) Specified depositary receipts – with respect to each class of specified securities relating to the rights represented by the subject specified deposi-

The MO regulates not only prospectuses, but also securities registration documents. For example, Article 5-1 of the SEL provides:

Any issuer who proposes to effect a registration pursuant to the provision of Paragraph 1 or 2 of the preceding Article [which provides for registration of public offerings or secondary distributions] shall, if the issuer is a corporation, file with the Prime Minister, pursuant to the provision of Cabinet Office Ordinance, a securities regulation document containing matters enumerated in the following Items. . . .<sup>149</sup>

Article 10 of the MO delineates the contents of securities regulation documents and provides the forms which issuers must use when registering securities.<sup>150</sup> The MO does not regulate the contents of prospectuses directly.<sup>151</sup> If, however, issuers provide different information in their prospectuses than in their securities registration documents, these issuers may be sued under Article 13-5 of the SEL.<sup>152</sup> Thus prospectuses have been carbon copies of securities registration documents. Accordingly, until recently, prospectuses have been difficult for lay individual investors to understand.

There is a new movement to introduce a plain language rule to mutual fund prospectuses.<sup>153</sup> The FSA amended the MO to require prospectus issuers to make prospectuses easily understandable for lay investors; these amendments were effective as of April 1, 2002.<sup>154</sup> However, the SEL and the MO contain no detailed rules like 17 C.F.R. § 230.421(d), which provides examples issuers should use when they write prospectuses. The only existing detailed rules in Japan analogous to the U.S. plain English rule have been issued by the Investment Trust Association, Japan, an industry group of financial institutions dealing with investment trusts.<sup>155</sup> These rules, however, are self-regulatory.

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tary receipts, the form prescribed by the respective Item depending upon the class of securities enumerated in the preceding respective Items.

*Id.*

149. See SEL, *supra* note 94, at Art. 5-1.

150. See MO, *supra* note 148, at Art. 10.

151. *Id.*

152. See SEL, *supra* note 94, at Art. 13-5.

153. See discussion *infra* notes 167-89 and accompanying text.

154. THE FINANCIAL SERVICE AGENCY OF JAPAN, TOKUTEI YUKASHOKEN NO NAIYO TOU NO KAJI NI KANSURU NAIKAKUFUREI TOU NO KAISEIAN NO KOHYO NI TSUITE [ABOUT THE RELEASE OF THE DRAFT OF CABINET OFFICE ORDINANCE CONCERNING DISCLOSURE WITH RESPECT TO SPECIFIED SECURITIES] (Dec. 19, 2001), at <http://www.fsa.go.jp/news/newsj/13/syouken/f-20011219-1.html> (last visited Sept. 19, 2003) [hereinafter RELEASE OF DRAFT ORDINANCE PAMPHLET].

155. THE INVESTMENT TRUST ASSOCIATION, JAPAN, MOKUROMISHO NO SAKUSEI

## 2. *The Law on Sale of Financial Products*

Over the last five years, new financial products such as mutual funds, foreign currency deposits, and derivatives have become popular among lay investors in Japan. However, because of inexperience and insufficient knowledge about these instruments, it is difficult for lay investors to recognize the risks of such financial products. Moreover, sometimes the broker-dealers' explanations of the risks of such financial products are insufficient; as a result, conflicts between the broker-dealers and investors will occur.<sup>156</sup> The LSFP was established to address such conflicts between broker-dealers and investors; it took effect in April, 2001.<sup>157</sup> Article 1 of the LSFP indicates that:

[t]his law has the purpose of promoting the protection of customers and thereby contributing to the sound development of the national economy by prescribing the matters that financial product providers should explain to customers in the sale, etc., of financial products, by making financial product providers liable to customers for damages where the customer is harmed by the financial product provider's failure to explain such matters, and establishing measures for ensuring that solicitations made by financial product providers in connection with the sale of financial products are proper.<sup>158</sup>

According to the outline of the LSFP released by the FSA, the LSFP addresses two issues: the "clarification of information provision requirements of financial service providers [broker-dealers], and liability for damages caused by violation thereof."<sup>159</sup> The LSFP's range extends from deposits and trusts to insurance products and securities.<sup>160</sup> Broker-dealers who sell financial products regulated by the LSFP must provide material information such as "risk (if any) of loss of principal," "potential causes of loss," "limitation on the period for exercising rights" and "the period for rescission" to customers, unless the customer is a professional investor such as a broker-dealer or the cus-

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NI ATATTENO GAIDORAIN [GUIDELINES CONCERNING THE CREATION OF PROSPECTUSES] (2002), available at <http://www.toushin.or.jp/info/pubcome2.pdf> (last visited Oct. 10, 2003).

156. KINYU KOUHOU CHUO IINKAI, KINYU SHOUHIN HANBAIHOU [THE CENTRAL COUNCIL FOR FINANCIAL SERVICES INFORMATION, THE LAW ON SALES OF FINANCIAL PRODUCTS], at <http://www.saveinfo.or.jp/kinyu/hanbai/hanbaiho.html> (last visited Sept. 13, 2003).

157. See OUTLINE OF LSFP, *supra* note 141, at 3.

158. See LSFP, *supra* note 141, Art. 1.

159. See OUTLINE OF LSFP, *supra* note 141.

160. *Id.*

tomers “has expressed that he/she does not need provision of such information.”<sup>161</sup> If broker-dealers do not give customers such material information, broker-dealers will be liable for financial damages.<sup>162</sup>

The LSFP ensures appropriate solicitation by broker-dealers.<sup>163</sup> Broker-dealers must publicize a solicitation policy in order to make sure that broker/dealers promote their financial products in an appropriate manner.<sup>164</sup>

#### IV. APPLICATION OF THE PLAIN LANGUAGE RULE TO JAPAN

Japan established the LSFP, a law the United States does not have, to bridge the gap between the investor’s ability to understand prospectuses and the convoluted language of such documents. If Japan had a plain language rule in addition to the LSFP, how would it affect Japan’s investment environment?

##### A. NEW MOVEMENT TO INTRODUCE THE CONCEPT OF THE PLAIN LANGUAGE RULE

There is a movement in Japan to introduce the plain language rule into securities regulations. On November 29, 2001, the Financial System Council (FSC)<sup>165</sup> within the Financial Service Agency released a report titled “The Study Concerning Improvement of the Contents of a Mutual Fund’s Prospectus.”<sup>166</sup> In this report, the council demonstrated the need to amend the MO concerning the contents of a prospectus in order to make

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161. *Id.*

162. THE FINANCIAL SERVICE AGENCY OF JAPAN, OUTLINE OF THE BILL ON SALES OF FINANCIAL PRODUCTS, at [http://www.fsa.go.jp/p\\_mof/english/system/fs003.htm](http://www.fsa.go.jp/p_mof/english/system/fs003.htm) (last visited Sept. 8, 2003).

163. *Id.*

164. *Id.*

165. See FIRST SUBCOMMITTEE MEETING, *supra* note 79. The FSC is a research group that is composed of members from representatives in the private sector and academic researchers. *Id.* The Planning and Coordination Bureau of the FSA can submit deliberations by advisory organs to the FSC. *Id.* On the other hand, the FSC can return the result of deliberations from advisory organs. *Id.*

166. THE FIRST SUBCOMMITTEE OF FINANCIAL SYSTEM COUNCIL IN THE FINANCIAL SERVICE AGENCY, TOUCHISHINTAKU-MOKUROMISHO NO KISAINAIYO NO KAIZEN NI TUITENO KANNGAEKATA [THE STUDY CONCERNING IMPROVEMENT OF THE CONTENTS OF A MUTUAL FUND’S PROSPECTUS] (Nov. 29, 2001), at [http://www.fsa.go.jp/singi/singi\\_kinyu/siryu/kinyu/dai1/f-20011129a.pdf](http://www.fsa.go.jp/singi/singi_kinyu/siryu/kinyu/dai1/f-20011129a.pdf) (last visited Mar. 17, 2002) [hereinafter PROSPECTUS STUDY].

mutual fund prospectuses more understandable for investors.<sup>167</sup> In particular, the report indicates how to express the contents of prospectuses in three concrete ways: a) use of understandable expression and writing, b) improvement of the arrangement of the contents, and c) use of graphs and charts.<sup>168</sup> It is apparent that this study is based on the U.S. plain English rule.

Mutual fund prospectuses became the target of reform because mutual funds have become an increasingly popular investment instrument for lay individual investors.<sup>169</sup> After World War II, the policy of separating banking and securities businesses, such as the Glass-Steagall Banking Reform Act, was adapted to the Japanese financial system.<sup>170</sup> Previously, only securities companies could sell mutual funds; banks could not sell them because of strict regulations.<sup>171</sup> In December 1998, as part of the financial system reform, the ban on sales of mutual funds by banks was lifted; almost all banks immediately launched into the sale of mutual funds.<sup>172</sup> Since the number of customers and bank branches is much greater than the number of securities companies, the banks' success in selling these financial products exceeded expectations.<sup>173</sup> In fact, the mutual fund market share of banks was only six and three tenths percent. In 1999; it increased to twenty-two and sixth tenths percent in February 2002.<sup>174</sup> Since many bank customers have no

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167. *Id.* at 8.

168. *Id.* at 2.

169. *See id.* at 1.

170. *See* SECURITIES MARKET 2001, *supra* note 85, at 28.

171. *See* NOBUYUKI KINOSHITA, KAISEI GINKOU HOU [AMENDED BANKING LAW] 157 (1st ed. 1999).

172. *See* SECURITIES MARKET 2001, *supra* note 85, at 49.

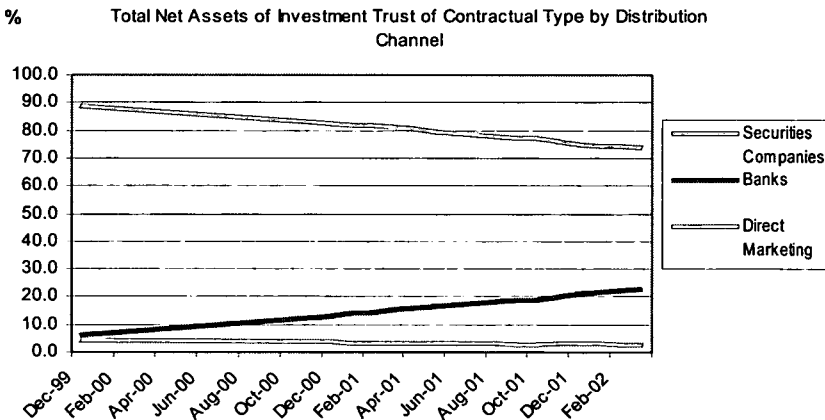
173. *Id.*

174. THE INVESTMENT TRUST ASSOCIATION, JAPAN, TOTAL NET ASSETS OF INVESTMENT TRUSTS OF CONTRACTUAL TYPE BY DISTRIBUTION CHANNEL (MARKET VALUE), available at <http://www.toushin.or.jp/result/getuji/g6.pdf> (last visited Mar. 17, 2002).

experience investing their money in financial markets, the increase of sales of mutual funds by banks resulted in an increase of lay-individual investors' indirect participation in financial markets. Today, mutual funds are an important instrument for lay-individual investors to enter financial markets in Japan.

However, some critics claim that current prospectuses are too difficult for individual investors to understand.<sup>175</sup> Currently, mutual fund prospectuses are so detailed and so complicated that lay-individual investors do not easily understand them.<sup>176</sup> In order to respond to this criticism, the FSC suggested that the method of writing mutual fund prospectuses should be amended.<sup>177</sup> Concretely, the FSC suggested MO amendments concerning disclosure with respect to specified securities.<sup>178</sup> The MO is a general rule; the Investment Trust Association, Japan (ITAJ) created specific guidelines for writing mutual fund prospectuses.<sup>179</sup>

The FSC report reaffirms that securities registration documents are not necessarily the same as prospectuses word for word.<sup>180</sup> Until shortly after release of the report, issuers were required to make the information of securities registration documents and that of prospectuses exactly alike.<sup>181</sup> Issuers often made their prospectuses by simply attaching a cover page to



175. See PROSPECTUS STUDY, *supra* note 166, at 1.

176. *Id.*

177. *Id.*

178. *Id.* at 8.

179. *Id.*

180. *Id.* at 5.

181. See PROSPECTUS STUDY, *supra* note 166, at 6.

the securities registration document. However, lay-individual investors had difficulty reading such prospectuses because securities registration documents were originally made only for registration purposes. Now, because of the shift in the purpose of the prospectus, material information will likely be carefully arranged and unimportant information will be omitted from the current prospectus.

On the basis of the FSC report, the FSA released a draft of the revised MO on December 19, 2001.<sup>182</sup> The amendments aim to restructure registration forms. In Form 4, which regulates the contents of security registration documents for mutual funds, the following sentence has been added as a caution: "Issuers are required to create security registration documents in such a way that investors can easily understand them . . . ."<sup>183</sup> This appears to be the implementation of a Japanese plain language rule. The amendment took effect on April 1, 2002.<sup>184</sup> Additionally, the ITAJ drafted and released more detailed guidelines regarding how to write mutual fund prospectuses.<sup>185</sup>

Since April 1, 2002, Japan has had its own plain language rule for mutual fund prospectuses.<sup>186</sup> The U.S. plain English rule and Japan's plain language rule are similar. Application of the rule will show whether any practical difference exists.

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182. See RELEASE OF DRAFT ORDINANCE PAMPHLET, *supra* note 154.

183. *Id.* at Form 4.

184. *Id.*

185. See THE INVESTMENT TRUST ASSOCIATION, JAPAN, MOKUROMISHO NO SAKUSEI NI ATATTENO GAIDORAIN [GUIDELINES CONCERNING THE CREATION OF PROSPECTUSES] (2002), at <http://www.toushin.or.jp/info/pubcome2.pdf> (last visited Mar. 27, 2002). First, this draft requests that issuer a) use appropriate size paper, b) use an appropriate size font, c) devise an arrangement of material information, d) not give the same information repeatedly, e) use a table of contents and an index, f) use a format of items and subitems, and g) illustrate basic information in security registration documents with graphs and charts. *Id.* As for the general caution concerning sentence expression, ITAJ further suggests that issuers a) use simple and easy expressions, b) make sentences short and not include multiple concepts in one sentence, c) write concretely and avoid vague expressions, and d) avoid multiple negatives and no rhetorical questions. *Id.* As for the general caution concerning terms, ITAJ suggest that issuers a) use few difficult technical terms as possible, b) explain such difficult technical terms if they must be used, c) include a general glossary for individual investors in an appendix, and d) standardize the terms used in the prospectus. *Id.* As for the general cautions concerning the use of photographs and illustrations, ITAJ suggests that issuers a) choose the best way to use illustrative information, and b) use such material carefully in order to avoid investor misunderstanding. As for the general cautions concerning use of graphs and charts, ITAJ suggests that issuers a) use no misleading expressions, and b) use no layouts which make the prospectus unreadable. *Id.*

186. *Id.* at 5-6.

## B. THE STRENGTHS OF THE PLAIN LANGUAGE RULE IN JAPAN

### 1. *The Plain Language Rule Enhances Investor Education*

Even if the LSFP protects lay-individual investors by making broker/dealers liable for giving unclear material information to investors, a problem remains as to how to educate these investors so that they can make investment decisions independently. Without prospectuses written in plain language, it is difficult for lay-individual investors to learn about securities and financial markets by themselves. The plain language rule may help resolve this issue. Lay-individual investors should be able to use a prospectus as a textbook on securities and financial market mechanisms in the same way that the plain English rule is used in the United States.

Moreover, in Japan, when lay-individual investors cannot understand a prospectus written in plain language and cannot obtain material information when financial technology becomes more complicated, the LSFP provides a remedy: even if lay-individual investors become “informed-laymen” by reading prospectuses written in plain language, broker-dealers must continue to provide material information to investors. This is the safety net and perhaps a more effective solution than merely adopting a plain language rule. The more complicated financial technology becomes, the higher the average level of knowledge required for lay-individual investors becomes. In the future, plain language may not be able to keep up with developments of financial products. In Japan, under the LSFP, the duty of broker-dealers continues, even if the financial products they sell continue to develop.<sup>187</sup> The safety net provided by the LSFP can work efficiently to educate investors as products and material information about them become increasingly complex.

### 2. *The Japanese Plain Language Rule Gives Fair Consideration To The Mentality of Japanese Investors*

In the United States, one can argue that the plain English rule will enable all investors to make wise investment decisions by reading a simply written prospectus. However, such an expectation is not reasonable in the Japanese investment environment because Japanese individual investors are much more

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187. See LSFP, *supra* note 141, Art. 3.



reluctant to invest in risk assets (such as securities) than U.S. investors.<sup>188</sup> Japanese people own much less stock than Americans do; they prefer safety assets because many Japanese individual investors have little knowledge or experience with securities and fear a loss will result from their own decisions.<sup>189</sup> Such a tendency is highlighted by the fact that individual investors' financial assets have not shifted from safety assets to risk assets, although deposit interest rates are remarkably low.

Will individual investors who tend to avoid investing in risk assets and have little knowledge and experience become more motivated to invest in financial markets if prospectuses are written in plain language? It is unlikely that the plain language rule alone could do this. If Japan had introduced a plain language rule without the LSFP, Japanese individual investors might feel unprotected because the plain language rule expects investors to read and understand prospectuses, and make investment decisions by themselves, which they have been traditionally unwilling to do. Because the LSFP imposes liability on broker-dealers for financial losses from broker-dealers' misleading explanations, as well as for failing to provide material information to investors, it has paved the way for the application of the plain language rule as extra protection.

Of course, problems concerning broker-dealers' accountabilities are likely not the only reason why Japanese investors prefer safety assets. Several other factors likely keep individual investors from investing in risk assets, such as lack of individual investors' knowledge of finance and concerns for market return in the future. The LSFP does not have the ultimate power to resolve all problems concerning financial markets, but does have the ability to resolve some problems concerning disclosure.

In the past several years, individual investors have surpassed corporate investors in terms of importance in Japan. In the early 1990s, many corporations invested a lot of money from their core business into financial markets because the market was so strong that they could receive a bigger return than from their core business in the short term. However, the investment environment has changed drastically since the collapse of the "bubble economy." In the stock market, many corporations be-

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188. THE BANK OF JAPAN RESEARCH AND STATISTICS DEPARTMENT, SHIKINJUNKAN NO NICHIBEIHIKAKU [COMPARISON OF FLOW OF FUNDS BETWEEN JAPAN AND THE UNITED STATES IN 2ND QUARTER, 2003] (Sept. 30, 2003), available at <http://www.boj.or.jp/stat/sj/data/sjhi032q.pdf> (last visited Oct. 12, 2003).

189. *Id.*

gan to sell stock in order to decrease their exposure to stock market risk.<sup>190</sup> On the other hand, American and European investors who had sufficient funds from the booming economy in the middle of the 1990s became a bigger presence in the Tokyo stock market.<sup>191</sup> American and European investors could absorb the impact of significant amounts of stock sold by Japanese corporate investors. However, it will be difficult to continue to expect American and European investors to support the Japanese stock market amid the unstable economy of the United States.

When domestic corporations, American investors, and European investors are reluctant to support the Japanese market, individual Japanese investors are expected to act as a last resort. In the current situation in Japan, it is quite important for not only market participants, but also the government, to attract individual investors in order to secure financial markets. The LSFP may transfer some investment risk from individual investors to broker-dealers by imposing liability on broker/dealers for financial losses from broker-dealers' misleading explanations. By doing so, the LSFP encourages individual investors to invest in financial markets and lends support to Japanese financial markets.

### *3. The Japanese Plain Language Rule Acts As A Countermeasure Against The Double Structure Of Prospectuses*

Under a plain language rule, prospectuses may have a double structure: one part for lay investors and another for professionals. Because of criticism that too much information provided in a prospectus confuses individual investors, the proposed amendment to the MO suggests a double structure for Form 4, which regulates the contents of security registration documents for mutual funds.<sup>192</sup> For example, the information about a brokerage firm which directs the management of such funds should be shifted to the end of the prospectus because the FSA does not recognize such information as vital for making investment decisions. Lay investors may not read the latter part because the language used is directed toward professional investors.

Under a plain language rule without the LSFP, if lay-individual investors suffer damages from not reading the latter

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190. See SECURITIES MARKET 2001, *supra* note 85, at 182.

191. *Id.*

192. See PROSPECTUS STUDY, *supra* note 166, at 6.

part, issuers and sellers will be exempt from liability as long as the Cabinet Office has accepted the prospectus. Under the LSFP, even if a double structure for lay investors and for professional investors is used because of the plain language rule, broker-dealers may explain information in the latter part of the prospectus to investors if broker-dealers recognize such information as material. For these reasons, the plain language rule together with the LSFP may be able to provide Japanese lay-individual investors more complete protection.

### CONCLUSION

The Japanese version of the plain language rule, in conjunction with the LSFP, puts Japanese investors in a stronger position than the plain English rule does for U.S. investors. The plain English rule gives U.S. investors a measure of protection, but the protection is not perfect. Together with the LSFP, which gives greater protection to investors by obligating broker-dealers to explain material information to investors, the plain language rule can work more efficiently for Japanese investors. Prospectuses written in plain language may be able to keep up with the reality of current financial technology, and lay-individual investors may be able to understand the information they contain, but in the future this may not be true. Prospectuses may not be able to explain complex mechanisms and risks in plain language, and lay investors may not be able to keep up with the development of financial products. If so, alternative measures must be established.

The LSFP provides some investor protection by requiring broker-dealers' explanations about material information, and the plain language rule can work for making prospectuses as understandable as possible. It would be impossible to bridge the difference between the lay investors' understanding of investment instruments and the increasing complexity of developing financial products only by changing the language of prospectuses. The LSFP is the foundation of investor protection in Japan, and the value of the Japanese version of the plain language rule is that it complements the LSFP by giving Japanese lay-individual investors an even wider participation in making their financial decisions.