

## COMMENT LETTER

May 21, 2021

# Attachment to Letter on Web-Based Investment Programs, September 2000

July 12, 2000

To: Division of Investment Management  
Securities and Exchange Commission

From: Investment Company Institute

**Subject: Folio[fn] Investmentments, Inc. and Similar Internet Portfolio Services**

We are submitting this memorandum in order to present our view that the investment product being provided by the broker-dealer Folio[fn] Investments Inc. ("Folio[fn]")—a product that it dubs "Folio[investing]" (the "Program")—constitutes the offer and sale of a separate security under the Securities Act of 1933 (the "1933 Act") and an investment company under the Investment Company Act of 1940 (the "1940 Act"). We believe that analysis of Folio[fn] and the Program under the 1933 and 1940 Acts demonstrates that the Program and its offering and sale should be registered and regulated under these Acts. We believe that Folio[fn] is the forerunner of a new wave of technology-driven investment vehicles that, should they not be appropriately regulated, could seriously undercut the investor protections built into the regulatory framework for investment companies and their advisers. Thus, we respectfully suggest that the Division of Investment Management consider the Program's characteristics in devising an appropriate regulatory response to potential abuse by those who are certain to replicate them.

## Summary

We believe that the Program is issuing, offering, and selling securities that are separate from the underlying securities in investors' portfolios. These securities derive from the pooling of investors' assets in the odd lot trade bunching and matching features of the Program, in the investment management involved in rebalancing investors' "Folios," and in the investment expertise built into "Ready-to-go" Folios. Thus, investors in the Program and Folios are purchasing investment contracts from Folio[fn] because these features interweave investors' fortunes with the efforts and success of Folio[fn] and the Program and because these features render investors' success largely dependent upon the efforts of others.

The Program and Folios also are investment companies under the 1940 Act because they are issuers of securities that are primarily engaged in the business of investing, reinvesting,

and trading in securities and because they share many of the essential features of investment companies. Furthermore, the policies underlying the 1933 and 1940 Acts—especially the anti-self-dealing, compensation limitation, independent director oversight, advertising, and disclosure provisions—argue for regulation of the Program and the Folios under these Acts. Finally, these investor protection concerns are heightened because the basic characteristics of Folio[fn] and the Program can be readily replicated by a wide range of promoters seeking to tap the public investment market.

## Facts

Folio[fn] is a registered broker-dealer incorporated and located in Virginia. Its founder, chairman and chief executive officer is Steven Wallman, former SEC commissioner. In March it announced its first investment product, Folio[investing], and it has just recently begun to offer and sell products to investors. Thus, the facts in this memorandum are based largely on press reports and Folio[fn]'s own promotional materials (available at its website, ).

The Program allows investors to acquire "Folios"—baskets or portfolios of stocks that the investor initially purchases in a single transaction. A Folio can include from one to fifty different stocks, chosen from a list of 2,500 stocks. Each stock carries a percentage weight that determines its proportion of a particular Folio. Investors make initial and subsequent purchases of dollar amounts of a Folio, not of a given number of shares of individual stocks. Should changes in market valuation alter the actual weighting of their holdings, investors also have the option to "rebalance" the Folio to the chosen weighting. After an investor clicks the "rebalance" button on his or her screen, Folio[fn] will automatically execute the purchases and sales necessary to reduce to the appropriate size the investor's holding of each over-weighted stock and increase to the appropriate size his or her holding of each under-weighted stock.

Using the Program, investors can devise a Folio from scratch, or they can choose from a number of "Ready-to-go" Folios created by Folio[fn]. Folio[fn] is offering a large number of Ready-to-go Folios, and their contents and types appear to vary considerably.<sup>1</sup> The investors interact with the firm primarily through the Internet: investors select and rebalance their Folios on web pages located on Folio[fn]'s website. Folio[fn] promotes the ease and personal control in investing in a Folio that result from the confluence of its method and the Internet interface. For instance, one page on Folio[fn]'s website states:

Folios deliver many of the benefits of stocks and mutual funds, and eliminate many of the disadvantages. With just a few mouse clicks, you can:

Create a diversified portfolio of stocks,

Buy stocks in dollar amounts or fractional shares,

Enjoy the benefits of Folios no matter how much—or how little—you have to invest,

Know exactly what you own at all times,

Rebalance your stock portfolio quickly and easily,

Manage holdings as much or as little as you want,

Avoid the hidden fees and annual tax bill of mutual funds,

Maintain total control over when you buy and sell, controlling your taxes to maximize your after-tax returns, and

Tailor your Folios to a risk level you find comfortable.

The major theme of Folio[fn]'s promotional materials is that Folio[fn] harnesses the power of information technology to simplify and make cheaper the construction of a diversified stock portfolio. As the website puts it:

"As you probably know by now, with Folios, you can easily create a diversified portfolio of stocks. In fact, with just a few mouse clicks, you can get instant diversification with a couple dozen stocks.

Before Folio[fn], it was much harder. You would have paid for 50 separate transactions. That's expensive. You would have also been forced to figure out what stocks to buy, and exactly how many shares of each company to buy. That's a pain. And you still might not have ended up with the kind of portfolio balance you really wanted."

It is not clear how Folio[fn] will manage the back-office operation necessary to sustain customers' Folios, but certain features are discernable. Each investor in a Folio will own a beneficial interest in a number of shares held by Folio[fn], including in most cases odd lots and fractional shares, of the various Folios' constituent stocks. Folio[fn] will hold these interests as record owner. Folio[fn] will effect investors' purchases, sales, and rebalancings by bunching all of the resulting transactions in each of two daily time windows and executing them twice a day. Folio[fn] claims that it will first try to match its investors' transactions internally at zero spread and that it will then bunch the remaining, unmatched trades and go to the market (the "Odd Lot Trading Service"). Folio[fn] claims that it has developed the technology necessary to implement the Odd Lot Trading Service.

Folio[fn] emphasizes that the Odd Lot Trading Service makes the Program accessible to smaller investors:

"With Folios, you can buy many stocks in one transaction and in any dollar amount you want. There is no minimum investment amount--you can invest \$100 or \$10,000. If you have \$10,000, you can simply choose to invest \$200 in each of 50 stocks. Or you can specify exactly how much (in dollars, not shares) of each stock you want to own. This is possible because our system allows you to own partial shares, like three and one-third shares of Microsoft. That lets you think about your stocks in dollar values, which many people find more intuitive than thinking in terms of shares."

The Program values the odd lots and fractional shares making up each Folio as if they were participation interests in whole lots of securities. Folio[fn] tacitly recognizes that the Odd Lot Trading Service is essential if investors' Folios are to realize the value that Folio[fn] quotes through account statements on its website. In a recent New York Times article, Wallman is cited as saying that "Folio[fn] can be profitable because it is building a computerized trading system that will keep most trades in-house, matching customer purchases and sales of popular stocks without incurring the costs of a middleman."<sup>2</sup> One of Folio[fn]'s financial backers is cited in the same article as saying that "the proprietary trade-matching and -processing system is the key. Once Folio[fn] builds a base of thousands of customers ... its technology-based system could become very profitable." One

can infer that, even after Folio[fn] reaches the critical mass of customers, trades, and assets necessary for the Odd Lot Trading Service to be profitable, Folio[fn] will need to commit substantial capital to the Program. Such capital will be needed so that Folio[fn] can hold in inventory odd lots and fractional securities from unmatched orders. (Folio[fn]'s website and press statements are silent on this subject).

While Folio[fn] claims that it does not offer investment advice, the provision of Ready-to-go Folios strongly resembles the sale of investment advice or investment management services. The description on Folio[fn]'s website of the method used to determine the contents of Ready-to-go Folios illustrates this resemblance:

"At FOLIO[fn], we select stocks for our Folios based on objective criteria, such as beta, market capitalization, price-to-book ratios, industry sectors and other objective measures . We believe this approach is consistent with the overwhelming number of studies that reveal the value of diversification and the difficulty of evaluating the merits of individual companies and selecting winning stocks.

We do not select stocks based on a subjective analysis or a feeling that the company may be more profitable or may grow faster in the future than its peers. For instance, we don't pick stocks because we think the company's management is talented or the company is developing the next hot consumer product."

This web page indicates that Ready-to-go Folios are designed to appeal to investors who want to rely upon the portfolio-designing prowess of others. Folio[fn] refers to its selecting of the stocks in the Ready-to-go Folios and to the criteria it uses for them. It uses the expert terminology of modern portfolio and financial theory—beta, price-to-book ratios, etc. The clear message is that Folio[fn] has investment management expertise that the typical investor and the typical broker do not. Thus, the offering of Ready-to-go Folios to the general public (and particularly to smaller investors) is an invitation to rely upon that expertise. One can infer that a significant number of investors indeed will rely upon that expertise.

The specific criteria used to select Ready-to-go Folios appear to vary considerably with the type of Folio. Nonetheless, it is apparent that Folio[fn] is building investment expertise into the Ready-to-go Folios. One set of examples Ready-to-go Folios designed to match an investor's tolerance for risk—illustrates the degree to which Folio[fn] is doing so. As the website explains:

"With Folios, you can also diversify your stock holdings in ways that best match the level of risk you feel comfortable with. We offer several "Ready-to-Go" Folios containing stocks based on their beta. Beta measures how closely a stock or Folio has followed the volatility of the Standard and Poor's 500 Index, which many regard as a good approximation of the overall stock market. Understanding beta will help you diversify in a way that is tailored to your needs."

This passage implies that Folio[fn] is providing investors access to the tools of modern portfolio theory while Folio[fn] does the actual financial theoretical work.<sup>3</sup> This built-in expertise resembles that offered in a unit investment trust ("UIT")—the selection before purchase of a fixed portfolio of securities by an investment professional. The investment and trading services involved with rebalancing a Folio resemble that provided by an index fund—buying and selling securities to maintain the weights assigned to individual securities in a pre-selected portfolio as circumstances change. The built-in expertise and rebalancing

function are thus essentially forms of investment management. (Hence, this memorandum refers to them as "Investment Management Services.")

Folio[fn] is trying to market Folios, including Ready-to-go Folios, as distinct financial products that have the benefits but not the disadvantages of mutual funds. The website states:

"While Folios and stock mutual funds share some of the same benefits, they are completely different investment products. For many investors, the differences could prove profound.

Folios provide many of the same benefits [as mutual funds]. They can provide instant portfolio diversification. And they also let people invest in them using modest dollar amounts, not shares."

The website also draws favorable contrasts between direct ownership of shares (Folios) and indirect ownership (mutual funds), between individual and professional portfolio management, and between fixed annual fees and percentage fees. Folio investors will retain most indicia of ownership of the individual stocks in their Folios. They will receive dividends and distributions and, according to Folio[fn], will retain corporate voting rights.

Folio[fn] also promotes Folios as offering investors more control than mutual funds over the tax consequences of their investments. An investor who purchases a Folio will be able to control the timing of each portfolio transaction, especially rebalancings. Thus, according to Folio[fn], the investor, unlike a mutual fund shareholder, will be able to control the timing of capital gains realization and taxes. The Folio investor, unlike a mutual fund shareholder, will also know that, on initial purchase, there are no hidden capital gains or related taxes.

One can own up to three Folios for a flat fee of \$295 a year, or \$85 per quarter. Each additional Folio is \$95 per year, or \$30 per quarter. Folio[fn]'s website claims that, for the smaller investor, this pricing structure contrasts favorably with mutual fund fees:

"Folio[fn] represents an excellent value for many investors when you consider that the average stock mutual fund costs \$467 a year. That is based on the amount owned by the typical fund investor (\$38,000) and the average "expense ratio" charged by stock funds (1.23%). Many investors don't realize that they pay these annual fees because they never receive a bill. The mutual fund simply takes their annual fees directly out of the fund's assets."

Folio[fn] also will offer real-time trades of individual stocks at \$14.95 each and a range of other investment products, including money-market and other mutual funds, and other financial services, including check-writing and ATM and credit cards. Folio[fn] apparently makes no representation that it will not increase its fees.

Folio[fn] has registered with the SEC as a broker-dealer but not as an investment adviser. Neither the Program nor the Folios are registered with the SEC under the 1933 Act as securities distinct from the underlying portfolio securities, nor are they registered as investment companies under the 1940 Act.

## **Analysis**

Folio[fn] augurs a trend—securities firms using the tools of information technology to create novel types of investment products for investing through the World Wide Web. The

technology can be used to significantly reduce the burden of securities regulation through the electronic delivery of prospectuses and other disclosure documents and through more timely and cost-effective communications with investors. Folio[fn], however, proposes to use technology to avoid most of this regulation by replacing the mutual fund shareholders' undivided interest in a securities portfolio with book-entry ownership of the portfolio securities by individual investors. Folio[fn] appears to believe that, because investors can elect to customize their portfolios and regardless of whether they make that election, it can avoid the advertising restrictions, disclosure requirements, self-dealing prohibitions, fee and sales charge limits and other basic characteristics of the regulatory pattern framed by the 1933 and 1940 Acts. If new investment products such as the Ready-to-go Folios are not subject to the relevant regulatory restrictions that apply to investment companies, the investor protections afforded by the regulatory framework for the investment company industry could be undercut by technological change. We believe, however, that there are sound arguments for regulating the Folios under both the 1933 and 1940 Acts. Our analysis is as follows:

### **A. Folio[fn] is offering and will be selling separate securities that should be registered under the 1933 Act.**

Whether the business plan of Folio[fn] involves unregistered offers and sales of securities and whether these represent interests in unregistered investment companies are distinct but related questions. Both questions turn on whether Folio[fn] is offering securities separate from the underlying securities that constitute the Program and Folios. As described above, through the Odd Lot Trading Service the Program and Folios pool investors' holdings of odd lots and fractional shares so that they can be purchased, managed, and sold as if they were whole lots. Thus, the price of a security in an investor's Folio as quoted by the Program is the current market price for whole lots, which reflects that the investor's holding is a pro rata share of an underlying whole lot. Further, the Program, by offering the Ready-to-go Folios, provides Investment Management Services that a significant number of investors in Folios will rely upon. In these respects, the offerings of the Program and the Folios are classic examples of investment contracts.

#### **1. Folio[fn] is offering investment contracts, which are securities as a matter of law.**

Section 2(a)(1) of the 1933 Act defines "security" to include investment contracts, which the seminal *Howey* opinion defines using a four-element test: "An investment contract . . . means a contract, transaction, or scheme whereby a person [1] invests his money [2] in a common enterprise and [3] is led to expect profits [4] solely from the efforts of the promoter or a third party . . . ." <sup>4</sup> The Program clearly meets the first and third elements. Whether it meets the second and fourth poses closer questions.

Generally all courts agree that the common enterprise prong of the *Howey* test is satisfied when there is a pooling of interests of several investors, a pooling known as "horizontal commonality." Courts disagree, however, on whether "vertical commonality"—one promoter and one investor involved in a common enterprise—alone suffices. The Ninth Circuit has adopted a more restricted vertical approach under which a common enterprise exists where "the fortunes of the investor are interwoven with and dependent upon the efforts and success [1] of those seeking the investment or [2] of third parties." <sup>5</sup>

The Program satisfies both the horizontal and vertical commonality tests, for two reasons. First, Folio investors will be relying on the Investment Management Services of Folio[fn].



Investors who rebalance will be using rebalancing services, and investors who purchase Ready-to-go Folios, except to the extent that they customize the Folio, will be relying on Folio[fn]'s investment expertise—its prowess in devising and identifying portfolios with the risk and other characteristics sought by the investor. Identification of the ownership of specific shares and fractional shares on Folio[fn]'s books and records will not lessen that reliance; absent customization, the Ready-to-go Folio investor will be in the same position as a UIT investor, who holds an interest in a fixed portfolio of securities selected by an investment professional.

Second, as noted, the typical investor's interest in a Folio will consist largely, if not entirely, of odd lots and of fractional shares.<sup>6</sup> The transaction costs (commissions and/or markups and markdowns) of executing individual purchase and sales orders of odd lots and fractional shares are cost-prohibitive for the typical investor. Thus, through the Odd Lot Trading Service, Folio[fn] will match and bunch investors' purchase and sales orders to permit economical trades. This matching and bunching constitutes horizontal pooling because it pools the trading capital of many investors and puts it at risk in the time between when the investor enters his or her order and the time Folio[fn] executes the matched or bunched orders. The matching and bunching also constitute vertical pooling, because the investor's trading capital is brought into a common enterprise with Folio[fn]'s trading efforts.

Furthermore, the success or failure of each Folio as an investment will be linked not only to the investment management but also to the trading, marketing and technological efforts and success of Folio[fn]. When the investor seeks to dispose of his Folio, the trades necessary to do so can only be executed economically through the Odd Lot Trading Service, which will be available only if Folio[fn] continues to provide that service. Similarly, an investor who wants to rebalance his or her portfolio also will have to rely on Folio[fn]'s willingness and ability to continue providing that service.<sup>7</sup> The fortunes of each Folio therefore depend not only on good portfolio selection and management, but also on Folio[fn]'s ability to attract and retain a critical mass of clients—that is, on the success of Folio[fn]'s sales and marketing efforts. For initial investors at least, their fortunes will also depend upon Folio[fn]'s ability to manage the novel technological accomplishment of matching and bunching so many odd and fractional orders. Finally, if Folio[fn] goes out of business or otherwise discontinues the service, most investors will be left with holdings that will be so expensive to rebalance, manage and liquidate that they will in effect lose significant value. Thus, the viability of each Folio as an investment vehicle will be "interwoven with and dependent upon the efforts and success of" Folio[fn].

The fourth element of the Howey test is that the investor must expect profits to be derived "solely from the efforts of a promoter or a third party." In applying the test, lower federal courts have rejected a literal interpretation of the word "solely." Ten circuits have adopted a more liberal and flexible interpretation, simply requiring proof that "the efforts made by those other than the investor are the undeniably significant ones, those essential managerial efforts which affect the failure or success of the enterprise."<sup>8</sup> As a result, many courts have found an investment constituted a security, even when the investor was required to participate to some extent, provided his efforts were not the undeniably significant ones.<sup>9</sup>

The Program satisfies the "efforts of others" element of the Howey test for two broad reasons. First, as noted above, Folio[fn]'s efforts in providing the Odd Lot Trading Service are the "undeniably significant" ones that are "essential" to the success of each Folio. Furthermore, it is a reasonable hypothesis that a significant, if not the overwhelming,

portion of Folio investors will use Ready-to-go Folios rather than devise Folios themselves and that significant numbers will likely not customize these Ready-to-go Folios to their own requirements. One cannot determine in advance the relative proportions of Ready-to-go investors to active managers or the degree of customizing: Folio[fn] has just begun to accept investments. Nevertheless, the greater the proportion and degree of such passive investing, the more Folio investors will be relying upon the investment expertise of Folio[fn]. Thus, even apart from reliance on the Odd Lot Trading Service, for the Ready-to-go Folios, the undeniably significant and essential efforts will be Folio[fn]'s. Indeed, a Folio investment will still constitute an investment contract even if the investor manages the Folio to a limited degree. As the SEC has noted, "an investment contract may be present in situations where an investor is not wholly inactive, but even participates to a limited degree in the operations of the business [enterprise]." [10](#)

Folio[fn] might argue that Folio investors' efforts in the selection and management of portfolio assets would be more significant than Folio[fn]'s. The argument could take two forms. First, the mere selection of a Folio itself, whether Ready-to-go or investor-devised, is the most significant of the efforts affecting a Folio's success or failure. Folio[fn] might argue that the selection of an investing strategy—a particular degree of risk (e.g., by choosing a Conservative Folio), a particular sector (e.g., by choosing a Technology Folio), or a particular social investing approach (e.g., by choosing a Women Leaders Folio)—itself has a greater impact on investing success than the selection of any particular basket of securities to effect that strategy or than the Odd Lot Trading Service. Second, Folio[fn] might argue that Internet investors are not passive, but can and will actively manage even Ready-to-go Folios. The interactive nature of the medium—just point and click!—combines with the characteristics of the typical Internet user—expecting and exploiting consumer choice—to paint a picture of active, rather than passive investors.

Nonetheless, Folio[fn]'s efforts will be the undeniably significant and essential ones. The Odd Lot Trading Service remains the unique and essential feature of the Folio[investing] system, and Folio investors will depend upon Folio[fn]'s continuing to offer that service. Without Folio[fn], most investors would be left with Folios that cannot be managed or rebalanced and the value of which would be considerably less upon liquidation.

Moreover, while the investor's choice of an investing strategy through a Ready-to-go Folio is significant, it involves no more than does the choice of a mutual fund. In both cases, the most difficult investment decisions lie in devising the portfolio that effectuates the strategy. A conservative portfolio weighted toward utility stocks will perform differently than one weighted toward industrial blue chips, and a technology portfolio weighted toward Microsoft, Intel and Cisco will perform differently than one made up of Internet startups. And, however active many Internet investors are, surely many will also prefer the ease and convenience of choosing a Ready-to-go Folio and leaving its composition completely or mostly untouched. Many also will not be knowledgeable or sophisticated enough to customize their Folios in any meaningful way. Courts have found that, even where an investor has the right to control the management of his or her investment, if the investor shows practical dependence or an inability to exercise meaningful powers of control or to find others to manage the investment, he or she is relying upon the efforts of others. [11](#) Thus, Folio[fn]'s investment expertise is an essential element of the service it is offering for Ready-to-go Folio investors who do not customize their portfolios to a significant degree.

In the Gary Plastic case, [12](#) the Second Circuit applied the Howey test to facts similar in significant ways to those presented by the Program. In Gary Plastic, Merrill Lynch had marketed and sold \$100,000 bank certificates of deposit (or "jumbo CDs") on



representations that the CDs were negotiable (due to regulatory changes), insured, and liquid. Merrill Lynch screened daily a group of banks, claiming that it had regularly reviewed and monitored each bank and that they were obtaining competitive yields for their customers. Merrill Lynch also claimed that it would maintain a secondary market for the CDs that would enable investors to sell the CDs back to Merrill Lynch at prevailing market rates without penalties. Plaintiffs sued Merrill Lynch under the antifraud provisions of the federal securities laws, claiming that the interest rates on the jumbo CDs were in fact lower than those the banks were offering other customers and that Merrill Lynch had taken the difference as a commission without disclosing this fact to plaintiffs. The district court dismissed the action on summary judgment, holding that the jumbo CDs were not securities and not subject to the securities laws.

The Second Circuit reversed on appeal, finding that Merrill Lynch was offering and selling securities that met the Howey test.<sup>13</sup> The court held that the program met the "common enterprise" and the "efforts of others" prongs of the test because investors in the jumbo CDs relied on the "efforts, knowledge and skill" as well as the "financial stability" of Merrill Lynch, and because their investments depended on Merrill Lynch's "managerial and financial expertise." The court emphasized two reasons for these conclusions. First, investors depended on the secondary market that Merrill Lynch created for liquidity and capital appreciation. The court noted that, if Merrill Lynch were to become insolvent or failed to maintain the promised secondary market, an investor would have difficulty liquidating a CD, which might cost the investor capital appreciation if prevailing interest rates were to drop. Second, the investor relied on Merrill Lynch's maintaining the program and its marketing efforts, because the success of the secondary market hinged on Merrill Lynch's success in finding new buyers of CDs and developing strong working relationships with issuing banks. The court concluded:

Here investors are buying something more than individual certificates of deposit. They are buying an opportunity to participate in the CD Program and its secondary market. And, they are paying for the security of knowing that they may liquidate at a moment's notice free from concern as to loss of income or capital, while awaiting for FDIC or FSLIC insurance proceeds.

Folio investors will be in a similar position to investors in Merrill Lynch's jumbo CD program. They will be buying something more than a portfolio of individual stocks. They will be buying an opportunity to participate in the Program and the Odd Lot Trading Service, which makes purchasing, managing, and selling Folios economically feasible. If Folio[fn] were to become insolvent or failed to provide the Odd Lot Trading Service, an investor would have difficulty liquidating a Folio. Investors will rely on Folio[fn]'s maintaining the Program and on its marketing efforts, because the success of the Odd Lot Trading Service, like that of the secondary market for jumbo CDs in *Gary Plastic*, will hinge on Folio[fn]'s success in finding new investors. And like the jumbo CD investors, Folio investors will be paying for the security of knowing that they could liquidate their Folios at a moment's notice free from concern as to loss of income or capital, while awaiting for SIPC distributions (which might even be in-kind, i.e., in illiquid odd lots and unmarketable fractional shares).

Thus, Folio[fn], through its website, is currently offering and selling securities separate from those constituting the portfolios underlying each Folio. Folio[fn] has not registered its offerings of the Program or Folios as securities under the 1933 Act, and thus is violating Section 5 of the Act.

## **2. The program and folios warrant registration as securities under the 1933 Act as a matter of policy.**

There are compelling policy reasons for the Program and Ready-to-go Folios to be registered as separate securities under the 1933 Act. As noted above, the fortunes of Folio investors to a significant extent will be dependent upon the efforts of Folio[fn] and interwoven with its fortunes. Thus, investors will need to be fully informed about the business, finances, and management of Folio[fn] and the Program. In particular, investors should be fully informed of the risk of loss they would face if the Program were no longer available to provide the Odd Lot Trading Service. To make an informed decision, investors considering the Ready-to-go Folios will need disclosures regarding Folio[fn]'s built-in investment management expertise. Finally, investors will need the protections of the 1933 Act provisions mandating prospectus delivery and regulating other forms of communication during offerings. As the citations from Folio[fn]'s website above show, Folio[fn] is making many questionable comparisons with mutual funds and other forms of investment. Folio[fn]'s claims should be subject to Section 11 and Section 12 liability and should receive regulatory scrutiny as do those of any other issuer of a security.

Compliance with the requirements of the 1933 Act would not appear to impose unreasonable burdens on Folio[fn]. Indeed, the information technology used by Folio[fn] could substantially reduce the costs of maintaining a current prospectus and delivering that prospectus to investors through posting the prospectus on its website.

## **B. The program and folios are investment companies under the 1940 Act.**

### **1. The program and folios meet the definition of "investment company" under the 1940 Act.**

The Program and Ready-to-go Folios are investment companies under Section 3(a)(1) of the 1940 Act if they are issuers of securities which are engaged, or propose to engage, (1) primarily in the business of investing, reinvesting, or trading in securities, or (2) in the business of investing, reinvesting, owning, holding, or trading in securities, and own or propose to acquire investment securities having a value exceeding 40 percent of the value of its total assets (exclusive of government securities and cash items) on an unconsolidated basis. The Program only offers equity portfolio securities, all of which are investment securities under this provision. If the Program or Ready-to-go Folios were investment companies within the statutory definition, they would be regulated and required to register under the 1940 Act.

The Program and Ready-to-go Folios are issuers of securities. The definition of "issuer" includes any organized group of persons, whether or not incorporated, that issues or proposes to issue a security.<sup>14</sup> The Program and Ready-to-go Folios also are engaged primarily in the business of investing, reinvesting, or trading in securities. Thus, they meet the Section 3(a)(1) definition of an investment company, and should be subject to regulation and registration under the 1940 Act unless they qualify for a statutory or regulatory exemption.

The Program can be distinguished from the Piette & Assoc. LTD interpretive letter.<sup>15</sup> Piette was an investment adviser that planned to aggregate contemporaneous buy or sell orders of clients for securities in a joint trading account at a broker in order to obtain lower commission costs. In the letter, the SEC staff took the position that the joint account was

not an investment company. Piette was merely providing this service incidentally to existing advisory clients as a cheaper way to execute trades. In sharp contrast, Folio[fn] is publicly offering the Program to prospective investors as a unique long-term investment vehicle. This vehicle integrates trade matching and bunching with the Investment Management Services so that investors can purchase, manage, and sell diversified portfolios largely consisting of illiquid odd lots and unmarketable fractional shares. Unlike Piette's service, the Program also requires an ongoing marketing effort to reach and maintain a critical mass of investors.[16](#)

Similarly, Folio[fn] and the Program should not be able claim exemption from the 1940 Act based upon any precedent set by the recent HOLDRs no-action letter.[17](#) In that letter, the staff granted no-action relief to Merrill Lynch's HOLDRs program from registration under the 1940 Act (but not the 1933 Act). The letter relied on the fact that HOLDRs are a mere custody arrangement allowing investors a convenient way to purchase, hold, and sell fixed baskets of stocks representing a given industry or sector. Merrill Lynch merely performs ministerial services for minimal administrative charges, selecting the stock through a mechanical process. Moreover, because HOLDRs round lots are exchange-listed and -traded, investors can sell their holdings for round lot value at any time without relying on Merrill Lynch. In contrast, Folio[fn] is holding out its program as a long-term investment vehicle that offers both an economically feasible way to invest in odd lots and fractional shares and ownership of a portfolio of securities selected by an investment professional, ownership that is in economic substance indirect.

Finally, the Program and the Ready-to-go Folios do not qualify for the rule 3a-4 "mini-account" exemption. Rule 3a-4 provides a non-exclusive safe harbor from the definition of investment company and from 1933 Act registration for programs under which investment advisory services are provided on a discretionary basis to a large number of advisory clients having relatively small amounts to invest. As an initial matter, the Program does not provide advisory services on a discretionary basis. Moreover, the conditions to the safe harbor are designed to ensure that clients in a program relying on the rule receive a particular sort of individualized treatment, including receiving sufficient attention from the adviser to their financial situations and investment objectives and retaining the ability to place investment restrictions on the management of their accounts.

The Program as presently designed would not provide sufficient individualized attention to investors in Folios to meet the conditions or the policy objectives of Rule 3a-4. Rule 3a-4 contemplates that a program would provide individualized attention in the form of human interaction rather than the Internet interface. For instance, one condition requires that personnel who are knowledgeable about the account and its management be reasonably available to the client. The rule also contemplates that a qualifying program would actively reach out to clients for updates about their financial situations and investment objectives. The web page medium, however much it invites interaction, still requires that the client take the initiative in making contact.

Furthermore, the Program and Folios share many of the essential characteristics of investment companies. Like investment companies, the Program and the Folios offer smaller investors the benefits of portfolio diversification through participation interests in round lots of shares. Like mutual funds and UITs, the Program and Folios offer investors the ability to liquidate or redeem their interests at market prices for round lots as of certain specified pricing times during each day. Like UIT investors, investors in Ready-to-go Folios who do not significantly customize will be relying on the built-in investment expertise of the investment professionals who put together the portfolio. Like mutual fund investors, Folio

investors will be relying upon the investment and trading management of investment professionals in keeping their portfolios balanced (or "rebalanced"). Like investment company investors' holdings, Folio investors' holdings will, in real economic terms, be indirect. Without the Program and the Odd Lot Trading Service to liquidate and rebalance Folios, Folio investors' holdings would be worth significantly less than market price. Folio[fn] may claim that it is offering these features as incidental to a brokerage account. However, when the features are considered as a whole, the Program and Folios bear a closer resemblance to investments in an underlying pool—an investment company—offered by a brokerage than to pure investments in individual securities through a brokerage account.

Thus, the Program and the Ready-to-go Folios are investment companies under the 1940 Act. Folio[fn] has not registered them as investment companies with the Commission, and thus is violating Section 7 of the Act.

## **2. There are compelling policy reasons that warrant regulation of the program and folios under the 1940 Act.**

There are compelling policy reasons to require that the Program, Ready-to-go Folios, and any similar products that might be offered by sponsors other than Folio[fn] register and be regulated under the 1940 Act. First, each of the distinctive features of such products present the possibility for self-dealing of the type that the 1940 Act was designed to prevent. For example, absent 1940 Act regulation, broker-dealers sponsoring Folio-like investment programs could use Ready-to-go Folios or their like as "dumping grounds" for securities inventory, including inventory from unsuccessful underwritings or proprietary trading programs. Disclosure of the resulting conflict of interest, even if made, would be obscured because each such security would be only one of several bundled and sold as a package. Congress, in enacting the 1940 Act, found that disclosure alone was not sufficient to protect investors from such practices in the context of investment company operations. Sections 17 and 10(f) and the other anti-self-dealing provisions of the 1940 Act are intended to combat these and similar abuses.

The Odd Lot Trading Service of the Program or similar programs might also pose conflicts of interest. This feature results in a large number of market orders of odd lots and fractional shares that need be executed only periodically. Absent 1940 Act regulation, a broker-dealer could abuse this discretion by executing these orders from its inventory when the timing best suited it. For instance, if it knew that other, larger trades in the same securities were pending execution, it might front-run those trades using the clients' market orders. It would be difficult for a client to discern or establish a failure to obtain best execution because of the indeterminacy of the timing of the order and because the broker could claim that it was difficult to execute an odd or fractional order. The anti-self-dealing provisions of the 1940 Act as well as those of the Investment Advisers Act are also designed to prevent these types of abuses.

The 1940 Act also regulates advisory and distribution charges. The current fee of \$295 would be 295 basis points of a \$10,000 investment. This fee is higher than most mutual fund expense ratios. Furthermore, absent 1940 Act regulation, there would be no constraints on raising the annual fee significantly in the future. For the reasons noted above, investors in programs such as those offered by Folio[fn] could find themselves locked into it through reliance on the Odd Lot Trading Service and hence captive to any future fee increases. Section 36(b) of the 1940 Act combats these types of abuses by imposing a fiduciary duty on adviser-sponsors of investment companies with respect to the compensation they receive.

Each of the conflicts of interest described above is inherent in the structure of the Program. While it appears that Folio[fn] has taken steps to allay some of these concerns (for instance, the tight windows for matching and bunching trades), other, less scrupulous sponsors might replicate the Program but with greater discretion built in. Thus, the structure could pose even greater conflicts of interest should it prove a popular investment vehicle. Experience has shown that these conflicts are difficult to detect and police. The 1940 Act forces investment companies to adopt a corporate governance structure that is designed to meet this difficulty: it requires them to have a board of directors, at least forty percent of whom are disinterested and who are bound by fiduciary duties to represent the interests of investors. This board of directors oversees and monitors the operations of the investment company to root out conflicts.

The advertising restrictions applicable to mutual funds also appear necessary and appropriate for offerings such as the Ready-to-go Folios. Absent those restrictions, Folio[fn] or another sponsor of a similar program might advertise the investment performance of a Ready-to-go Folio that had particularly high returns in a manner inconsistent with the requirements of Form N-1A and the investment company advertising regulations under the 1933 Act. These provisions are designed to standardize and prevent abuses in these types of communications with investors.

Regulation and registration under the 1940 Act would not appear to impose unreasonable burdens on the Program. Although the Program and the Ready-to-go Folios are not identical to traditional investment companies in all respects, other novel investment vehicles — notably variable insurance products — have adapted to the regulatory pattern, and so could the Program. The requirements of the 1940 Act might be altered through such narrowly-tailored exemptions as are necessary for the Program's operations and fully consistent with the investor protections ensured by the Act. Nonetheless, the burdens of compliance with the 1940 Act are borne by the rest of the investment company industry, and only if Folio[fn] also bears these burdens will there be a level competitive playing field.

### **C. Investor protection concerns are heightened because the characteristics of Folio[fn] and the program can be readily replicated by a wide range of promoters seeking to tap the public investment market.**

There is little to prevent financial dot.coms and other firms from adopting the methods embedded in the Program, repackaging them, and promoting them as their own. One prominent analyst has stated that the "folio concept is a pretty big idea that's going to stick in some form."<sup>18</sup> Indeed, two firms have already announced plans to provide substantially similar programs later this year. The details available concerning one, Netfolio.com, are more complete, and its similarity to Folio[fn] is striking.<sup>19</sup> The Netfolio investor fills out a short online questionnaire intended to determine risk tolerance and a financial profile, and, using this information, Netfolio's system generates a single recommended "eBasket" of five to forty stocks derived from one of ninety predetermined "Time Tested Strategies," such as the MidCap 20, Tomorrow's Leaders 10, or Blended Market Index. The Netfolio program selects an eBasket from the Time Tested Strategies by applying screens based on financial ratios. The investor can customize or rebalance the eBasket with a click of the mouse. The visitor to the Netfolio website can view, backtest, and compare the investment performance of each of the Time Tested Strategies. The eBasket's securities are bought, held, and sold through a custody account at Bear Stearns. It is not clear if the eBaskets will include odd lots or fractional shares or if Bear Stearns has committed to purchase and sell these at whole lot prices. It is also unclear whether investor trades will be matched or bunched in

tight windows. The annual fee for the program will be \$195. Netfolio's website touts the investment advice it provides, and it is registered as an investment adviser with the SEC.

Two other new web-based broker-dealers—BuyandHold.com and Sharebuilder.com—are offering investment products that share key features with Folio[fn].<sup>20</sup> Both feature "dollar-based investing"—the ability to purchase fractional shares in individual equities for a small commission.<sup>21</sup> Like Folio[fn], both programs bunch investors' trade orders and execute them periodically (BuyandHold twice per day, Sharebuilder once per week). Like Folio[fn], both programs limit customers' investments to a given list of stocks. Like Folio[fn], both companies have designed their programs to appeal to smaller, web-savvy investors. BuyandHold has a minimum investment of \$20 per stock; Sharebuilder has no minimum. Sharebuilder's accounts range in size from \$20 to \$40,000. However, neither offers the equivalent of "Ready-to-go" Folios or Folio[fn]'s portfolio rebalancing features. <sup>22</sup>

It is not our purpose here to analyze these other programs. Rather, their examples illustrate how easily other firms can replicate Folio[fn]'s Program or some of its characteristics and how these other programs might have more potentially abusive features. Thus, we respectfully suggest that the Division consider not only the Program, but also its general characteristics and their certain replication.

## Conclusion

Folio[fn] is offering and selling unregistered securities in investment companies in violation of the 1933 Act and the 1940 Act. Careful legal and policy analysis of Folio[fn] and the Program demonstrates that the Program, the Ready-to-go Folios and their offering and sale should be registered and regulated under these Acts. Folio[fn] is the forerunner of a new wave of technology-driven investment vehicles that, should they not be appropriately regulated, could undercut the investor protections built into the regulatory framework for investment companies.

### ENDNOTES

1 Folio[fn]'s website categorizes Ready-to-go Folios into types, each focused on a particular type of investment strategy. The types (and some representative examples) are: Social Issues Folios (e.g., the Women Leaders Folio and the Environmentally Responsible Folio), Special Folios (e.g., the Dogs of the Dow Folio and the Stockcar Champs Folio), Geographic Folios (i.e., region- and country-based), Major Market Folios (e.g., the Folio 30, based on the Dow Jones Industrial Average), Investment Style Folios (e.g., Large-Cap Growth), Risk-Tailored Folios (e.g., Aggressive, Conservative, or Market), and Sector Folios (e.g., the Technology Folio).

2 Patrick McGeehan, *The Unmutual Fund*, New York Times, May 18, 2000, at C1.

3 The central insight of modern portfolio theory is that the risk and reward characteristics of an investor's entire portfolio, and not those of the individual investments contained within, determine expected investment performance.

4 SEC v. W.J. Howey, Co., 328 U.S. 293, 298-299 (1946).

5 SEC v. Glenn W. Turner Enter., Inc., 474 F.2d 476, 482 n.7 (9th Cir. 1973), cert. denied, 414 U.S. 821 (1973). The Commission has endorsed this approach. See *Union Home Loans*, Sec. Ex. Act Rel. 19,346, 26 SEC Dock. 1346, 1348 (1982). See also Loss and Seligman,



Securities Regulation, vol. II 996.

6 Consider a Folio worth \$50,000 with 50 stocks equally weighted. Each holding will be worth \$1,000. If a stock is bought at \$30, the holding will consist of 33-1/3 shares. If the stock is bought at \$80 a share, the holding will consist of 12-1/2 shares.

7 Folio<sup>[fn]</sup> even states on its website that "[y]ou usually can't invest by dollar amounts because most brokers won't allow you to buy fractional shares of stock." Of course, in this statement Folio<sup>[fn]</sup> is promoting the advantages of investing through Folio<sup>[fn]</sup>, not disclosing the costs of liquidating should Folio<sup>[fn]</sup> fail.

8 SEC v. Glenn W. Turner Enter., Inc., 474 F.2d at 482.

9 While the U.S. Supreme Court expressly reserved judgment on whether the term "solely" should be interpreted literally, it deleted the term in its restated formulation of the test: "The touchstone is the presence of an investment in a common venture premised on a reasonable expectation of profits to be derived from the entrepreneurial or managerial efforts of others." United Hous. Found., Inc. v. Forman, 421 U.S. 837, 852 n.16 (1975).

10 Commission's Statement to Builders and Sellers of Condominiums of their Obligations under the Securities Act, Sec. Act Rel. 5347 (Jan. 18, 1973).

11 See, e.g., Hocking v. Dubois, 885 F.2d 1449, 1460 (9th Cir. en banc, 1989), cert. denied, 494 U.S. 78 (1990) (condominium unit can be a security); SEC v. Aqua-Sonic Products Corp., 687 F.2d 577, 582-584 (2d Cir. 1982) (Friendly, J.) (dental product franchise is a security where franchisees did not have experience marketing dental supplies); Williamson v. Tucker, 645 F.2d 404, 424-25 (5th Cir. 1981) (general partnership or joint venture interest can be a security). Williamson enumerates and Hocking cites factors for determining an investor's de facto dependence. Among these factors are "(2) the partner or venturer is so inexperienced and unknowledgeable in business affairs that he is incapable of intelligently exercising his partnership or venture powers; or (3) the partner or venturer is so dependent on some unique entrepreneurial or managerial ability of the promoter or manager that he cannot replace the manager of the enterprise or otherwise exercise meaningful partnership or venture powers." 645 F.2d at 424.

12 Gary Plastic Packaging Corp. v. Merrill Lynch, Pierce, Fenner & Smith., Inc., 756 F.2d 230 (2d Cir. 1985).

13 756 F.2d at 240.

14 1940 Act Section 2(a)(22) defines "issuer" to include any person who issues any security. Under Section 2(a)(28), a "person" includes a company, and under Section 2(a)(8) a "company" includes any organized group of persons, whether incorporated or not.

15 Piette & Assoc. LTD (pub. avail. Sept. 17, 1981). See also Owen T. Wilkinson & Associates, Inc. (pub. avail. Dec. 30, 1987).

16 On the same grounds, one can readily distinguish the line of no-action letters addressing issuer-sponsored odd lot buy-back and round-up programs. See, e.g., John Hancock Mutual Life Insurance Company (pub. avail. Nov. 1, 1999); NCR Corporation (pub. avail. Mar. 12, 1997); U.S. West, Inc. (pub. avail. Feb. 22, 1996); Disston Associates, Inc. (pub. avail. Apr. 25, 1988). In these letters, the staff of the Divisions of Corporation Finance and Market Regulation granted no-action relief from the Securities Act registration and broker-dealer

registration provisions for programs in which issuers or their agents, generally in connection with extraordinary transactions such as an asset spinoff or an insurance company demutualization, offered to buy back or round up to whole lots existing shareholders' odd lot holdings. In none of these cases did the sponsor of the program publicly offer it to prospective investors as a long-term investment vehicle involving the purchase, management, and sale of odd lots, let alone of diversified portfolios of securities.

17 Merrill Lynch, Pierce, Fenner & Smith (pub. avail. Sept. 3, 1999).

18 Patrick McGeehan, *The Unmutual Fund*, New York Times, May 18, 2000, at C1 (quoting John Rekenenthaler, research director for Morningstar, Inc.).

19 See Michael Santoli, *Buggy Whip Funds? Former Industry Insider Sees a New, New Thing Supplanting Mutuals*, Barron's, June 26, 2000. See also Netfolio's website at . The demonstration on the website bears a remarkable resemblance to Folio[fn]'s, from the general characteristics of the program down to the visuals and the accompanying music. Details concerning the other firm, Electronic Investing Corp., are sketchier. It evidently intends to introduce "build-your-own" funds through its website by September. See Patrick McGeehan, *The Unmutual Fund*, New York Times, May 18, 2000, at C1. Its website at only states unhelpfully that "eInvesting is creating a new generation of investment products."

20 See, e.g., Borzou Daragahi, *Buying Stock a Little at a Time*, Money, May 2000, at 140; Ilana Polyak, *New Sites Let You Put Spare Change into Stocks*, TheStreet.com, March 30, 2000.

21 BuyandHold charges \$20 to open an account and \$2.99 per trade. Sharebuilder charges \$5 per purchase, which drops to \$2 for recurring monthly purchases, and \$19.95 per sale, which it executes in real-time rather than in periodic batches. Sharebuilder does not charge an initial fee.

22 BuyandHold claims to have about 40,000 clients.