

Letter on Web-Based Investment Programs, September 2000

July 12, 2000

Paul F. Roye
Director, Division of Investment Management
U.S. Securities & Exchange Commission
Mail Stop 5-6
450 5th Street, N.W.
Washington, DC 20549

Re: Web-Based Investment Portfolios

Dear Mr. Roye:

We are submitting for the staff's consideration a memorandum on the issue of whether the investment program being offered by Folio Investments, Inc. ("Folio") and other similar web-based programs involve the offer and sale of a separate security under the Securities Act of 1933 and an investment company under the Investment Company Act of 1940. The memorandum sets forth persuasive legal and policy arguments that these products are subject to regulation under the 1933 and 1940 Acts. We urge that the Division of Investment Management address the serious issues raised by the memorandum in fashioning an appropriate regulatory response to these products.

As the memorandum notes, Folio offers through its website investment products it calls "Folios"—baskets or portfolios of stocks that the investor purchases in a single transaction. A Folio can include from one to fifty different stocks chosen from a list of 2,500 stocks selected by Folio, and each stock carries a percentage weight that determines its proportion of a particular Folio. The shares in each Folio, containing for the most part odd lots and fractional shares, will be recorded on Folio's books as belonging to each individual investor. Folio will effect investors' purchases, sales, and rebalancings by grouping all of the resulting transactions in each of two daily time windows and executing them by matching and/or bunching them.

Investors can choose from a large number of "Ready-to-go" Folios created by Folio the contents and types of which are as varied as those of mutual funds. Investors also can customize their Folios at or after purchase by substituting stocks or changing their weights. Folio has registered with the SEC as a broker-dealer but not as an investment adviser, and it has not registered any of its products under the 1933 Act or the 1940 Act.

Folio's program augurs a trend—firms using the tools of information technology and the web to create and offer novel types of investment products that allocate fractional interests in pools of securities to individual investors in ways that previously were not cost-efficient. Programs like those offered by Folio replace the investment company shareholders' undivided interest in a securities portfolio with book-entry ownership of the portfolio securities by individual investors. Folio appears to believe that, because of book-entry ownership, and because investors can elect to customize their portfolios (whether or not they actually do so), 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.

The memorandum concludes that Folio is issuing, offering, and selling securities that are separate from the underlying securities in investors' portfolios. The separate securities derive from the pooling of investors' capital in the odd lot trade matching and bunching features of the Program, in the investment expertise built into "Ready-to-go" Folios, and in the investment and trading expertise involved in rebalancing investors' Folios. These features interweave investors' fortunes with the efforts and success of Folio, and investors in the Program will rely largely on Folio's efforts. Such reliance is the hallmark of an "investment contract," which is a security under the 1933 Act.

Furthermore, the Program and Folios are investment companies within the meaning of the 1940 Act. They are issuers of securities that are primarily engaged in the business of investing, reinvesting, and trading in securities, and they share many of the essential

features of traditional investment companies. Like traditional investment companies, the Program and Folios offer smaller investors the benefits of portfolio diversification through participation interests in round lots of securities. Like fund investors, investors in Ready-to-go Folios who do not significantly customize will be relying on the built-in investment expertise of investment professionals. Like mutual funds, the Program and Folios offer investors the ability to liquidate or redeem their odd lots and fractional interests at market prices for round lots. Moreover, without Folio's trade matching and bunching service to liquidate and rebalance their Folios, investors' holdings will be unmanageable and worth significantly less than market price: for the typical investor, the costs of executing odd lot transactions are substantial, and fractional shares are unmarketable.

The policies underlying the 1933 and 1940 Acts—especially the anti-self-dealing, compensation limitation, independent director oversight, and disclosure provisions—justify regulation of Folio's program. Absent regulation, broker-dealers sponsoring Folio-like investment programs could use Ready-to-go Folios as "dumping grounds" for securities inventory, including inventory from unsuccessful underwritings or proprietary trading programs. Furthermore, Folio's current fee of \$295 would be 295 basis points of a \$10,000 investment, which is higher than most mutual fund expense ratios. Absent regulation, there would be no constraints on fee increases for locked-in investors. In addition, without prospectus requirements and advertising regulation, there would be no assurance of standardized and non-abusive claims regarding performance and other matters.

Folio is not alone in its ability to offer prepackaged investment portfolios: other firms are already adopting, repackaging, and promoting similar investment vehicles. Therefore, it is important to consider not only Folio's products, but also their general characteristics and their potential for abuse. The Institute believes that, if not adequately regulated, such products could undermine the basic investor protections intended for investment company shareholders.

For these reasons, the Institute respectfully requests that you and your staff carefully examine the issues raised by the enclosed memorandum. After you have had an opportunity to review it, I will call you with a view toward arranging a meeting to explore these issues further.

Sincerely,

Craig S. Tyle
General Counsel

[Enclosure](#)

cc: Meyer Eisenberg
Deputy General Counsel
U.S. Securities & Exchange Commission