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Web-Based Investment Securities: Should Personal Stock-Baskets Be Subject to 1933 Act Registration

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Web-Based Investment Securities: Should Personal Stock-baskets Be Subject to 1933 Act Registration?

The dawning of the Internet age, combined with a booming economy, brought about a marked increase in direct investment by individuals.[1] Former commissioner of the Securities and Exchange Commission (SEC), Steve Wallman, played a leading role in bringing advanced technologies into the securities industry, and founded the web-based investment company FOLIO*fn* in 1998. Wallman's innovation, FOLIO*fn*, is an investment program designed to bring the stock market to the rapidly diversifying pool of individual investors.

FOLIO*fn* describes its investment service as an alternative to both individual stock picking and mutual funds.[2] The company allows an investor to invest in the stock market "without the complexities, risks, and costs of building [a portfolio] one stock at a time."[3] A "folio"[4] is a group of publicly-traded stocks that can be purchased in a single transaction using the FOLIO*fn* system.[5] When an individual invests in a folio, he has the ability to buy and sell up to fifty securities in one transaction, place orders in dollar amounts rather than in share amounts, trade without commission fees, and control tax expenditure investment risks.[6] FOLIO*fn* asserts that this method of investing

1. *See* Gaston F. Ceron, *The Best Way to . . . Trade Stocks*, WALL ST. J., Dec. 6, 1999, at R32 (noting that 4.6 million online investors had traded at least once in the prior six months). The number of online trading accounts increased from 15.9 million to 20.5 million (29%) during the period from the first quarter of 2000 to the first quarter of 2001 even as the NASDAQ index dipped sixty-eight percent. Dave Pettit, *Still Clicking*, WALL ST. J., June 11, 2001, at R4.

2. FOLIO*fn*.com, *Our Services: FOLIO Investing*, *at* http://www.foliofn.com/content/files/services_folioinvesting.shtml (description FOLIO*fn*'s investing system and services) (last visited Aug. 22, 2001) (on file with the North Carolina Law Review).

3. *Id.*

4. Folios are often called "stock-baskets" in other similar investment programs.

5. An investor chooses a "ready-to-go" folio, which consists of a prepared portfolio of stocks, or he can build a folio from scratch. FOLIO*fn*.com, *Learn More: What's a Folio?*, *at* http://www.foliofn.com/content/files/2.shtml (describing how to create and administer a folio) (last visited Aug. 22, 2001) (on file with the North Carolina Law Review). "Ready-to-go" folios, for example, may be composed of the DOW components, the largest fifty companies of the S&P 500, or top technology companies. *See, e.g.*, Karen Damato, *'Personal Funds' May Challenge Industry*, WALL ST. J., Oct. 6, 2000, at C1 (stating that FOLIO*fn* provides seventy-five different ready to go folios); FOLIO*fn*.com, *Learn More: Overview*, *at* http://www.foliofn.com/content/files/1.shtml (providing a full list of "ready-to-go" folios) (last visited Aug. 22, 2001) (on file with the North Carolina Law Review).

6. *See* FOLIO*fn*.com, *supra* note 2; *see also* Stacy Forster, *The Feeling's Mutual:*

provides all the advantages of individual stock and mutual fund investing,[7] while eliminating the disadvantages.[8]

In September of 2000, the Investment Company Institute (ICI)[9] submitted a memorandum to the SEC regarding the legality of FOLIO*fn* under federal securities law.[10] In this memo, the ICI argues that FOLIO*fn* is "issuing, offering, and selling securities separate from the underlying securities in investors' portfolios"[11] that have not been registered as required by the Securities Act of 1933 (1933 Act).[12] The ICI's challenge to FOLIO*fn* and similar web-based investment vehicles is significant not only because of its members' market power

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New Services Let Investors Manage Their Own Mutual Funds, WALL ST. J., June 11, 2001, at R28 (giving a general description of FOLIO*fn* and similar online investment services).

7. The advantages of mutual fund investing include diversification and simplicity. *See* FOLIO*fn*.com, *Learn More: Why Folios Are Better Than Mutual Funds*, *at* http://www.foliofn.com/content/files/3c1.shtml (last visited Aug. 22, 2001) (on file with the North Carolina Law Review). The advantages of stock investing include tax management and corporate voting rights. *See* Patrick McGeehan, *The Unmutual Fund: The Iconoclast Says He Has a Better Idea for Individuals*, N.Y. TIMES, May 18, 2000, at C1; FOLIO*fn*.com, *Learn More: Why Folios Are a Better Way To Own Stocks*, *at* http://www.foliofn.com/content/files/3b1.shtml (last visited Aug. 22, 2001) (on file with the North Carolina Law Review).

8. The disadvantages of stock ownership, according to FOLIO*fn*, are the expense required to diversify, the fees per trade, and the inability to invest in dollar amounts. *See* FOLIO*fn*.com, *Learn More: Why Folios Are a Better Way to Own Stocks*, *at* http://www.foliofn.com/content/files/3b3.shtml (last visited Aug. 22, 2001) (on file with the North Carolina Law Review). The disadvantages of mutual fund ownership, according to FOLIO*fn*, are indirect ownership, no control over tax consequences, and percentage fees. *See* FOLIO*fn*.com, *Learn More: Why Folios Are Better Than Mutual Funds*, *at* http://www.foliofn.com/content/files/3c2.shtml (last visited Aug. 22, 2001) (on file with the North Carolina Law Review).

9. The ICI represents investment companies that sell mutual funds, closed-end funds, and unit investment trusts. It represents its members and their mutual fund shareholders in matters of regulation and legislation. INVESTMENT COMPANY INSTITUTE, ABOUT THE INVESTMENT COMPANY INSTITUTE, *at* http://www.ici.org/about_ici.html (providing information on the ICI) (last visited Aug. 22, 2001) (on file with the North Carolina Law Review).

10. INVESTMENT COMPANY INSTITUTE, INSTITUTE COMMENTS ON WEB-BASED INVESTMENT PROGRAMS, *at* http://www.ici.org/issues/portfolio_cvr.html (last visited on Aug. 22, 2001) (on file with the North Carolina Law Review) [hereinafter ICI COMMENTS].

11. *Id.*

12. Securities Act of 1933, ch. 38, 48 Stat. 74 (codified as amended at 15 U.S.C.A. §§ 77a-77aa (West 1997 & Supp. 2001)). To register a security under federal law, the security's offeror must file an appropriate registration statement with the SEC and pay a fee. *Id.* § 77f. The registration statement discloses material information about the offered security. *Id.* at § 77g; *see also* THOMAS LEE HAZEN, THE LAW OF SECURITIES REGULATION 115–16 (3d ed. 1996). The type of information disclosed and the particular form used for the registration statement is dependent on the size and nature of the offering. *Id.* at 116. None of FOLIO*fn*'s "products" are registered under the 1933 Act. ICI COMMENTS, *supra* note 10.

in the financial world, but also because the ICI possesses the power to affect financial regulation at the state and federal levels.[13]

The SEC's determination of whether FOLIO*fn* is offering a security will have enormous ramifications. Web-based investment has grown by leaps and bounds during the past few years and has extended personal investing to a much larger group of individuals.[14] Other web-based companies are offering stock portfolios virtually identical to those marketed by FOLIO*fn*.[15] While the SEC might not want to close the door on products that make investing available to the common citizen, it may fear that a relaxed inquiry would open the door to riskier products that could hurt the investing community.[16]

Although web-based products caught the ICI's attention only recently, FOLIO*fn* was not the first company to sell stock-baskets as individual investments. In 1989, Fidelity briefly offered stock-basket investments.[17] Fidelity discontinued offering stock-baskets because they were not profitable, not because the securities laws threatened this practice.[18] The ICI's silence in 1989 raises the question of why it is now taking a position against stock-baskets. One answer is that the Internet has brought stock investment to a larger number of people. The investors' ability to obtain easily diversified stock portfolios may cause them to "fire" their fund managers and to run their own portfolios.[19] Furthermore, personal-fund services, like FOLIO*fn*, may call attention to other weaknesses of managed stock mutual funds.[20]

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13. *See, e.g.*, Charles Gasparino, *Mutual Funds Are Unlikely to Trim Fees*, WALL ST. J., Mar. 25, 1996, at C23 (reporting on the ICI's ability to convince Congress to end state mutual fund regulation); Charles Gasparino, *SEC Shelves Plan to List Money-Fund Data Quarterly*, WALL ST. J., Dec. 27, 1995, at 19 (reporting that ICI pressure on the SEC forced the commission to scrap regulations designed to let investors realize their mutual fund holdings).

14. Ceron, *supra* note 1.

15. Many technology-based investment firms such as BuyandHold.com, Sharebuilder.com, Netfolio.com, and Electronic Investment Corporation have plans to offer similar products. Judith Burns, *Fund Firms Worry About Web Products*, WALL ST. J., Sept. 11, 2000, at C25 (describing the mutual fund industry reaction to stock-basket products). Offering stock-baskets will not be limited to Internet companies, however, as both Fidelity Investments and Charles Schwab are in the process of offering stock-basket portfolios. Damato, *supra* note 5.

16. *See* Memorandum from Investment Company Institute, to the Division of Investment Management of the Securities Exchange Commission (July 12, 2000), *available at* http://www.ici.org/portfolio_com_attach.html [hereinafter ICI Memo] (on file with the North Carolina Law Review).

17. Damato, *supra* note 5 (reporting that Fidelity will offer its customers stock-baskets again, after discontinuing such products twelve years ago).

18. *Id.*

19. *Id.* (describing how stock-baskets differ from traditional mutual funds).

20. *Id.* John Bogle, founder of Vanguard Group, stated, "They are going to be a good

While the ICI might legitimately fear the possibility that these funds will hurt investors if they are not properly regulated, a more significant reason for ICI's opposition is the negative impact of competition on the mutual fund industry.[21] The ICI has not accused UNX, Inc., a company offering stock-basket trading to institutional investors and financial advisors for more than a year, of violating SEC registration requirements.[22] The ICI began to speak up only when companies began to make stock-baskets available to individuals. Although the ICI's memorandum to the SEC raised both liquidity issues and possible needs for disclosure, an ICI spokesperson conceded that one of its main concerns was FOLIO*fn*'s ability to avoid fee and advertising regulations.[23] It appears, therefore, that the ICI would protect mutual funds to the disadvantage of investors. Whereas the ICI's motivation might not totally discredit its argument that stock-baskets are securities, this motive renders its arguments questionable. The SEC should not feel pressured by the market power of the ICI.

The first step in evaluating the ICI's arguments is to determine if FOLIO*fn* sells investments fitting the definition of a "security."[24] Section 2(a)(3) of the 1933 Act defines the term "security."[25] In addition to notes, stocks, bonds, and other investments that are widely thought of as securities, the definition also includes "investment contracts."[26] In *SEC v. W.J. Howey, Co.*,[27] the Supreme Court defined an investment contract as 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.[28] If an investment program meets these four criteria, it is a security subject to the requirements of the 1933 Act.[29]

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competitor and put pressure on costs in the mutual fund field." *Id.*

21. Not all members of the mutual fund industry agree with the ICI. Fidelity, a major mutual fund company, asserts that stock-baskets are not mutual funds and should not be subject to mutual fund regulations. *Id.*

22. *See id.*

23. Burns, *supra* note 15; *see also* ICI Memo, *supra* note 16.

24. Securities Exchange Act of 1933 § 5, 15 U.S.C.A. § 77b(a)(1) (West 1997 & Supp. 2001).

25. *Id.*

26. *Id.*

27. 328 U.S. 293 (1946).

28. *Id.*

29. In *Marine Bank v. Weaver*, the Supreme Court added a further limiting requirement to the *Howey* test: for an instrument to be a security, the investor must risk loss. 455 U.S. 551, 558–59 (1982). The Supreme Court held that a conventional certificate

Despite the Supreme Court's articulation of what constitutes an investment contract, it is very difficult to apply the *Howey* test to FOLIO*fn*'s investment program. The first and third elements of the test are met because people invest money in folios and expect profits from their investments. The common enterprise and promoter effort elements of the test, however, present much closer questions.

The first question is whether FOLIO*fn*'s efforts in supplying stock-baskets for customers constitutes a common enterprise. The circuit courts are split on the question of what relationship is necessary to create a common enterprise. The circuit courts have developed three distinct approaches to the common enterprise question. The Third, Sixth, and Seventh Circuits hold that only "horizontal commonality"[30] creates a common enterprise.[31] Horizontal commonality requires a pooling of interests, usually combined with a pro rata sharing of profits and losses.[32] The Fifth Circuit holds that broad "vertical commonality"[33] suffices, but not necessarily to the exclusion of a horizontal commonality approach.[34] Vertical commonality requires only that the investor and promoter be involved in a common venture without requiring that other investors also be involved in the enterprise.[35] The First, Second, Ninth, and Eleventh Circuits hold that "strict vertical commonality"[36] creates a common enterprise, but not necessarily to the exclusion of horizontal commonality.[37] Strict vertical commonality means that the investor's

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of deposit was not a security because federal banking regulations and the Federal Deposit Insurance Corporation (FDIC) eliminate all risk of loss to the investor. *Id.* at 558–59.

30. Revak v. SEC Realty Corp., 18 F.3d 81, 87 (2d Cir. 1994).

31. *See* SEC v. Infinity Group Co., 212 F.3d 180, 187–88 (3d Cir. 2000), *cert. denied*, 121 S. Ct. 1228 (2001); Cooper v. King, 1997 U.S. App. LEXIS 11296, at *5 (6th Cir. 1997) (per curiam); Milnarik v. M-S Commodities, Inc., 457 F.2d 274, 276 (7th Cir. 1972), *cert. denied*, 490 U.S. 887 (1972); *see also* HAZEN, *supra* note 12, at 33 (stating that horizontal commonality clearly satisfies the *Howey* common enterprise requirement).

32. *Revak*, 18 F.3d at 87.

33. *Id.*

34. SEC v. Cont'l Commodities Corp., 497 F.2d 516, 522–23 (5th Cir. 1974). Broad vertical commonality means that the success of the investment made is primarily dependent on the efforts of the promoter. *Id.*

35. *Revak*, 18 F.3d at 87.

36. *Id.* at 88; *see also* Brodt v. Bache & Co., 595 F.2d 459, 461 (9th Cir. 1978) (holding that a promoter furnishing investment counsel for a commission did not meet the common enterprise test because there was no correlation between investor's success and promoter's efforts). In *Brodt*, the court found that the promoter's weak efforts robbed the investor of potential gains, but that did not necessarily mean the investor would suffer serious losses. *Id.*

37. *See Revak*, 18 F.3d at 88; Villeneuve v. Advanced Bus. Concepts Corp., 698 F.2d 1121, 1124 (11th Cir. 1983), *aff'd en banc*, 730 F.2d 1403 (11th Cir. 1984); *Brodt*, 595 F.2d at 461 (9th Cir. 1978); Schofield v. First Commodity Corp., 638 F. Supp. 4, 7 (D. Mass.

fortunes are tied directly to the promoter's fortunes.[38] The Fourth, Eighth, and Tenth Circuits have not considered the issue.

To support a finding that FOLIO*fn* is offering a security, the ICI argues that many of the shares are fractional,[39] requiring that trading take place via the odd lot trading service,[40] which bunches buy and sell orders together.[41] Therefore, FOLIO*fn* engages in horizontal pooling by risking investors' combined trading capital during the period of time between when orders are entered and when they are actually executed.[42]

FOLIO*fn*, however, is not clearly engaging in horizontal pooling, as the ICI asserts. Profits and losses are not taken on a pro rata basis as required for horizontal commonality.[43] One investor might sell a stock for a profit while another investor might sell a stock at a loss even though they executed the trades at the same time.[44] Even though FOLIO*fn*'s customers all use the odd-lot trading service, having a common agent in the marketplace does not mean those customers are pooling their assets. In *Revak v. SEC Realty Corp.*, the

1985), *aff'd*, 793 F.2d 28 (1st Cir. 1986).

38. *Revak*, 18 F.3d at 88; *see also Brodt*, 595 F.2d at 462 (holding promoter furnishing investment counsel for a commission did not meet the common enterprise test because there was no correlation between investor's success and promoter's efforts). In *Brodt*, the court found that the promoter's weak efforts robbed the investor of potential gains but that did not necessarily mean the investor would suffer serious losses. *Id.*

39. Folio investments are sold in dollar amounts rather than share amounts. Some investors have interests that are only a portion of a whole share (i.e., one-third of a share or five-and-four-fifths of a share).

40. FOLIO*fn*'s "odd lot trading service," as it is dubbed by the ICI, tries to match buy and sell orders of any particular stock together so that the trade can be made in-house without going through a middleman. ICI Memo, *supra* note 16. Only when FOLIO*fn*'s computer system is unable to match orders for a particular stock will the orders be sent to the market for ordinary execution. *Id.* FOLIO*fn*'s founder believes that this method of keeping trades in-house is the secret to profitability. McGeehan, *supra* note 7; *see* ICI Memo, *supra* note 16.

41. ICI Memo, *supra* note 16. FOLIO*fn* also provides a market transaction service for $14.95 per share. FOLIO*fn* fee schedule, *available at* http://www.foliofn.com/content/education/costcalc_fees.jsp (last visited Oct. 24, 2001) (on file with the North Carolina Law Review). Market transactions do not help those that invested smaller dollar amounts, however, because the fee may be larger than the value of the individual security in their folio.

42. ICI Memo, *supra* note 16.

43. *Revak*, 18 F.3d at 87.

44. Stock prices are not constant, so one investor may profit on a sale while another who bought at a higher price does not realize a gain on the sale.

Second Circuit held that purchasers using the promoter's services established a common agency, not a common enterprise.[45]

FOLIO*fn*'s program presents a case similar to *Revak*. FOLIO*fn*'s customers are relying on FOLIO*fn* to serve as their agent in the stock market. Even though investor trades are "pooled" at execution, each investor's fortune does not necessarily depend on the profitability of the enterprise as a whole.[46] Rather, profitability depends solely on the change in market price of the stocks comprising an investor's folio—supporting a strong argument that no horizontal commonality exists under FOLIO*fn*'s scheme.[47] Therefore, in the Third, Sixth, and Seventh Circuits, FOLIO*fn* may not be an investment contract and thus not a security for 1933 Act purposes.

With respect to vertical commonality, the ICI argues that the success of each folio depends on the investment management, trading, marketing, technological efforts, and success of the FOLIO*fn* program as a whole.[48] If FOLIO*fn*'s business is unsuccessful, investors may be stuck with securities that have no value outside FOLIO*fn*'s unique program. The ICI fails to consider that regulations put in place by the SEC protect investors from the possible demise of their broker-dealer.[49] Mutual funds have additional characteristics that create a common enterprise: soliciting contributors, commingling customer funds with each other, and relying on investment expertise of the promoter to produce a profit.[50] Current federal law enables investors to recoup their investments when their broker-dealers become insolvent.[51] Since investor

45. *Revak*, 18 F.3d at 88. Because there was no rent-pooling arrangement between the investors, the court did not think that there was evidence of horizontal commonality. *Id.*

46. *See id.* at 87.

47. In an action against an issuer of a security, the complaining party has the burden of proving that the investment product offered is a security under the 1933 Act. Gary Plastic Packaging Corp. v. Merrill Lynch, Pierce, Fenner & Smith, 756 F.2d 230, 237 (2d Cir. 1985). In an action against FOLIO*fn* charging that it is offering separate securities, the complaining party will have to prove that folios are securities.

48. ICI Memo, *supra* note 16.

49. 17 C.F.R. §§ 240.15c3-1, -2, -3 (2001); *see also infra* notes 66–84 and accompanying text.

50. Subcommittee on Annual Review, Annual Review of Federal Securities Regulation, 40 BUS. LAW. 159 (1984) (using these characteristics to establish that a group deposit administration annuity was like a mutual fund); *see also* Peoria Union Stock Yards Co. Retirement Plan v. Penn Mutual Life Ins. Co., 698 F.2d 320, 324 (7th Cir. 1983) (noting that "[m]utual-fund shares are of course securities").

51. *See infra* notes 77–85 and accompanying text; Securities Investors Protection Act of 1970, 15 U.S.C.A. §§ 78aaa–78lll (West 1997 & Supp. 2001) (establishing the Securities Investor Protections Corporation (SIPC) and the SIPC fund).

interests are therefore protected and not linked to FOLIO*fn*'s success, there is no common enterprise created by a vertical relationship. The broker-dealer regulations[52] sufficiently disalign the interest of investors to the promoter so that no common enterprise is created.

Even assuming there is a common enterprise, courts face a second question—whether investors profit from the efforts of FOLIO*fn*. The Supreme Court's original formulation of the *Howey* test required that the investor's profits derive "solely" from the efforts of others.[53] Since *Howey*, debate has ensued about whether to define "solely" narrowly to mean that an investor can make no efforts in the realization of profits, or more broadly so that an investor can be somewhat involved as long as the main efforts behind the investment are put forth by the promoter.[54] The SEC has noted that in an investment contract, an investor may participate to a limited degree in the operations of the business.[55] Since *Howey*, ten circuits have held that a broad definition of "solely from the efforts of others" is appropriate.[56] Furthermore, the Supreme Court has dropped the word "solely" from its latest statement of the test, indicating that a broad definition will probably be upheld, though the issue remains unresolved.[57]

The FOLIO*fn* program would not constitute a security under a strict interpretation of this prong of the *Howey* test because investors participate in the realization of profits by picking stocks, making trades, and controlling the tax consequences of their folio investments.[58] But, because a broader interpretation will probably be

52. *See infra* notes 77–89 and accompanying text.

53. SEC v. Howey Co., 328 U.S. 293, 298–99 (1946).

54. SEC v. Unique Fin. Concepts, Inc., 196 F.3d 1195, 1201 (11th Cir. 1999); Bailey v. J.W.K. Props., Inc., 904 F.2d 918, 920 n.3 (4th Cir. 1990); SEC v. Glenn W. Turner Enter. Inc., 474 F.2d 476, 482 (9th Cir. 1973).

55. Guidelines as to the Applicability of the Federal Securities Laws to Offers and Sales of Condominiums or Units in a Real Estate Development, Securities Act Release No. 5347, [1972–1973 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 82,539, at 82,539 (Jan. 4, 1983).

56. Steinhardt Group v. Citicorp, 126 F.3d 144, 152–53 (3d Cir. 1997); SEC v. Life Partners, Inc., 87 F.3d 536, 545 (D.C. Cir. 1996); *Bailey*, 904 F.2d at 920 n.3; Messer v. E.F. Hutton & Co., 833 F.2d 909, 916–17 (11th Cir. 1987); Meyer v. Dans un Jardin, S.A., 816 F.2d 533, 535 (10th Cir. 1987); Youmans v. Simon, 791 F.2d 341, 345 (5th Cir. 1986); SEC v. Prof'l Assocs., 731 F.2d 349, 357 (6th Cir. 1984); SEC v. Aqua-Sonics Prods. Corp., 687 F.2d 577, 582 (2d Cir. 1982); Goodman v. Epstein, 582 F.2d 388, 408 n.59 (7th Cir. 1978); *Turner*, 474 F.2d at 482 n.7.

57. United Hous. Found., Inc. v. Forman, 421 U.S. 837, 852 n.16 (1975) (commenting on the *Turner* interpretation without discussing its validity).

58. *See supra* note 6 and accompanying text.

upheld, it is necessary to consider whether FOLIO*fn* meets the more liberal definition. The ICI argues that by providing the odd lot trading service, FOLIO*fn* is extending the main efforts in realizing profits for its investors.[59] Because investors are dealing in small and fractional shares, they would be unable to trade without FOLIO*fn*. Since profits on stocks are realized at the time of sale,[60] the promoter's efforts are more important than the investor's efforts in securing profits, according to the ICI. Without the service, FOLIO*fn*'s customers cannot sell their stocks and realize any profits on their own. In reality, without FOLIO*fn*'s trading services, investors in FOLIO*fn* products have no control. Furthermore, the ICI argues that the investor's effort in choosing a basket is fundamentally the same as choosing a mutual fund, which has been held to be a security and subject to the 1933 Act.[61]

One counter-argument to the ICI's position is that investing in a folio is different than choosing a mutual fund because part of the decision in choosing a mutual fund is selecting not only an investment strategy but the supervising manager of the fund.[62] Because mutual fund holdings can change at any time without investor consultation, the promoter puts forth greater effort, which supports a holding that mutual funds are securities. This argument fails to acknowledge, however, that FOLIO*fn* manages its customers' portfolio at a different level. Whereas a mutual fund manager is responsible for managing his fund,[63] the FOLIO*fn* managers are responsible for managing the entire FOLIO*fn* program: the website, the trading service, and other day-to-day business operations.[64]

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59. ICI Memo, *supra* note 16.

60. This is especially true in today's corporate structure, where many companies do not pay or have reduced payments of stock dividends. Karen Hube, *More Dividends Go the Way of the Dinosaur*, WALL ST. J., Feb. 24, 2000, at R6. Many investors must sell appreciated stock to make gains. *See* C. Frederic Wiegold, *Dividends Are Less Popular Among Young Investors,* WALL ST. J., Feb. 25, 1999, at R10.

61. United States v. Faulhaber, 929 F.2d 16, 19 (1st Cir. 1991).

62. *See* Jonathan Clements, *Getting the Most For Your Money: Does Your Stock Fund Pass These Three Tests?*, WALL ST. J., July 23, 1991, at C1; *see also* 1 MATTHEW BENDER, FEDERAL SECURITIES ACT OF 1933 § 2.01(11)(c)(v) (A.A. Sommer, Jr. ed., 2001) (discussing collective investment vehicles).

63. *See* Clements, *supra* note 62.

64. In executing a trade for a customer, FOLIO*fn* first will try to match orders with other customers seeking to trade in the same security. If there is no match, FOLIO*fn* must send the order to the market to complete the transaction. *See* FOLIO*fn*.com, *FOLIO forum: What's a Window Trade?*, *at* http://www.foliofn.com/content/forum/all_about/article_000511jn.shtml (last visited Aug. 23, 2001) (on file with the North Carolina Law Review).

In both situations, the success of the investment depends largely on the ability of the manager to succeed in his job: stock picking for the mutual fund manager and running the odd lot trading service for the FOLIO*fn* manager. Furthermore, the Ninth Circuit has held that even if an investor has a right to manage the investments in his portfolio, if he is practically dependent on the expertise of another, the promoter's efforts prong of the *Howey* test is met.[65] FOLIO*fn* will likely be seen as making the primary efforts in this investment program. Whether FOLIO*fn* meets the promoter's efforts prong, however, may depend on how it compares to other cases in which courts have analyzed investment programs based on the requirements of the *Howey* test.

Not all investments that fall within the definition of a "security" under the 1933 Act fall under the regulations of the Act.[66] When another federal regulation adequately protects investors, it is unnecessary to subject issuers to the federal securities laws.[67] The rationale is that agencies should avoid regulatory "double-coating"[68] because no reason exists to justify subjecting issuers to the added costs of 1933 Act registration when purchasers are already adequately protected.[69]

The main issue raised in the ICI's memorandum to the SEC is liquidity; the ability of investors to sell the assets in their folio for cash.[70] In the FOLIO*fn*'s case, the market sets the value of the folio through the prices of the underlying securities. FOLIO*fn* is unable to affect the value of the underlying securities except by impacting the demand for securities in general by increasing availability to investors. Because the market determines value here, the issue turns on whether FOLIO*fn* presents investment risk in addition to those risks already inherent in stock ownership.

Many of the risks that publicly traded stockholders face, in addition to market uncertainty, arise because transactions are

65. *See* Hocking v. Dubois, 885 F.2d 1449, 1460 (9th Cir. 1989) (en banc) (citing Williamson v. Tucker, 645 F.2d 404, 424–25 (5th Cir. 1981)).

66. Marine Bank v. Weaver, 455 U.S. 551, 558–59 (1982) (stating that an instrument that seems to fall under the 1933 Act is not to be considered a security if the context otherwise requires).

67. *Id.*

68. Gary Plastic Packaging Corp. v. Merrill Lynch, Pierce, Fenner, & Smith, Inc., 756 F.2d 230, 241 (2d Cir. 1985) (providing context for the term "double coating" as a situation where investors are already "abundantly protected" by another federal regulatory scheme).

69. *Marine Bank*, 455 U.S. at 558–59.

70. In addition, the ICI is concerned about the possible failure of FOLIO*fn* as a company. *See* ICI COMMENTS, *supra* note 10.

affected using middlemen.[71] Therefore, it is extremely important to protect investors through regulation from possible broker improprieties. FOLIO*fn* is such a registered broker-dealer.[72] Registered broker-dealers must comply with another set of SEC regulations,[73] including the SEC's customer protection rules, examination rights, record-keeping standards, and various other unwritten rules.[74] Furthermore, registered broker-dealers are subject to professional conduct codes, sales practice regulations, and salesperson qualification provisions of self-regulatory organizations (SROs).[75] These extensive requirements serve as a tool to implement and to enforce SEC regulations and to help further the policies set forth by the 1933 and 1934 Acts.[76]

A primary function of the broker-dealer regulations is to help secure the financial responsibility of broker-dealers.[77] Because broker-dealers often maintain custody of the securities belonging to their customers (a situation that is especially true at FOLIO*fn*), the

71. Using a middleman for market transactions poses additional risks because the investor usually does not have physical possession of securities and the investor must rely on the middleman to properly execute trades at the desired time for the desired price. *See infra* notes 72–73 and accompanying text. By requiring middlemen to effect securities transactions, customers are also subject to improper broker-dealer activity such as churning, excessive charging, high pressure sales tactics, and unsubstantiated recommendations. HAZEN, *supra* note 12, at 515–20, 463, 510–12, 501–03.

72. FOLIO*fn* is a registered broker-dealer with the SEC, all fifty states, and Puerto Rico. *See* NASD Regulation, Inc., *NASD Regulation Public Disclosure Program*, *at* http://www.nasdr.com/2000.htm (allowing an online search for registered broker-dealers) (last visited Aug. 22, 2001) (on file with the North Carolina Law Review). A broker-dealer not only conducts transactions for others' accounts, but also buys and sells securities for his own account. 15 U.S.C.A. § 78c(a)(4)–(5) (West 1997 & Supp. 2001) (defining "broker" and "dealer"). In general, a broker-dealer must apply to the SEC and receive approval, become a member of a self-regulatory organization (SRO) and the Securities Investor Protection Corporation (SIPC), comply with state requirements, and ensure that all associated persons satisfy the qualification requirements. *See* SECURITIES EXCHANGE COMMISSION, DIVISION OF MARKET REGULATION, COMPLIANCE GUIDE TO THE REGISTRATION AND REGULATION OF BROKERS AND DEALERS, *at* http://www.sec.gov/divisions/marketreg/bdguide.htm [hereinafter SEC GUIDE] (last visited Aug. 22, 2001) (on file with the North Carolina Law Review).

73. Being a registered broker-dealer submits a company to regulation by the SEC. SEC GUIDE, *supra* note 72.

74. Alexander C. Dill, *Broker-Dealer Regulation Under the Securities Exchange Act of 1934: The Case of Independent Contracting*, 1994 COLUM. BUS. L. REV. 189, 217. For specific rules and regulations, see 15 U.S.C.A. §§ 78o, 78q(a)–(b) (West 1997 & Supp. 2001); 17 C.F.R. § 240.17a-3 (2001).

75. Dill, *supra* note 74, at 217.

76. *Id.*

77. *Id.* at 207.

SEC requires certain safeguards to assure that customers can recover securities in the event a broker-dealer becomes insolvent.[78]

In the broker-dealer context, Congress and the SEC use three specific areas of regulation to provide the desired customer protection.[79] First, the SEC requires segregation of customer funds and securities from the broker-dealer's own assets and inventory.[80] Second, the SEC promulgated rule 15c3-1,[81] which requires a broker-dealer to maintain a minimum amount of net capital and prohibits broker-dealers from incurring an aggregate indebtedness in excess of 1500% of its net capital.[82] These two rules ensure that customers and creditors of a broker-dealer are protected if the enterprise fails.[83] Additionally, the rules eliminate investor risk by prohibiting financially unqualified entities from registering as broker-dealers.[84] Third, Congress created an industry-wide fund to satisfy claims of customers when a broker-dealer becomes insolvent.[85]

The SEC regulations of broker-dealers are not only concerned with financial responsibility; registered broker-dealers, including FOLIO*fn* are also subject to the SEC rules prohibiting fraud in securities transactions.[86] These antifraud provisions prohibit misstatements or misleading omissions of material fact and fraudulent or manipulative acts and practices in connection with the purchase or sale of securities.[87] The essence of the SEC's rules is that broker-

78. *See* HAZEN, *supra* note 12, at 461 (describing measures that the SEC takes to assure a broker-dealer's solvency).

79. In addition to these requirements, the SEC also requires broker-dealers to submit to examinations and inspections, register in the lost and stolen securities program, submit to fingerprinting, and maintain information on affiliates that may impact the financial condition of the broker-dealer. SEC GUIDE, *supra* note 72.

80. 17 C.F.R. §§ 240.15c3-2, -3 (2001).

81. *See* Exchange Act Rule 15c3-1, 17 C.F.R. § 240.15c3-1 (2001); Securities Exchange Act of 1934, ch. 404, 48 Stat. 881, § 15(c)(3) (codified as amended at 15 U.S.C.A. § 78o(c)(3) (1994)).

82. Rule 15c3-1, 17 C.F.R. § 240.15c3-1(a)(1)(i) (2001).

83. Michael P. Jamroz, *The Net Capital Rule*, 47 BUS. LAW. 863, 863 (1992) (outlining the basic structure of the Net Capital Rule and describing its fundamental sections and underlying policy considerations). The net capital rule requires broker-dealers to "maintain sufficient liquid assets to enable it to liquidate," satisfying all customer claims, without the need for formal proceedings. *Id.*

84. Dill, *supra* note 74, at 218.

85. Securities Investors Protection Act of 1970, 15 U.S.C.A. §§ 78aaa–78lll (West 1997 & Supp. 2001) (establishing the Securities Investor Protections Corporation (SIPC) and the SIPC fund).

86. SEC GUIDE, *supra* note 72.

87. *Id.* The most notable rules are established under section 10(b) of the 1934 Act, which is a broad provision prohibiting the use of any deceptive device in connection with a purchase or sale of a security. Rules promulgated under section 10(b) require customer

dealers should be prohibited from taking advantage of their superior knowledge of the market.[88] The SEC may also curtail activities that are "manipulative, deceptive, fraudulent or otherwise unlawful."[89] Because the underlying stocks in folios are publicly traded and widely known, the main regulatory issues deal with whether FOLIO*fn* is a safe place to invest. Antifraud rules help to alleviate any concerns that FOLIO*fn*'s officers may be acting in their own best interests rather than those of their customers.

The SEC broker-dealer requirements seem to make further regulation of FOLIO*fn*, and similar web-based investment programs, redundant and therefore unnecessary. If the company can buy back the securities when its customers need cash, as the net capital rules require, investors that purchase stocks from FOLIO*fn* in this fashion face no additional risks. Because the underlying securities have market value independent of FOLIO*fn*'s program, registration under the 1933 Act should not be required.

To determine whether FOLIO*fn* is offering a security, a court will use analysis similar to that used in a case involving another investment bundle. In 1985, the Second Circuit decided *Gary Plastic Packaging Corporation v. Merrill Lynch, Pierce, Fenner and Smith.*[90] In that case, the court held that bank certificates of deposit (CDs), sold by Merrill Lynch, acting as an intermediary for its customers, were securities even though CDs sold directly by banks are not securities under the 1933 Act.[91]

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confirmation, disclosure of credit terms, and restrict insider trading. Securities Exchange Act of 1934 §§ 10b-10, 10b-16, and 10b-5, 17 C.F.R. §§ 240.10b-10, 240.10b-16, and 240.10b-5 (2001). Rule 10b-5 has been interpreted broadly by courts to prohibit more than just fraud. *See* United States v. O'Hagan, 521 U.S. 642, 651–52 (1997) (holding that 10b-5 also covers insider-trading activities). In addition, the SEC may bring an action against a broker-dealer for fraudulent activity under section 17(a) of the 1933 Act. Securities Exchange Act of 1933, § 17(a), 15 U.S.C.A. § 77q(a) (West 1994 & Supp. 2001). Rules promulgated under 17(a) generally require broker-dealers to treat their customers fairly. Roberta S. Karmel, *Is the Shingle Theory Dead?*, 52 WASH. & LEE L. REV. 1271, 1273–74, 1295 (1995) (noting courts have held that "by hanging up a shingle" and doing business as a broker-dealer impliedly represents that the broker will treat customers fairly).

88. Karmel, *supra* note 87.

89. SEC GUIDE, *supra* note 72.

90. 756 F.2d 230 (2d Cir. 1985).

91. *Id.* at 242. It should be noted that, according to *Howey*, the definition of a security was supposed to be broad and ambiguous, giving courts wide discretion in making a determination. *See* SEC v. Howey, 328 U.S. 293, 299 (1946). Supreme Court precedent thereby ensured that lower courts will always have some level of discretion when applying the *Howey* test, even in a clear case. *See* Marine Bank v. Weaver, 455 U.S. 551, 560 n.11 (1982).

In *Gary Plastic*, the Second Circuit focused on the common-enterprise and promoter-efforts prongs of the *Howey* test.[92] In evaluating the common enterprise, the court stated that Merrill Lynch established a common enterprise by investigating issuers, marketing the CDs, and creating a secondary market for them.[93] The court also held that investors in this program relied on the efforts of the program's promoter, Merrill Lynch.[94] On behalf of its investors, Merrill Lynch negotiated with the banks to get favorable interest rates on the CDs.[95] Also, Merrill Lynch's creation of a secondary market tied the liquidity of the CDs to the financial solvency of Merrill Lynch.[96] If the secondary market did not exist, investors would not have had the advantages of liquidity and capital appreciation.[97] The court stated further that the success of the program depended on Merrill Lynch's standing as an investment power and its ability to negotiate with banks.[98]

After discussing the *Howey* test, the court inquired into the existence of other regulatory law covering the program at issue.[99] If such laws exist, then holding that the investments were securities would be a "double-coating" of regulation.[100] The court stated that if investors have no other protection, the court has a greater incentive to view the investments as securities.[101] In *Gary Plastics*, banking law

92. Gary Plastic Packaging Corp. v. Merrill Lynch, Pierce, Fenner & Smith, 756 F.2d 230, 240 (2d Cir. 1985).

93. *Id.*

94. Note that the Second Circuit did not apply a strict meaning to "solely" from the efforts of others requirement. *See id.* (noting a "significant portion" of the investment hinges on Merrill Lynch's expertise).

95. *Id.* For a more detailed description of how Merrill Lynch operated its program, see Raphaela M. Giampiccolo, *The Second Circuit Illuminates the* Howey *Investment Contract Test's Impact on Novel Financing Instruments*, 52 BROOK. L. REV. 1001, 1004–05 (1986).

96. *Gary Plastic*, 756 F.2d at 240.

97. *Id.*; *see* Jana M. Winograde, *Classifying a Foreign Bank Certificate of Deposits as a Security: The International Impact of* Wolf v. Banco Nacional de Mexico, 4 B.U. INT'L L. J. 451, 464–65 (1986).

98. *Gary Plastic*, 756 F.2d at 240–41. Merrill Lynch's market power was the distinguishing factor from the Supreme Court's holding in *Marine Bank*. *Id.* at 241.

99. *Id.* at 240–41.

100. *Id.* This holding is based on the Supreme Court's mandate in *Marine Bank v. Weaver*. 455 U.S. 551, 552 (1982). The crux of *Marine Bank* is that when another federal regulatory scheme protects investors and helps to eliminate the risk of loss, the need for federal securities law protection disappears. *Id.* at 558–59.

101. *Gary Plastic*, at 240–41; *see also* J. Christopher Kojima, *Product-Based Solutions to Financial Innovation: The Promise and Danger of Applying Federal Securities Laws to OTC Derivatives*, 33 AM. BUS. L.J. 259, 304 (1995) (stating that the Supreme Court has held that an instrument otherwise meeting the *Howey* test is not a security if already covered by another regulatory framework).

did not regulate these investments, which created a regulatory gap.[102] The court indicated that the possible lack of government control weighed heavily in its determination that the CDs offered by Merrill Lynch were investment contracts and therefore subject to the 1933 Act.[103] Whether a regulatory gap exists, according to the Second Circuit, appears to be the most important factor in determining if an investment should be deemed a security and subject to SEC regulations.[104] Even if an investment contract meets the definition of a security, this threshold issue must be overcome before it becomes subject to the 1933 Act.[105]

The main similarity of the program offered by Merrill Lynch in *Gary Plastic* and the stock-baskets offered by FOLIO*fn* is that the investment's liquidity depends on the ability of the seller to maintain the program. If FOLIO*fn* becomes financially insolvent, investors will not have a defined group of other investors willing to trade shares in house (without going to the market) or to pool shares to make market transactions feasible.[106] Initial investors experience not only the risk inherent in the stock market, but uncertainty about FOLIO*fn*'s ability to successfully use its system technology to maintain a market for its customers. Inability to trade the investment in the marketplace is the same problem Merrill Lynch's customers would face if Merrill Lynch were no longer able to provide a secondary market for the CDs it sold.[107] The argument that FOLIO*fn* is selling a security just like Merrill Lynch in *Gary Plastics* can be refuted, however. In *Gary Plastics*, the Court was not really concerned with an investment power like Merrill Lynch becoming insolvent, but with Merrill Lynch merely giving up on the program.[108]

There are major differences, however, between the CDs sold by Merrill Lynch and the investments offered by FOLIO*fn*. First, FOLIO*fn*'s program does not exist solely because of its standing as an

102. *Gary Plastic*, 756 F.2d at 241–42 (noting that absent the securities laws, investors in Merrill Lynch's program had no federal antifraud protection).

103. *Id.* Some experts have criticized the lack of other federal regulations requirement. *See* Marc I. Steinberg & William E. Kaulbach, *The Supreme Court and the Definition of "Security": The "Context" Clause, "Investment Contract" Analysis, and Their Ramifications*, 40 VAND. L. REV. 489, 504–18 (1987).

104. *Gary Plastic*, 756 F.2d at 241 (stating that "a gap would exist . . . that would strip the investor of needed federal protection"). Without proper regulation, investors lack federal protection against fraud and misrepresentation in the marketplace. *Id.*

105. *See supra* notes 66–69 and accompanying text.

106. *See* McGeehan, *supra* note 7 (describing FOLIO*fn*'s trading strategy).

107. *See* Winograde, *supra* note 97, at 465.

108. *Gary Plastic*, 756 F.2d at 240 (noting Merrill Lynch customers were relying on the implicit promise that Merrill Lynch would maintain marketing efforts).

investment power.[109] To the contrary, similar programs have emerged in both Internet companies[110] and more established investment companies.[111] Packaging stocks into various baskets, therefore, does not require any special market power or leverage.[112] The program can be provided by any broker-dealer with access to the software who wishes to make it available to its customers.

Second, in *Gary Plastic*, Merrill Lynch not only monitored banks selling CDs (to ensure their credit-worthiness), but also negotiated interest rates directly with those banks.[113] Investors relied on Merrill Lynch's expertise, making its efforts the most important part of this investment.[114] FOLIO*fn* presents a different case. FOLIO*fn* does not negotiate or monitor the companies in its folios.[115] Nor does FOLIO*fn* provide much assistance to customers who create their own folio.[116] Furthermore, the Internet itself is interactive by nature. The Internet allows investors to use companies like FOLIO*fn* to control what stocks they wish to hold, what stocks they wish to trade, and when they wish to trade them.[117]

In conclusion, the protections of 1933 Act registration can be guaranteed without holding that FOLIO*fn* is offering a security. The purposes of the 1933 Act are twofold: to provide full and fair disclosure of securities sold in interstate commerce, and to protect investors from fraudulent securities practices.[118] The broker-dealer

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109. This is in contrast to Merrill Lynch's market strength in *Gary Plastic*. Here, Merrill Lynch took an investment that must be held normally until maturity and made it freely tradable and therefore, redeemable before that date. *Gary Plastic*, 756 F.2d at 240; *see* Winograde, *supra* note 97, at 465.

110. *See supra* note 15 and accompanying text.

111. Fidelity Investments and Charles Schwab are both in the process of offering stock-baskets. Damato, *supra* note 5.

112. Furthermore, the packaging of stocks into bundles by Internet broker-dealers does not change the fundamental nature of the investment, unlike Merrill Lynch in *Gary Plastic*. *See* Winograde, *supra* note 97, at 465.

113. *Gary Plastic*, 756 F.2d at 240–41.

114. *Id.*

115. FOLIO*fn* simply makes publicly traded stocks already available in the marketplace available in a different format. *See* Damato, *supra* note 5 (describing FOLIO*fn*'s product as a personalized fund product consisting of an assortment of U.S. stocks).

116. *Id.* (noting investors may construct folios "on their own or with considerable assistance").

117. ICI Memo, *supra* note 16; *see also* Gaston F. Ceron, *How Technology Changed the Way We... Invest in Stocks*, WALL ST. J., Nov. 13, 2000, at R32 (describing the effects of online trading on investing).

118. Securities and Exchange Act of 1933, ch. 38, 48 Stat. 74 (1933) (codified as amended at 15 U.S.C.A. § 77a (West 1997 & Supp. 2001)); *Gary Plastic*, 756 F.2d at 237; David B. Guenther, *The Limited Public Offer in German and U.S. Securities Law: A*

regulations act in a way that eliminates any liquidity problems created by FOLIO*fn*'s structure. Since those are the only real "1933 Act disclosure" concerns uncovered by the *Howey* analysis—all the necessary disclosure is given by the registration and regulation of the underlying stocks that compose an investor's folio.

Investors are also protected from any possible fraudulent activity by FOLIO*fn* or other web-based investment programs when broker-dealers run the programs. Therefore, further requirements placed on these types of investment programs will not serve any useful purpose and result only in over-regulation. Excessive regulation can often raise the cost of doing business to prohibitive levels, thereby stopping otherwise desirable business activity.[119]

Unnecessary 1933 Act registration is especially costly because of its comprehensive disclosure requirements.[120] These added costs might cause FOLIO*fn* and other similar programs to reduce their products available to customers.[121] There is no reason to slow down these types of innovative investment programs, which make securities investment available to the general public.

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Comparative Analysis of Prospectus Act Section 2(2) and Rule 505 of Regulation D, 20 MICH. J. INT'L L. 871, 898 (1999); Cynthia A. Williams, *The Securities and Exchange Commission and Corporate Social Transparency*, 112 HARV. L. REV. 1197, 1209–10, 1223–26 (1999).

119. *See* Marshall B. Kapp, *Health Care in the Marketplace: Implications for Decisionally Impaired Consumers and Their Surrogates and Advocates*, 24 S. ILL. U. L.J. 1, 29–30 (1999).

120. Michael McDonough, *Death in One Act: The Case for Company Registration*, 24 PEPP. L. REV. 563, 595 (1997).

121. *See id.*