Developing Opportunities for Islamic Investing in the United States Securities Markets: Personal Portfolio Programs (Folios)

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Introduction

Over the past few years, the SEC has been forced to respond to evolutionary — in fact, revolutionary — changes by either revising existing regulations or creating new rules as a result. It is within this constant assessment and revision process that some of the most far-reaching impacts upon the future of securities markets have occurred. The advent of Internet trading and its attendant technologies in the past decade has played its role in destroying the definitions of instruments and markets that have been in existence for nearly a century. The boundaries that became rather rigid over time have now become more permeable. It is within this expanding environment that new instruments and markets are finding more room to maneuver, creating opportunities for finance based on Islamic precepts as well.

Two of the most prominent opportunities created by this new regulatory environment are Alternative Trading Systems (ATSs) and Folio investing (Folios). ATSs, to use the SEC s terminology, encompass the now popular Electronic Communications Network (ECN) trading platforms that have arisen to blur the distinction between securities markets and broker/dealers. More on the subject of ATSs can be found in my paper Alternative Trading Systems and the Viability of an Islamic ECN . Folios are also a recent addition to the securities universe, blurring the distinction between instruments such as direct equity securities and mutual funds to such a point that some commentators believe Folios to be new instruments in themselves. To some extent, ATSs and Folios are demonstrative of the industry s newfound capability to create and expand definitions of instruments and markets. This paper takes a brief look at how this flexible regulatory environment could allow institutions and instruments adhering to the Islamic Shari ah to flourish as never before, and some the issues that will arise as a result of increased activism in this respect.

Personal portfolios also referred to popularly as folios - do not represent an opportunity for Islamic finance in that a door once closed to it has suddenly been opened, but rather it stems from recent developments in the field of financial instruments. At this stage of this product s history, a discussion of its impact is necessarily sketchy. In June of 2000, the first personal portfolio service was introduced by a firm named Foliofn, founded by former SEC Commissioner Steven Wallman. Since then, other firms have arisen to announce planned services as well, including Netfolio and UNX — both planning to establish operations with folios as their core offerings. The traditional brokerage houses have not been inactive, however, and E*Trade has announced their plans to add folios to their range of offerings as well. New entrants are Sharebuilder.com and Buy and Hold.

Beyond this, the only facts known with any surety are the characteristics of folios themselves. Meanwhile, the debate on the exact impact these characteristics might have on

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As of September 10, 2001, Netfolio announced that it would cease operations by the end of the month.

investors, and therefore their proper regulatory treatment, continues. These instruments have blurred the distinctions set by long honored boundaries. Folios have blurred the distinctions between different instruments and services. Only recently has the SEC addressed some of the issues brought forward by concerned industry observers. In order to understand the issues surrounding folios, it is necessary to first treat what is immediately apparent — that is, what folios are and how they work in practice. Then, the discussion will focus on the debate that Folios have generated by reviewing recent exchanges between industry advocacy groups. The paper will then conclude by offering some practical suggestions to institutions that might desire to take advantage of this new type of service while wishing to avoid some of its more questionable aspects.

Description of Personal Portfolios (Folios)

Personal portfolios can be reduced to several significant and general characteristics. In the first place, they are usually a collection of a set number of stocks grouped together by virtue of a common denominator. Therefore, there might be a folio of stocks within a certain industry, a folio of stocks with common risk characteristics, and, of course, a folio of Islamically acceptable stocks. In this light, folios seem to be identical to a mutual fund. However, folios are the creatures of their owners. That is, the investor can inspect the holdings of the folio and drop or add stocks to fit their particular preferences. In this way, the investor is acting as his or her own fund manager. In fact, the investor can construct a folio on his or her own, from scratch, but usually with a maximum number of stocks allowed in the folio. In addition, the folio services will also set a maximum number of folios allowed to each investor. Trades entered by the folio investors as a result of their adjustments are executed at pre-set times during the day. Therefore, these instruments do not lend themselves to trading.

In return for this service, the investor pays a flat monthly fee. The existing folio services, being registered as broker-dealers, have not forgotten the common commission business. The investor can also place individual trades as well for a separate, per trade commission. This type of trading is done by those investors who are making purchases outside of their folios or by those who wish to make a purchase or sale immediately rather than wait for the prescribed times at which folio trades are made. A further unique characteristic is that the investor specifies a dollar amount for his folio purchase rather than individual trades placed by number of shares. Thus, if an investor were wishing to buy a folio of the Dow 30 stocks, he or she would simply invest a certain dollar amount into such a folio. This dollar amount chosen by the investor is then spread across the Dow 30 stocks in the exact weighting as they stand in the Dow Jones Industrial Index. Investing by dollar amount rather than by share amount obviously leaves the investor with fractional shares — the handling of which is a source of concern to certain industry participants.

Let s use a simplified example, in which times have been good to riba-based banks, and only three Shari ah-compliant companies exist in the Islamic Market Index, based on the Debt-to-Equity ratio measure. The weightings are:

ABC 50%
XYZ 30%
LTD 20%

We will also assume at first that they have conveniently closed at:

ABC $10
XYZ $6
LTD $4

Our firm, FolioInc, marketing IndexFolio, will be dealing with three clients: Investors A, B, and C. Each investor places the following instructions (or orders):

Investor A: Buy $1000 IndexFolio (Resulting in $500 ABC, $300 XYZ, and $200 LTD
or 50 shares ABC, 50 shares XYZ, and 20 shares LTD)
Investor B: Buy $1000 IndexFolio (Resulting in $500 ABC, $300 XYZ, and $200 LTD
or 50 shares ABC, 50 shares XYZ, and 20 shares LTD)
Investor C: Sell 100 shares ABC ($1000 of ABC)

Investors A and B have placed the simplest orders, probably to either begin the folio, or to add to it, keeping in line with the accepted weightings. Investor C has decided to change the weightings in IndexFolio for some reason, and has therefore placed a more specific order.

Given this scenario, FolioInc will aggregate these orders and even match some of its own buy and sells. Looking at the orders above, particularly by comparing them in terms of shares, we notice Investors A and B *in aggregate* wish to buy 100 shares of ABC. As a result they may have their orders pooled and then matched against Investor C s sell of 100 shares ABC. The remainder of Investors A and B s orders will also be pooled and presented to the market as one order. These two methods of aggregating and matching allow FolioInc to control costs. This is also the source of an issue that might be regulated in more detail by the SEC in the near future. The idea that a firm internalizes its order flow is contrary to SEC goals. An internalized order is not exposed to the broader market and therefore not subject to price improvement possibilities. However, in defense of FolioInc, matching is done after a specific price has been determined and price improvement would not make sense. In addition, this activity is not internalization in the exact definitional sense. Lastly, like many other broker/dealers, our imaginary folio company would not be prohibited from making order flow payment arrangements with market makers. Payment for order flow is definitely an issue being studied by the SEC and may be subject to future restrictions. These issues will be studied more in-depth below.

A more realistic scenario is one in which the prices of each of our imaginary stocks does not so easily conform to the weightings and the dollar amount invested by each investor. Let s change each stocks price:

ABC $10.25
XYZ $6.50
LTD $4

Now, a $1000 investment by both Investor A and B is a little more problematic. Basically, FolioInc must have a program in place to spread the $1000 invested by each investor over the three issues while keeping the exact weighting of congruous to their weightings in the index. No numerical example is needed here to drive home the point: there will be substantial issuance of odd lot and fractional shares. Even if we create a second folio, say TechFolio, if an investor wishes to place an investment by dollar amount — as is done with mutual funds — then even a folio of one stock would result in fractional shares. It is not the concept of index weighting that causes this; it is the concept of investing by dollar amount itself.

The handling of fractional shares is another controversial process. It is assumed, in general, that our imaginary firm, FolioInc would have to commit its own capital to buy whole shares and divide them up into fractions to distribute to the clients. This may only matter to a sponsor who does not have its own trading arrangements established and therefore must invest new money to establish a trading activity at least to meet the commitments of the folio program. As an alternative, the aggregation of orders may result in exactly enough shares to split into whole and fractions when the orders are filled, but this seems more likely in theory rather than in

practice. If it is a case in which the folio company purchases pools of shares, and that also, the investors are issues a portion of those pools, then the case that folios involve the issuance of a security — much like a mutual fund share — begins to have merit.

Folios have some clear advantages. The most obvious is the cost involved in investing in a folio versus a mutual fund or investing in individual stocks. Again, the example of the Dow 30 stocks can be used. In order to construct a portfolio of these 30 stocks, the investor would have to place 30 different trades, all accruing a separate commission charge. The alternative, of course, would be to simply invest the money in a Dow 30 index fund and allow a professional to track it. While the investor may not pay a commission, a mutual fund will pay its advisor for managing the fund. The cost of professional management of the money in the fund is greater than if the investor were to pay the flat monthly rate charged by the folio services. In addition, since the investor is the manager of his or her own fund when he or she purchase a folio, they will also control the realization of capital gains and losses, and hence the tax consequences of their investing. This is not the case had the money been placed with a mutual fund.

The cost comparison perspective does not hold in all cases, of course. The applicability of this less expensive than mutual funds slogan depends on the actual pricing of the folio service and the value of the assets held in the account by the investor. For example, using the most recent average annual expense ratio figure of 1.23%, a mutual fund investor pays $12.30 per $1000 he or she has invested in funds for expenses. For folios, the comparison must be made against the sum of monthly fees per thousand. For example, if we know that the firm charges $25 per month as its flat fee — or $300 per year — then we have the information we need to make a comparison. Obviously, if an investor holds only $1000 in a folio, he or she does not achieve cost advantages. The assets necessary to achieve this would be more in the ballpark of $24,390. Existing folio companies have made this comparison to mutual funds using a figure depicting the average balance held in mutual funds — a figure which varies between $25,000 and $38,000. If the investor fits this average picture, then folios in comparison to mutual funds are less expensive.

Existing folio companies have also been quick to add that the real cost savings arise from the fact that the investor can place an unlimited number of trades for a set fee. Had the investor been forced to resort to the open market to accomplish a pseudo-index portfolio, the commission charges would have been astronomical. In asserting this aspect, the folio companies conveniently forget that the investor could have accomplished this by going to an index mutual fund. In short, the cost advantage argument applied by folio firms can sometimes be a little loose in its overlapping logic.

The Regulatory Debate

The Investment Company Institute (ICI), an advocate organization for investment companies, has led the call asking the SEC to consider the issues raised by folios.[1] While at first, there seemed to be concern about the administrative or legal status of the fractional shares generated by folio activities, the ICI in subsequent correspondence and statements to the SEC backed away from this assertion. At first, it was theorized that the fractional shares held by the folio company were evidenced by an undivided interest placed proportionately in each investor s account. This is similar to the way in which a mutual evidences ownership in its assets. Hence, if this were accepted, then it would be an acknowledgement of the issuance of shares . With the issuance of fractional shares on this underlying pool of whole shares, registration would be required, since in effect, like a mutual fund a new security was being issued. Instead, as will be demonstrated, the ICI used the generation of fractional shares as evidence of the creation of an investment contract rather than new shares . This did not undermine the apparent strength of their argument since an investment contract is also considered the issuance of a new security and is thus subject to registration as such.

Basically, the ICI contended that an investment contract was being created because investors would have to rely upon the folio companies expertise to such a degree that such the legal and regulatory definition of an investment contract would be met. This reliance existed because of two main characteristics of folio investing:

- The pre-packaged folios and the ability to re-balance their holdings used modern financial methods and portfolio management theory. The ICI contends that the investor who likely did not understand the methods or procedures he was accessing with the click of a mouse was thus relying on the expertise of the folio companies creating these instruments and the specific portfolios it was offering;
- The ability to trade in fractional shares and odd lots in approximation to round lot prices was another concern. Normally, trading in fractional shares and odd lots is cost prohibitive. Yet folio firms used execution methods that allowed for the trading of fractional shares and odd lots at close to full share prices. The reliance of the investor is created that in the event of the bankruptcy of a folio company, the investor might be in the position of liquidating a great number of these fractional shares and round lots under the usual, most costly terms of trading. Therefore, the continued operation of the folio companies fractional and odd lot trading service was key in shielding the investors from considerable losses.

In addition, the ICI also listed other concerns with the fractional and odd lot trading service. In executing investors trades, the folio companies would bunch trades — as in the example used in the foregoing section — and matching trades with other order flow. In this case, the ICI expressed concerns with potential abuses in these practices.

It is important to delve somewhat further into the issues surrounding the creation of an investment contract, since treatment of some of these issues will be key to a potential sponsor of future Islamic folios. The issue of greatest concern is the possibility of a folio program being subject to registration as a new security. The Securities Exchange Act of 1933 (1933 Act) defines an investment contract as a security [2]. The question then is left open to regulatory and legal guidance as to what is deemed an investment contract. This issue was most notably addresses in a Supreme Court decision written in 1946, known as the Howey opinion[3]. The Supreme Court derived a four-element test that would define an investment contract. These four elements are:

- A person invests their money;
- The money is invested in a common enterprise;
- The investor is led to expect profits on the investment;
- These profits are to be derived solely from the efforts of a promoter or third party.

To re-phrase this in a more fluid manner: an investment contract exists if an investor invests his or her money in a common enterprise that relies on the efforts of a promoter or third party in order to generate profits on that investment. The ICI contends that of the four points delineated above, folio programs clearly meet the first and third elements[4]. There seems to be little argument with the ICI on this point. Clearly, investors invest their money in the folio program and clearly they do so seeking a profit. The argument begins when points two and four are discussed.

In moving to the issues of these remaining two points, the ICI again relies again on established legal standards. The existence of a common enterprise is measured against the degree commonality , which is then split into horizontal commonality and vertical commonality . Horizontal commonality exists when two or more investors interests are brought into a common pool. Vertical commonality is said to exist when investors interests are brought under the control of a third party or promoter. Hence, if a group of people pool their interests and place this pool

under the control or management of a third party, a common enterprise is said to exist. Since vertical commonality depends upon how reliant the pool under his or her management is upon his or her services or successful operation, this discussion then leads directly into point four as defined by the Howey opinion — the dependence of the investors on the efforts of a third party or promoter.

The ICI s argument holds that while the folio companies do not actually pool the folio investors assets and then evidence their undivided interest in that pool, there is a concerning amount of pooling when the folio applies its fractional share and odd lot trading service. In doing do, the folio company must bunch trades. During the time that this is done until the time of final execution, the folio company is creating horizontal commonality. In addition, once this pool is created, the execution of the trade depends upon the expertise of the folio company — a third party. Hence, vertical commonality is also created. With both aspects of commonality present, the folio becomes an investment contract. The ICI also holds that the construction of pre-packaged portfolios and the tools created to allow the investor to re-balance their folio holdings also constitutes a significant degree of cooperation between sponsor and investor to such a point at which vertical commonality is once again created. Here, the ICI s argument hinges on whether or not the SEC sees the temporary pooling of assets during a brief execution period as the existence of horizontal commonality based on the intent behind the definition promulgated by the courts. Also, the SEC would have to agree that executing the trades of folio investors in this manner caused any greater degree of reliance upon its execution capabilities than a typical brokerage firm does in the course of executing normal trades for its clients.

It would seem that by establishing the presence of vertical commonality, the fourth point of the Howey opinion s test would also be satisfied. On the contrary, the wording of the Howey opinion creates one more issue. The fourth point requires that the investors be *solely* reliant on the efforts of a third party or promoter. Vertical commonality only stands as evidence that there is reliance on the efforts of a third party, but it does not preclude that success might also be dependent on the efforts of the investors in addition to the efforts of a third party. The ICI further contends that the definition of sole reliance is met, according to the interpretation of the courts, when: 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 [5]. The success of the ICI s argument, in this respect, then hinges upon whether the SEC would agree with assertion that the folio companies efforts are the undeniably significant efforts being made.

All of the preceding only applies to one of the ICI s assertions: that folios should be treated as securities and thus subject to registration under the 1933 Act. This can be summed up by saying that the ICI believes that folios, based on the fact that they fit the four-prong test in the Howey opinion, are investment contracts. Hence, since they are investment contracts, they are included under the definition of a security per the 1933 Act and therefore subject to registration under that law.

However, the ICI further asserts that folio programs should also be regulated under the Investment Company Act of 1940 (1940 Act). In this respect, the ICI s assertion is that folio companies, through their updating and fractional share and odd lot trading service, qualify as investment companies since this constitutes on-going professional management. However, justification for this assertion seems to stem from the fact that the relationship established by folio companies is significantly different than the traditional relationship established between a client and a broker dealer. It does not necessarily follow that if it is different than the client-broker dealer relationship, it therefore must be a client-investment company relationship.

Additionally, the 1940 Act defines an investment company as an issuing entity that is or holds itself out as being engaged primarily, or proposes to engage primarily, in the business of investing, reinvesting, or trading in securities. [6] Citing the legislative history behind this act, the ICI makes a further point regarding the interpretation of an issuing entity. As such, the ICI

contends that an actual issuance need not occur, such as the case with mutual fund shares, which are the most common evidence of the existence of an investment company. The ICI asserts:

> The law is clear that an investment vehicle does not have to involve pooling of assets in a single entity to be an issuer and hence as investment company: it need only involve an organized group of persons. An investment company is formed from the separate accounts of investors who have purchased in separate accounts of investors who have purchased in separate accounts the same pre-packaged portfolio and rely upon the sponsor s portfolio updating service rather than significantly customize their portfolio (and thus hold the same or substantially the same securities)[7]

It should be noted that while the law is clear, based on numerous citations made by the ICI, that an investment vehicle does not have to involve the pooling of assets, what immediately follows in the latter part of the above quote is not necessarily as clear. In the latter part of the text, it is the ICI claiming that it is clear that pre-packaged portfolios are investment vehicles.

Finally, as a matter of sound policy, the ICI states that the SEC should regulate folio firms more closely. For now, we will quickly enumerate the concerns the ICI cites calling for closer regulation. We will then return to them in somewhat more detail when we address structural issues facing potential Islamic folios. The issues of concern are:

- The trading service, as structured, could raise self-dealing issues in the execution of trades;
- Competent disclosure of fees and regulation thereof;
- Appropriate oversight by a board of directors, given that it is acknowledged that folios are sufficiently like mutual funds to warrant such a board;
- Sufficient regulation of advertising as established under the 1940 Act.

In response to this well-documented argument made by the ICI, the Securities Industry Association (SIA) submitted comments to the SEC. The SIA s response was somewhat dismissive in its approach to the ICI s lengthy assertions[8]. The SIA s belief is that the current regulatory framework is adequate to cover the concerns cited by the ICI. The SIA does specifically quote the SEC s Rule 3a-4 which denies the existence of an investment company in cases where the investor(s) retain certain rights over the securities in their accounts. Thus, while the ICI maintains that a group of clients, who purchase substantially equal batches of securities but hold them in individual accounts, as is the case with pre-packaged folios, are investment companies, the SIA maintains that Rule 3a-4 provides the exception.

The ICI, in its petition, only mentions Rule 3a-4 by way of passing. The ICI s argument attempts to block use of this safe harbor by stating that this is only allowed to accounts that receive a certain level of individualized attention, i.e. the identification of personal investment objectives. The SIA believes that the ICI missed something. Rule 3a-4(5) states that regardless of the level of the discretion taken by a third party in managing the account, the account or accounts will not qualify as an investment company if the owner of the assets in the account can execute certain activities equivalent to those he or she could execute if this account was not part of the program. These activities would normally include withdrawing cash or securities, vote those securities, be provided with timely notification of transactions, and take action against any issuer of the securities in the account without being obligated to join or have others in the program join in this action.

In arguing in this light, the SIA is allowing that this is only a consideration if, and only if, the ICI s assertion that folios constitute discretionary programs is true. If the folio programs are

discretionary, then the SIA still maintains that they meet this safe harbor from qualifying as an investment company. As an explanatory point, a discretionary account, or program, is one in which the client does not hold final authority over the buy and sell decisions of the manager. The classic case of this is a mutual fund, where mutual fund investors do not have the right to veto the fund manager s decisions. On the other hand, a non-discretionary account, or program, is one where the investor does withhold the right to accept or reject the buy and sell decisions. In this manner, these decisions become more like recommendations to the investor.

The ICI claims they are discretionary since the folio program does not establish a sufficiently individualized program, and further, that it is most likely that program participants will blindly follow the recommendations of the folio sponsor in terms of updating and rebalancing the portfolio holdings. This is a weak assertion. The SIA responds that such regulation should be based on factual evidence rather than the likelihood of an event occurring. In sum, the SIA opposed the ICI s petition to the SEC on the following points[9]:

- Customers make their own decisions when it comes to choosing a portfolio and the securities within that portfolio;
- They directly own each security once that portfolio is purchased;
- Customers retain control over the assets as required by Rule 3a-4;
- The SIA does not agree that there is a common enterprise as asserted by the ICI; and
- Customers do not expect profits dependent on the efforts of the third party sponsor.

At last, on August 23, 2001, the SEC made its first official comment on the status of these programs. In essence, the SEC denied the ICI s petition for rulemaking, citing no interpretive issues were raised by the creation of folio programs and that existing regulation was sufficient to cover the concerns. However, the SEC reserved the right to explore these programs further if abuses or interpretive issues did arise after a period of their operation proved the existence of such abuses or interpretive issues.

Practical Considerations of Establishing a Shari ah-compliant Folio Program

The purpose of the foregoing, in-depth discussion was no so much to evaluate the merits of each party s arguments, but rather to highlight the concerns raised by the creation of personal portfolios. The SEC s response to the ICI s petition did not preclude further regulatory attention in the future. Any future rulemaking could address the concerns of the ICI up to their fullest extent. The most responsible response to this fact is to identify all possible factors that could be addressed or restricted at a later date and structure the Shari ah-compliant folio program in such a way that future regulatory changes impact it in the least possible manner. To do so, this discussion will treat as correct as many of the ICI s assertions as feasible and then suggest methods of reducing the concerns they raise. What follows is by no means an exhaustive list of concerns and suggestions.

The points among the ICI s major concerns that need to be addressed are:

- The degree of the investor s reliance on the sponsor s expertise in terms of financial theory;
- The degree of the investor s reliance on the fractional share and odd lot trading service;
- Prevention of potential trading abuses;
- Disclosure and regulation of fees;
- Board oversight of general and advertising disclosure; and
- Rule 3a-4 safe harbor compliance.

Investor reliance on a third party

Any discussion of this point necessarily overlaps with a discussion of the application of the Rule 3a-4 safe harbor . Rule 3a-4 exempts discretionary programs from registration as an investment company, if a certain level of individualized attention is given to the means and the end purpose of the investor s account. The ICI contends that this is not the case with folios. It is not the case because of excessive reliance on the part of the investor on the program sponsor. Admittedly, the ICI believes that the investor will not question the update and rebalancing recommendations of the sponsor and therefore be reliant. As already stated, this is a rather weak assertion. The fact is that the option will be present for the client to have the final authority on decisions made to update or rebalance. The ICI believes that in constructing the pre-packaged portfolios, the sponsor will use tools of modern portfolio management theory that will be inaccessible to the common investor. Likewise will be the case in the continual management of the folio that leads to updates or rebalancing.

The sponsor can treat this concern in several ways. Firstly, the folio could be built around already established guidelines, such as an index. Therefore, all subsequent changes are made by the index and not the folio sponsor. The sponsor merely communicates that changes have been made and allows the investor to mimic the independent index. Secondly, the sponsor could strictly limit the criteria it uses in the construction of the folios. Lastly, the sponsor could refuse to offer pre-packaged folios all together and require that the investor create the folio using the tools the sponsor offers, and even in this case, the sponsor could continue to limit the criteria available to the investor. The primary goal common to all of these suggestions is that the sponsor places the burden of action on the investor in order to dispel the aura of reliance on its management role.

Investor reliance on the special trading service

The ICI asserts that the trades necessary to construct these unique portfolios would normally be quite costly since they would almost always involve fractional shares and odd lots. The bunching activity of the sponsor, on behalf of the investor, allows for these trades to be executed at close to round lot prices. The concern arises from the fact that there may not be adequate protection of the investor should the sponsor for any reason cease this trading service. Should this occur, then the investor would be forced to liquidate at normal trading costs and substantial losses could be incurred.

Again, there are several methods of recourse for the potential sponsor. The sponsor could allow the creation of folios involving round lots — or full shares. In the case of an index fund, the folio would then be unable to exactly track the index itself and only approximate it. Using other financial criteria would be somewhat easier. For example, a folio built on stocks that have less than 33% debt does not inherently require that the folio must be built using fractional or odd lot shares. If the sponsor feels that prohibiting fractional share and odd lot trading is too restrictive, it could establish such a service with several safety nets. These provisions could include conducting the service through a third party or entering into an agreement with a third party ensuring the continuance of the trading service in the event of the demise of the sponsor. This third party may simply pledge to execute the liquidating trades of the investors that participated in the folio program. The use of a third party to execute the folio trades can also help avoid any possible problems or alleviate constraints where the sponsor will not or cannot commit large amounts of its own capital to the venture.

Prevention of potential trading abuses

The discussion of reliance on the continuation of the sponsor s trading service leads naturally into a discussion of potential abuses of this service by the sponsor while it is being offered. For example, if the sponsor has a proprietary trading program — that is, it trades for its own account or is a securities dealer that holds its own inventory — it could use folios as a dumping ground for certain securities. In other words, the sponsor could use the folio program and trades to get itself out of some positions that had soured. There are numerous ways this could be done, one of which is to match trades being bunched for the specified folio execution windows against positions in the proprietary trading accounts. How exactly this is done raises many issues, since the sponsor technically may have advanced notice of the folio trade being readied on its possible effect on the market price of the stock in question (similar to the classic definition of front running). In addition, the sponsor may violate restrictions on trading ahead of customer limit orders as well. If this happens to not be the case, then there are still concerns over whether or not matching the orders internally obtains the best execution possible since the order may not be exposed to the market for price improvement possibilities. When the folio order could extricate the proprietary account from a difficult position, the temptation to commit one of these abuses is strong. Furthermore, the abuses mentioned here are not the only possibilities.

To alleviate these concerns, the sponsor could implement several measures. It could simply prohibit matching, which may temper the advantages of the trading service as well. Similarly, the sponsor could institute stringent administrative walls between departments so that the proprietary traders could not know of forthcoming trades on the part of the folio program. The sponsor could also bunch these trades and then submit them to a third party market maker for execution. This lessens the opportunity for self-dealing, but issues such as best execution and internalization still exist. However, these issues exist independent of the implementation of a folio service. Structural issues in the overall markets give rise to these concerns, not folios themselves. In addition, folios are not the only instruments to suffer from these drawbacks, since they are general concerns. The possibilities for alleviating this concern are as numerous as structure a broker dealer can take under normal industry circumstances.

The ICI also mentions that the quality of the executions of these pooled orders gives rise to further reliance on the expertise of the sponsor. One response would be to develop guidelines establishing a tight execution window for these trades, depending on the degree of control the sponsor has in this regard. If the trades are executed with third party market makers, the sponsor may have no control. The goal in this respect is to make the execution of these trades non-discretionary in terms of its actual execution. The trade must be executed as quickly as possible as opposed to being worked for whatever reason that may exist. Again, this is a matter of policy that will have to be dealt with by the sponsor, since allowing an order to be worked so that a better price might be obtained may outweigh the risks of such activity, such as a worse price being obtained. Again, this is not a risk inherent to folios, since any trade submitted by a client to a broker runs these same order-handling risks. The issue here is that this becomes a consideration if loose execution windows and broader execution discretion transmute folio activity into interpretive concerns.

Disclosure and regulation of fees

One of the enticements of folios programs are the cost savings in terms of fees paid by participants versus normal commissions to achieve the same portfolios and normal management fees charged by mutual funds. As was discussed above, the cost savings versus normal commissions is obvious. The exception arises, however, when comparing these savings to mutual funds. There is a critical mass that the investor s account must reach before he or she is paying less per dollar under management than he or she would be paying to a mutual fund. Above, we

used the example fee of 1.23%, which translated into a dollar amount of about $24,390 as the point at which the investor was paying less than a mutual fund.

This raises several issues for the sponsor. The sponsor must adequately disclose the fact that these savings do not hold true for all amounts invested. The comparison is highly relative. Given that this paper proposes the establishment of an Islamic folio, it would seem that such open disclosure would be a matter of course based on Islamic principles. From a practical standpoint, the sponsor must decide if it is going to restrict the participants in a folio program by restricting minimum investment into such a program. Given that 1.23% is an industry-wide average of management fees, the sponsor may wish to limit investment to no less than $25,000. However, the cost savings could still be lost by normal devaluation caused by market valuation over time. As the value of the portfolio drops with the market value of the stocks that comprise it, the portfolio could fall below the minimum asset value at which the cost savings over mutual funds is achieved. The other approach to this problem is to lower the monthly fee charged, making it more competitive while expanding the program s accessibility if a minimum investment is imposed. The lower the monthly fee, the lower the total annual cost of the folio program. Hence, the folio program will also become more competitive when the cost is compared to that of mutual funds. Nevertheless, the sponsor will still be offering a product with a fixed, predictable revenue stream as opposed to the vagrancies of commission revenue.

Board Oversight

The ICI raised a concern that folios were sufficiently similar to mutual funds to warrant the oversight of a Board of Directors. Primarily, the concern was that is a folio were built around a stated investment objective, like a mutual fund, then oversight would be necessary to ensure that the sponsor was only making update and rebalancing recommendations that were congruent to that stated objective. An Islamic folio inherently has the answer to this issue. The folio itself, or the Islamic broker dealer could make this oversight the purview of a Shari ah Board. Again, there is a great deal of flexibility with which the sponsor can treat this issue. As just indicated, the sponsor can appoint a Shari ah advisor or board of advisors for the folio program based on Shari ah principles. Likewise, the sponsor may avail of an already existing board if its core business is based on Shari ah principles. In the case of indexes, such as the Dow Jones Islamic Market Index, any subsequent changes to the criteria used by the index will have been overseen by the index s Shari ah Board as well.

As for the activities of individual sponsors, it is always recommended that the sponsoring firm have at least one Shari ah advisor to treat a host of issues, including the issues enumerated in this paper. Shari ah principles treat more than just financial measures. These principles include full disclosure, activities of board members and employees of the financial entity — which establish a high standard of honesty and fair dealing - as well as interpretive issues pertaining to the trading activity of the clients of the firm, to name just a few. Dividends still accrue to the folio owner directly, so the advisor(s) must notify the investors of purification requirements on these dividends. Also, they must periodically check to ensure the Shari ah-compliant firms remain as such. Folios have one particular full disclosure issue of note. This disclosure issue revolves around the stated cost savings versus mutual funds, as discussed in detail in the immediately preceding section.

Rule 3a-4 Compliance

Again, SEC Rule 3a-4 is intended as a safe harbor for discretionary programs from the requirement of registration as investment companies. The program — in this case the folio programs — must give sufficient attention to the goals and objectives of each investor. The wider the array of folios a sponsor offers, the more important this becomes, since an investor can delineate his or her preferences and the sponsor can recommend a certain number of folios. Of course, this is also contingent on whether or not the sponsor offers pre-packaged folios. In requiring that the investor pick the criteria for screening the stocks that will comprise the folio, the sponsor has only somewhat alleviated the concerns that an investor is too reliant on the sponsor s services. On the other hand, the sponsor could also simply contend that it is offering the tools an investor needs to make informed decisions, combined with a specialized trading service that allows for more exact weighting of portfolios. This will largely remain an interpretive issue unless the SEC promulgates new rules specifying objective measures of an investor s reliance on the sponsor s services. The wisest course would be to define this reliance as conservatively as possible.

To further thwart any concerns of non-compliance with Rule 3a-4, the sponsor must also safeguard the rights of the program participants in regard to their assets. The investors must have the same rights over their holdings as they would otherwise have in a normal brokerage account. The investors have the final say over the disposition of those holdings, having considered all updated information provided them by the sponsor. The investors must also retain all rights of ownership and the rights implied by that ownership, such as rights to participate directly in dividends, shareholder voting, and unilateral action against the corporation that issued the individual securities being held as part of the folio. Here, again, the role of a Shari ah advisor is key. Among the responsibilities of an advisor or board of advisors is a constant review effort in which firms are audited to ensure continued compliance with the Shari ah. If a change in status takes place, then the advisor(s) can notify each investor and notify each investor of their rights and responsibilities. In doing so, the folio sponsor is acknowledging that each program participant has full rights as a shareholder in each of the individual securities that comprise the folio itself.

Conclusion

In summation, personal portfolios offer attractive possibilities for Islamic financial institutions, namely any future Islamic brokerage house. Unless changed in the near future, folios will offer brokerages a source of fixed revenues at little relative cost. Many of the drawbacks facing emerging Islamic financial institutions can be avoided by marketing folio services. At the same time, however, the same institutions can attract much needed assets by offering some of the same value that mutual funds offer, without the expense of establishing the fund and the subsequent challenge of poor economies of scale inherent in new mutual funds with a small, but growing asset base. Folios offer a relatively low-cost way in which the emerging Islamic financial institution can compete with its already establish non-Islamic counterparts.

Folios are new and innovative, offering the Islamic financial institutions a means of differentiating their services from those of any other non-Islamic financial institution at which any number of Muslim investors can be found holding accounts. Secondly, as Islamic mutual funds also emerge in the U.S. markets, they will at first suffer from poor economies of scale as their assets under management grows. The smaller the fund, the more impact the advisory and operation fees have on the return to the investor. Economies of scale can quite conceivably drive prospective Muslim investors away from these new Islamic funds to the mutual funds of non-

Islamic financial institutions. Folios again offer another attractive draw to the assets of Muslim investors.

Moreover, from the institutional point of view, folio services offer a source fixed fees as opposed to the less reliable revenues provided by pure commission-based brokerage services. A trend has been emerging for the past several years all across the financial industry. This trend reflects a move away from commission-based services to fixed fee revenue sources. Trading activity, and hence commission revenues, can be notoriously cyclical , as recent experience has taught many brokerage houses. It is no wonder that there is a drive to move toward the predictability offered by any number of fixed fee services, such as money management and financial planning. Lastly, any broker-dealer can offer folios. They do not require any additional registration. As of now, they are not considered separate instruments, but rather services offered by brokerage houses. The cost of registering a mutual fund is in and of itself daunting enough to give a fledgling financial institution, such as most Islamic financial institutions are in the United States, reason to pause. Folios represent a manner in which these institutions can offer a method of investing similar to investing in a mutual fund.

It is only through constant innovation in products and institutions that the Islamic financial industry will be able to draw the active assets of Muslim investors away from their current place with non-Islamic financial institutions. Without this innovation, the Islamic financial industry cannot expect these assets to move from existing institutions to the newer ones based on Islamic principles. In essence, a strong strain of differentiation is required — differentiation between Islamic and non-Islamic financial institutions. This differentiation cannot be represented simply by the presence of Islamic principles, but new and creative ways of investing according to those principles. Simply touting a firm as Islamic will not secure that companies place within the industry, nor will the simple offering of an Islamic screen immediately draw Muslim investors and their assets. Innovation is needed that not only supports the necessary activities of the Islamic financial institutions being established in the United States, but also that supports the identity of the Islamic financial industry as whole.

ENDNOTES

[1] Investment Company Institute, Memorandum on Folio and Other Internet Portfolio Services, (Washington D.C., July 12, 2000) and Petition to SEC on Portfolio Investments Programs (Washington D.C., March 28, 2001). These are available at the ICI s website, www.ici.org.
[2] Securities Exchange Act of 1933, Section 2(a)(1). [15 U.S.C. 77b(a)(1)].
[3] SEC vs. W. J. Howey, Co., 328 U.S. 293 (1946).
[4] Petition to SEC on Portfolio Investment Programs, (Washington D.C., March 28, 2001) p. 7.
[5] SEC vs. Glenn W. Turner Enterprises., Inc., 474 F. 2d 476. 482. Quoted in Investment Company Institute, Petition to SEC on Portfolio Investment Programs, (Washington D.C., March 28, 2001) p. 8.
[6] Investment Company Act of 1940, Section 3(a)(1)(A) [15 U.S.C. 80a-3].
[7] Petition to SEC on Portfolio Investment Programs, (Washington D.C., March 28, 2001) p.11.
[8] Securities Industry Association, Re: Investment Company Institute Petition for Rulemaking dated March 28, 2001, (Washington D.C., June 14, 2001).
[9] Ibid., p. 4.