Promoting Efficient Arrangements Between Portals and Online Brokers

June 26, 2000

Intuit Inc.
Electronic Financial Services Council

This white paper is being submitted in response to SEC Commissioner Laura S. Unger's invitation to provide input on issues discussed at the February 22, 1999, West Coast roundtable on Internet issues – "Online Trading: Can We Keep Apace of Cyberspace?" The views discussed herein do not necessarily reflect the business practices of the sponsors of this white paper.

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I. Objective

When addressing business arrangements between broker-dealers and portals, the staff of the Securities and Exchange Commission ("SEC") has limited the structure of the compensation arrangements to minimize investor protection considerations they have associated with the payment of transaction-based compensation. The following discussion proposes that more flexible compensation arrangements may be permitted consistent with investor protection.

II. Executive Summary

Portals have helped bring more investment-related information to investors in a more timely fashion. This includes financial news, quotes, investor educational materials, as well as more substantive content such as research that was once made available almost exclusively to institutional investors. As the Internet and electronic commerce continue to develop, financial service providers such as broker-dealers are presented with new opportunities to market their services and reach investors either directly through their own web sites, or indirectly, through portals. Portals and broker-dealers frequently would like the flexibility to enter into arrangements under which broker-dealers can market their services to portal users in exchange for variable compensation, including transaction-based compensation.

The SEC staff has historically permitted such marketing or solicitation arrangements between broker-dealers and unregistered persons without requiring registration of the unregistered persons only where a number of conditions are satisfied. These conditions have been designed to ensure that the unregistered persons are not "effecting transactions in securities" or otherwise acting as broker-dealers. In the arena of arrangements between broker-dealers and portals, these conditions have focused disproportionately on limiting the payment of transaction-based compensation. The result is that there is a disconnect between the economic desire to structure compensation arrangements in a flexible and efficient manner that corresponds to the evolving business environment of the Internet, and the regulatory need to carefully structure arrangements in order to

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* *This white paper is submitted on behalf of Intuit Inc. and the Electronic Financial Services Council ("EFSC"). Intuit is a leader in e-finance, including financial software and web-based financial services for consumers and small businesses. Intuit's Quicken.com® web site (www.quicken.com) is a leading financial site, offering a comprehensive set of financial news, information and tools, including insurance, mortgage, investment and tax preparation services. EFSC is an organization that represents leading companies from various sectors within the financial services industry that deliver financial services over the Internet. The EFSC was established in January of 1999, and the organization's mission is to meet consumer needs for easier access to financial products and services by updating laws and regulations to facilitate electronic commerce. EFSC's web site is located at www.efscouncil.org. Intuit and EFSC gratefully acknowledge the contributions of other portals and broker-dealers that have provided input and commented on this white paper. This white paper was prepared with the assistance of Steven W. Stone and Jennifer L. Klass of Morgan, Lewis & Bockius LLP.*

address investor protection concerns. This disconnect can be reconciled by focusing on the following principles:

- Transaction-based compensation is just one of a number of factors that should be considered in determining whether a particular person is a broker-dealer subject to registration and regulation. It should *not* be the dispositive factor.

- Portals should not be viewed as "effecting transactions in securities" within the meaning of Section 3(a)(4) of the Securities Exchange Act of 1934 ("Exchange Act"), regardless of the type of compensation to be received. The temptation to characterize every person who receives transaction-based compensation as a broker-dealer runs counter to the premise of functional regulation on which the securities laws are based. Application of broker-dealer concepts to portals should be based more upon any active role played by portals in effecting customer transactions.

- Marketing arrangements between portals and broker-dealers do not, in reality, implicate investor protection issues that necessitate application of broker-dealer registration and regulation to portals. Broker-dealers participating in such arrangements are regulated by the SEC and the National Association of Securities Dealers, Inc. ("NASD") and, as such, are responsible for the manner in which they conduct business.

- The potential for "high pressure sales tactics" that the SEC has historically associated with the receipt of transaction-based compensation is not presented by portals. Investors are most vulnerable to high pressure sales tactics when they are interacting personally with a salesperson in whom they have placed their trust and confidence. Investors simply do not have the same type of personal dealings or relationship with portals.

- The narrow focus on transaction-based compensation ignores the larger environment in which the arrangements between broker-dealers and portals are developing. The manner in which electronic commerce is conducted constantly changes and is difficult to predict. Competitive pressures affecting portals and broker-dealers alike necessitate that the compensation arrangements be flexible. Unduly restricting arrangements between portals and broker-dealers in a manner not directly related to investor protection issues is, at the very least, inefficient from economic and policy perspectives.

- If marketing arrangements between broker-dealers and portals are viewed as raising any conflict of interest concerns (and we do not think they do), these are best dealt with through disclosure – the principle underpinning much of our federal securities laws. Disclosure – not substantive regulation – is the approach taken by the SEC in the case of solicitation arrangements between registered investment advisers and "solicitors" under Rule 206(4)-3 under the Investment Advisers Act of 1940 ("Advisers Act"). If flexibility in adviser solicitation arrangements has been permitted without need for subjecting solicitors to adviser registration requirements, then it is unclear why advertising arrangements involving broker-dealers should be subject to far greater restrictions. This is particularly so given that investment advisers are fiduciaries, and broker-dealers – while they may take on a fiduciary role – frequently act in a lesser capacity.

III. Determination of Broker-Dealer Status

Section 3(a)(4) of the Exchange Act currently defines a "broker" to mean "any person engaged in the business of effecting transactions in securities for the account of others, but does not include a bank." A "dealer" is defined in Section 3(a)(5) of the Exchange Act to mean "any person engaged in the business of buying and selling securities for his own account, through a broker or otherwise, but does not include a bank, or any person insofar as he buys or sells securities for his own account, either individually or in some fiduciary capacity, but not as part of a regular business." Section 15(a) of the Exchange Act requires every broker or dealer engaged in interstate activities to register with the SEC.

The statutory definitions of broker and dealer establish a system of functional regulation under which a particular person is regulated according to its actual activities.[1] A person who is "engaged in the business of effecting transactions in securities for the account of others" may be subject to broker-dealer registration and regulation.[2] Although the SEC staff has from time-to-time identified certain considerations that bear on broker status,[3] neither the SEC nor its staff has ever outlined a conclusive list of factors that is determinative of broker-dealer status. Instead, the concept of "effecting transactions in securities" has been interpreted broadly,[4] and the determination of broker-dealer status has been based on the application of a number of factors or "badges" applied flexibly where investor protection warranted. While no one factor has been dispositive, the presence of multiple factors has increased the likelihood that a person would be deemed to be acting as a broker-dealer.

These badges have developed over time largely as a result of staff interpretation. As the following discussion demonstrates, when faced with the question of whether a particular person is engaged in the business as a broker-dealer, the SEC staff considers the various facts and circumstances surrounding that person's

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[1] John Polanin, Jr., *The "Finder's" Exception from Federal Broker-Dealer Registration*, 40 Cath. U.L. Rev. 787, 798 (Summer 1991).

[2] For purposes of this discussion, the question of whether a person is effecting transactions in securities on behalf of others (as opposed to himself or herself) is the more relevant inquiry. Thus, while the term broker-dealer is used, the discussion will focus primarily on the broker definition.

[3] *See InTouch Global, LLC* (pub. avail. Nov. 14, 1995) (focusing on: (i) the type of and basis for any compensation received; (ii) the extent to which the person holds the funds or securities of others; (iii) the extent of contact with the public; and (iv) the recurrence of the securities activities). *See also In re Joseph Kemprowski and the Cambridge Consulting Co.*, Exchange Act Release No. 35058 (Dec. 8, 1994) (citations omitted) (noting that a number of factors are relevant in determining whether a person was acting as a broker, including whether the person: (i) actively solicited investors; (ii) advised investors as to the merits of an investment; (iii) acted with a certain regularity of participation in securities transactions; and (iv) received commissions or transaction-based remuneration).

[4] *See MuniAuction, Inc.* (pub. avail. March 13, 2000) (citations omitted) (stating that "[a] person effects transactions in securities if he or she participates in such transactions 'at key points in the chain of distribution.' Such participation includes, among other activities, assisting an issuer to structure prospective securities transactions, helping an issuer to identify potential purchasers of securities, soliciting securities transactions (including advertising), and participating in the order-taking or order routing process (for example, by taking transaction orders from customers).").

activities. The determination of broker-dealer status depends on the accumulation of the factors or badges that suggest broker-dealer activities on the one hand, or the presence of countervailing factual, policy or regulatory considerations on the other.

A. Finder's Fee Arrangements

In the context of a specific distribution of limited partnership interests in a Canadian hockey team (the Senators), the SEC staff determined that singer Paul Anka was not required to register as a broker-dealer.[5] Under the terms of their arrangement, Mr. Anka provided representatives of the Senators hockey team with the names and addresses of people whom he believed would be interested in purchasing limited partnership interests. Mr. Anka was not to participate in the negotiations between the Senators and the investors or otherwise directly contact investors to solicit their interest. In return for his referrals, Mr. Anka was entitled to receive a ten percent commission on sales to any person whom he recommended.

In determining that Mr. Anka was not required to register as a broker-dealer in connection with his involvement in this distribution, the SEC staff focused on the limited scope of Mr. Anka's activities and also the nonrecurrence of those activities. Specifically, Mr. Anka had not previously engaged in or acted as a broker or finder in other offerings of securities, and he represented that he had no intention to do so in the future. The nonrecurrence of the finder's activities was also relevant to an earlier no-action request in which the additional representation that the unregistered person had not previously and would not subsequently engage in the offering or distribution of securities contributed to the SEC staff's decision to reverse its earlier denial of a no-action request.[6]

Despite the presence of transaction-based compensation, the SEC staff was persuaded that, because this was a one-time occurrence in which Mr. Anka would not be effecting transactions or discussing investments, registration was not required. This was so despite the facts that Mr. Anka's involvement related to a *specific* offering of securities and that no registered broker-dealer was involved. By contrast, portal arrangements generally involve marketing a broker-dealer's services *generally (*not *specific* offerings of securities) and any securities transactions are effected by a registered broker-dealer.

The SEC and its staff have in other instances not required broker-dealer registration where the activities of the persons in question are limited to passive activities that do not involve negotiating contracts, discussing details, or making recommendations to potential customers. In the context of an arrangement between two "finders" who provided consulting services to financial institutions and a registered broker-dealer marketing an investment strategy thought to be attractive to savings and loan associations, the finders were not required to register where their activities were "confined to introduction."[7] The finders set up the initial meeting and introduced the parties, but did not discuss or recommend a particular investment strategy, evaluate the financial impact of the use of the strategy, explain or comment on the details of how the strategies might

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[5] *See Paul Anka* (pub. avail. July 24, 1991).

[6] *See Carl L. Feinstock* (pub. avail. April 1, 1979) (reconsideration of no-action request); *John DiMeno* (pub. avail. Oct. 11, 1978).

[7] *See Financial Charters & Acquisitions, Inc. and Hirshen & Associates* (pub. avail. Nov. 25, 1984).

operate, or attend subsequent meetings. Only the broker-dealer had the authority to negotiate contracts with the financial institutions and implement the investment strategies.

Similarly, Rule 3a4-1 of the Exchange Act permits certain associated persons of an issuer to engage in "passive" sales activities relating to offerings of that issuer's securities without being deemed to be brokers.[8] The permitted activities are limited to prevent the associated persons from being involved in soliciting customers or effecting securities transactions. Thus, under Rule 3a4-1(a)(4)(iii)(A), the issuers' associated persons may prepare written communications, but the communications can only be delivered through the mail or other means not involving oral solicitation of a potential purchaser. The associated persons may also respond to inquiries of potential purchasers, but the communication must be initiated by the potential purchaser, and the content of the responses is limited to information contained in the offering documents.[9] Finally, the associated persons may perform ministerial and clerical work involved in effecting transactions, but may not themselves effect those transactions.[10]

In the factual situations discussed above, the nature of the activities in which the unregistered persons were engaged was limited in order to ensure that they were not "effecting transactions in securities."

B. Bank Networking Arrangements

The SEC staff has considered the question of broker-dealer registration extensively in the context of "networking" arrangements between broker-dealers and certain federal and state chartered banks, savings and loan associations, savings banks, and credit unions (collectively, "Financial Institutions").[11] Under these arrangements, broker-dealers may provide securities brokerage services on the premises of the Financial Institutions so long as a number of conditions are satisfied. These conditions are designed to ensure that unregistered persons are not engaging in securities or investment-related activities and to ensure that the customers of the Financial Institution understand the difference between the services provided by the Financial Institution and those provided by the broker-dealer. Thus, for example, the securities-related activities are required to take place in an area that is physically separate and clearly segregated from the deposit-taking area of the Financial Institution, the broker-dealer must approve all advertising relating to brokerage activities, and all customer communications must indicate clearly that brokerage services are provided by the broker-dealer and not the Financial Institution.

With regard to compensation arrangements, the broker-dealers have been allowed to pay various types of fees to a Financial Institution based directly on securities transactions that occur at or are attributable to the activities conducted on that Financial Institution's premises. Although unregistered employees of the Financial Institutions are not similarly permitted to receive transaction-based fees, they could receive a "one-

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[8] *See Persons Deemed Not to be Brokers,* Exchange Act Release No. 22171 (June 27, 1985).

[9] Exchange Act Rule 3a4-1(a)(4)(iii)(B).

[10] Exchange Act Rule 3a4-1(a)(4)(iii)(C).

[11] *See, e.g., Chubb Securities Corporation* (pub. avail. Nov. 24, 1993); *Mid-Hudson Savings Bank FSB* (pub. avail. May 28, 1993); *Interactive Financial Solutions, Inc.* (pub. avail. Dec. 15, 1992).

time fee of a nominal, fixed-dollar amount, wholly unrelated to the execution of securities transactions or the volume of securities traded by the customer."[12] Such a fee typically is payable upon the unregistered employee's referral of a customer to the broker (such referral frequently taking the form of setting up an appointment with a registered representative, having the customer complete a questionnaire or account application, and in some cases the customer's actually opening an account[13]).

The determination that these Financial Institutions and their employees should not be subject to broker-dealer registration was based in part on the fact that, although the Financial Institutions and their employees had contact with potential investors, their activities were limited to prevent them from "effecting transactions in securities." In addition, banks (but not other non-bank Financial Institutions) are excluded from the statutory definitions of broker and dealer under Sections 3(a)(4) and 3(a)(5) of the Exchange Act largely because they are already subject to regulatory schemes designed to ensure investor protection.[14] Requiring banks to register as broker-dealers would subject them to duplicative and unnecessary regulation. More than anything else, the outcome in these letters can perhaps best be explained by policy issues arising out of changes in banking regulation. A 1982 decision by the Comptroller of the Currency reinterpreted the Glass Steagall Act to permit national banks to establish subsidiaries that offered discount brokerage services to banking and nonbanking customers.[15] This decision significantly expanded the brokerage activities of national banks, which were previously limited to providing accommodation brokerage services for traditional banking customers.[16] It also put financial institutions that were not national banks at a significant disadvantage. The *Chubb Securities Corporation* line of no-action letters is, implicitly, an attempt to level the playing field among different types of Financial Institutions.

More recently, the bank networking arrangements discussed above were codified in the Gramm-Leach-Bliley Act, which significantly alters the Glass Steagall divisions between banking and brokerage activities dating from the 1930's. In this regard, Section 201 of Title II of Gramm-Leach-Bliley Act amends the definition of "broker" found in Section 3(a)(4) of the Exchange Act to create a specific exemption for third-party brokerage arrangements. In particular, new Section 3(a)(4)(B)(i) when effective in May 2001 will exempt from the definition of a broker a bank that "enters into a contractual or other written arrangement with a broker or dealer registered under [the Exchange Act] under which the broker or dealer offers brokerage

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[12] *Mid-Hudson Savings Bank FSB* (pub. avail. May 28, 1993).

[13] *See INVEST Financial Corporation* (pub. avail. August 27, 1993); *Independent Financial Securities, Inc.* (pub. avail. July 21, 1993); *Capital Securities Investment Corporation* (pub. avail. Feb. 3, 1993); *UVEST Financial Services Group, Inc.* (pub. avail. Nov. 24, 1992); *The Dime Savings Bank of New York, FSB* (pub. avail. June 30, 1992); *Laughlin Group Advisers, Inc*. (pub. avail. March 11, 1992); *Anchor National Financial Services, Inc.* (pub. avail. Jan. 22, 1992).

[14] *See American Bankers Assoc. v. SEC*, 804 F.2d 739, 746 (D.C. Cir. 1986) (noting that "there is much evidence in the [Exchange] Act's legislative history that Congress decided to exempt banks from the broker-dealer jurisdiction of the SEC because they were already subject to systematic government oversight").

[15] *In re Security Pacific National Bank*, [1982-83 Transfer Binder] Fed. Banking L. Rep. (CCH) ¶ 99,284 (Aug. 26, 1982).

[16] Lewis Loss and Joel Seligman, *Securities Regulation* § 8A.2.d.(i) (1995).

services on or off the premises of the bank" if the arrangement meets certain conditions patterned after the *Chubb Securities Corporation* no-action letter.

C. Non-Profit Organizations

The SEC staff has permitted marketing programs under which broker-dealers compensate non-profit organizations, including trade associations, professional associations, and charitable organizations (collectively, "Non-Profit Organizations") in return for endorsing the broker-dealer's services without requiring the Non-Profit Organizations to register as broker-dealers.[17] Under these letters, the activities of the Non-Profit Organizations are typically limited to promotion and marketing. In *Security Pacific Brokers, Inc.*, for example, the Non-Profit Organization endorsed the use of the broker's services in written communications, allowed the use of its name for co-branding purposes, distributed advertising and other literature explaining the types of possible brokerage accounts (including a schedule of commission rates and a toll-free telephone number that could be used to open an account), provided access to membership and mailing lists, allowed the brokers to advertise in their publications and at their conventions and meetings, and performed incidental activities to assist the broker in promoting its brokerage services. The Non-Profit Organizations were compensated in a number of ways, including a percentage of revenues generated by the brokerage activities of its members, a fixed amount based on every brokerage account opened by a member, a percentage of the average monthly balance of the total dollar amount of mutual fund shares held in member accounts, and a fixed percentage of revenue generated from equity transactions that occurred in the accounts.

All advertising and other materials relating to the broker-dealer or its securities activities was either prepared or authorized by a broker-dealer, which was responsible for ensuring the accuracy of the material and its compliance with SEC and NASD requirements. In addition, references to the Non-Profit Organizations in advertising and sales literature were required to clearly identify the fact that the Non-Profit Organizations were not registered broker-dealers and that all securities brokerage activities were performed exclusively by the broker-dealer. The Non-Profit Organizations and their employees were not permitted to recommend or endorse specific securities or be involved in the financial services offered by the broker-dealer including, the opening, maintenance, administration, or closing of accounts and the solicitation, processing, or facilitation of transactions relating to securities.[18]

The fact that the SEC staff permitted these extensive marketing arrangements without requiring broker-dealer registration is, presumably, a function of the non-profit status of the organizations at issue. While the SEC staff may have concluded that these organizations are not engaged in the "business" of being a broker or dealer because of their non-profit status, it is hard to envision why these sort of arrangements raise any fewer investor protection issues than arrangements with portals, especially since portals typically play a far more passive role in advertising or marketing a broker-dealer's services.

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[17] *See, e.g., Attkisson, Carter & Akers* (pub. avail. June 23, 1998); *Thomas F. White & Co., Inc.* (pub. avail. Aug. 15, 1996); *Security Pacific Brokers, Inc.* (pub. avail. Mar. 5, 1985); *Ewing Capital, Inc.* (pub. avail. Jan. 22, 1985).

[18] *See, e.g., Attkisson, Carter & Akers* (pub. avail. June 23, 1998).

D. Affinity Groups

Although the tax-exempt nature of the Non-Profit Organizations is a factor, it was apparently not dispositive because in at least two other situations the SEC staff has permitted similar marketing arrangements involving the payment of transaction-based compensation between broker-dealers and service providers or affinity groups (together, "Affinity Groups").[19] These arrangements are nearly identical to the marketing arrangements between broker-dealers and the Non-Profit Organizations discussed above. Like the Non-Profit Organizations, the involvement of the Affinity Group was limited to marketing and promotion, and all securities transactions were conducted directly between the Affinity Group member and the broker-dealer. In each case, the unregistered entity and its employees were not permitted to participate in providing the available brokerage services to their members other than through the distribution of written marketing materials.

IV. Application of the Badges in the Context of Electronic Commerce

The SEC first raised the issue of transaction-based compensation in the electronic commerce context more than fifteen years ago in its 1984 Computer Brokerage Systems release, when it stated that it was "not addressing . . . whether a company that provides communication and information services and transmits orders between investors and broker-dealers for a transaction related fee would be required to register as a broker-dealer under Section 15(a) of the [Exchange] Act."[20] SEC staff interpretation subsequent to the 1984 Release has incorporated conditions intended to clarify the respective roles of the portals (or other unregistered persons) on the one hand, and the broker-dealers on the other and to ensure that the unregistered persons would not be deemed to be "engaged in the business" of effecting transactions in securities.[21] Despite the presence of these conditions, many of which are identical to and were taken directly from the no-action letters dealing with Financial Institution networking arrangements, Non-Profit Organizations and Affinity Groups, the SEC staff continues to analyze compensation arrangements between broker-dealers and unregistered persons by focusing primarily on the question of transaction-based compensation. The disproportionate emphasis on transaction-based compensation is unusual for a number of reasons. First, it is inconsistent with the flexible approach to broker-dealer regulation discussed above. Second, it runs counter to the theory of functional regulation established under the securities laws. Third, it ignores the larger context of electronic commerce against which these compensation arrangements are developing and being negotiated. Lastly, it fails to consider the more fundamental regulatory approach of disclosure. Each of these points is discussed in more detail below.

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[19] *See, e.g., Merrill Lynch, Pierce, Fenner & Smith, Inc.* (pub. avail. July 9, 1987); *Security Pacific Brokers, Inc.* (pub. avail. July 21, 1985).

[20] *Computer Brokerage Systems*, Exchange Act Release No. 21383, n.4 (Oct. 9, 1984) [the "1984 Release"].

[21] *See, e.g., Evare, LLC* (pub. avail. Nov. 30, 1998); *Charles Schwab & Co., Inc.*(pub. avail. Sept. 18, 1997) ["*Schwab II*"]; *Charles Schwab & Co., Inc.* (pub. avail. Nov. 27, 1996) ["*Schwab I*"]; *Quick America Corporation* (pub. avail. June 28, 1993).

A. No Single Factor is Dispositive

As we have seen, broker-dealer status is normally determined by consideration of all of the relevant facts and circumstances, including the extent of the securities-related activities and any countervailing regulatory or policy considerations. While transaction-based compensation is a consideration, it is clearly not dispositive. In fact, each of the no-action letters discussed above permitted the receipt of some form of transaction-based compensation without requiring broker-dealer registration.

In the no-action letters issued to online broker Charles Schwab & Co., Inc. ("Schwab"), however, the SEC staff went to great lengths to limit the terms of the compensation arrangements. In *Schwab I,* the SEC permitted certain online service providers to receive a nominal flat fee for each order transmitted to Schwab in return for allowing Schwab to make its brokerage services available to the subscribers of the online services. In *Schwab II,* Schwab was permitted to compensate certain information providers, specifically First Call Individual Investor Services and Standard & Poor's, for making their content available to Schwab's customers through its web site. In *Schwab II,* the information providers were compensated based on the greater of a base monthly fee or a variable fee calculated by the number of active households (*i.e.*, households that had engaged in at least one on-line securities trade in a given month, regardless of whether the household had accessed information from the information providers) multiplied by a nominal amount. Although the SEC staff permitted variable compensation based on the number of orders transmitted or the number of households trading, the SEC staff was careful to note that the compensation arrangements could not vary based on the number of trades made by a particular household, the number of shares purchased, the value of the underlying securities, or whether an order resulted in an executed trade.[22]

These letters were designed to provide guidance as to permissible variable compensation arrangements in an emerging online environment. Perhaps as a result of this attempt to provide guidance, however, the conditions imposed in the Schwab letters are among the most restrictive of the no-action letters dealing with compensation arrangements between broker-dealers and unregistered persons. The restrictive approach to the conditions imposed on compensation arrangements between portals and broker-dealers is inconsistent with the fluid and evolving manner in which electronic commerce is conducted and is not substantially related to investor protection concerns.

B. Functional Regulation

The temptation to characterize every person who receives some form of transaction-based compensation as a broker-dealer may have some practical appeal in that the receipt of compensation arguably "demonstrates success in effecting transactions for the account of others"[23] and may, therefore, suggest broker-dealer activity. However, this approach focuses on form (in this case, the form of the compensation) over function and in doing so runs counter to the whole premise of functional regulation on which the federal securities laws are based. The focus should not be on whether portals are receiving some form of transaction-based

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[22] *See also Evare, LLC* (pub. avail. Nov. 30, 1998) (reconfirming these conditions in the context of the compensation paid to the sponsor of a desktop application designed to allow various parties to connect to existing broker-dealer trade execution systems in order to communicate with those systems on-line).

[23] 15 David A. Lipton, *Broker-Dealer Regulation* § 1.04[3][a] (1998).

compensation, but whether they meet the functional definition of a broker-dealer. In other words, are the portals "effecting transactions in securities?" As with the activities of the unregistered persons identified in the no-action letters discussed above, the activities of the portals are essentially "passive." Portals allow users to more easily access and locate the broad array of information that is available on the Internet. The users can then access, sort, and format the information according to their personal preferences. Portals also run paid advertising for which the advertisers are responsible.

The portals are not engaged in any of the traditional indicia of brokerage activity. Portals do not take part in the financial services offered by a broker-dealer. The arrangements between portals and broker-dealers are similar to the marketing programs under which Affinity Groups and Non-Profit Organizations may promote the broker-dealers' services through endorsements, co-branding arrangements and disseminating advertisements and informational information about the broker-dealers. However, in each case the actual securities-related activities took place between the broker-dealer and the end customer. Similarly, online broker-dealers use portals to reach and promote their services to the users who visit the portals' web sites. Once a customer identifies a broker-dealer, he or she then accesses the broker-dealer's web site for additional information about opening accounts or trading securities. The portals are not involved in the opening, maintenance, administration, or closing of accounts, the solicitation of trades, or the resolution of problems, discrepancies or disputes involving brokerage accounts or related securities transactions. The portals do not answer questions or engage in negotiations involving brokerage accounts or related securities transactions. Although portals may organize information and hold data entered by the customer or provided at the customer's request by his or her broker-dealer, it is the broker-dealer that holds the cash and securities on behalf of the customer. Similarly, portals may provide links for a customer to transmit information to a broker-dealer, but it is the broker-dealer that accepts customer orders, executes trades, routes orders to markets for execution, extends any margin, carries the customer's account, and performs the other functions performed by broker-dealers.

Although portals do not effect securities transactions, they do make investment-related information available to their users. Most portals accumulate investment-related information and resources from third parties and make it available on their web sites.[24] In some cases, portals create and disseminate content of their own but generally take precautions to separate advertising from their editorial content.[25] Regardless of whether portals disseminate third-party content or create and disseminate content of their own, portals do *not* recommend specific securities in any sense for which customer suitability obligations would arise if the portals were

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[24] Even where the portals are not creating their own content, they may need to exert limited control over third-party content and postings made available via their web sites. For example, in order to limit liability, a portal may impose limitations on third-party content or retain the right to edit or pull down content that is defamatory, pornographic or otherwise improper. The SEC staff should recognize that, in establishing parameters and instituting procedures designed to prohibit unlawful, fraudulent or otherwise injurious content, the portal or its sponsor should not be viewed as the publisher of this third party content.

[25] *See* Laura S. Unger, Commissioner, U.S. Securities and Exchange Commission, *Online Brokerage: Keeping Apace of Cyberspace* (1999) [the "*Unger Report*"] at Section IX.C.1.

treated as broker-dealers. So, the fact that portals may make investment-related information available to their users would not justify regulating them as broker-dealers.[26]

In the context of Rule 3a4-1, which governs when persons associated with an issuer of securities may participate in selling activities involving that issuer's securities without being deemed to be brokers, the SEC elaborated on the concerns underlying transaction-based compensation noting that "[c]ompensation based on transactions in securities can induce high pressure sales tactics and other problems of investor protection which require application of broker-dealer regulation under the [Exchange] Act."[27] Investors are most vulnerable to "high pressure sales tactics" when they are interacting personally with a salesperson in whom they have placed their trust and confidence. Investors simply do not have the same type of personal dealings or relationship with portals. While broker-dealers have the capability to exert influence over investors through repeated personal contact, portals have no personal contact and have little control over the customer's access to information at the time an investment decision is made. Although portals might use "push" technology to send specific content to particular users, the transmission of this information typically is based on parameters defined by the customer (expressly or by his or her conduct on the portal's web site) and does not rise to the level of personal contact. Portals are one of many electronic media through which investors can obtain information. Because investors do not have an expectation of any ongoing personal contact or a fiduciary relationship with a portal, the potential for abusive sales practices typically associated with the receipt of transaction-based compensation does not appear present.

In these ways, advertising arrangements between portals and broker-dealers do not, in reality, implicate investor protection issues that necessitate application of broker-dealer registration and regulation on portals. Moreover, broker-dealers participating in such arrangements are regulated by the SEC and the NASD are, as such, are responsible for how they deal with customers and conduct business.

C. Electronic Commerce

The focus on transaction-based compensation in an online environment ignores not only the other factors or badges that typically determine broker-dealer status, but also larger policy considerations. Unduly restricting arrangements between portals and broker-dealers in a manner not directly related to investor protection issues is, at the very least, inefficient from economic and policy perspectives.

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[26] While broker-dealers may disseminate their own investment-related content or otherwise provide investment advice as an incident of their securities business, this does not mean that portals should be treated as broker-dealers when engaging in this activity. At most, when disseminating their own investment-related content for compensation, portals might be viewed as providing investment advice under the Advisers Act. This is because, under Section 202(a)(11) of the Advisers Act, the issuance of analyses or reports on securities for compensation is a core function of an investment adviser. Nonetheless, when undertaking these core advisory functions, portals fall squarely within the Advisers Act's "publisher's exclusion," which excepts from the definition of investment adviser "the publisher of any *bona fide* newspaper, news magazine or business or financial publication of general and regular circulation." It makes little sense to regulate portals as broker-dealers by virtue of them engaging in activities incidental to the brokerage business when Congress has determined that publishing activities do not warrant application of the principal regulatory statute governing investment advice – the Advisers Act.

[27] *Persons Deemed Not to be Brokers*, Exchange Act Release No. 22172 (June 27, 1985).

Unlike an advertisement placed in print media that can, by selecting the newspaper or magazine in which the advertisement is placed, be narrowly targeted to a specific demographic group, information posted on the Internet is widely available to people around the world. Portals are required to track information about the people that access their web sites and provide this information to broker-dealers and other advertisers in order to justify the value they provide to a particular advertiser. As the *Unger Report* correctly points out, the business model at issue is essentially an advertising business model.[28] Like other media purchases, broker-dealers and other advertisers want the costs associated with web site placement to reflect the revenue resulting from that placement. But, unlike other media purchases, the methods of quantifying the impact of doing business over the Internet (and of doing business itself) change all the time. As a result, it is difficult to quantify the benefit of these arrangements up front or as circumstances change. The ability to enter into more flexible compensation arrangements gives the broker-dealers and the portals the ability to react to the market and negotiate more efficient compensation arrangements as technology and experience increase. Such compensation arrangements "further the Commission's goal of assuring economically efficient transactions in securities and the efficiency of the order entry and execution process."[29] Flexible compensation arrangements also permit the broker-dealers to pass increased efficiencies along to investors by providing more services at a lower price.

Although the hope was that the Schwab letters would provide increased understanding within the industry of permissible arrangements between broker-dealers and portals, there is, in fact, substantial variation between the business arrangements of various broker-dealers and portals. These details were brought to the attention of the NASD, and presumably the SEC staff, in connection with the NASD's June 1998 requests to most online broker-dealers for information regarding their compensation arrangements with online services companies (the "June Request"). Since the submission of this information there has not, to our knowledge, been any discussion or indication that any of the arrangements identified in connection with the June Request are problematical. Meanwhile, however, the possible compensation arrangements and the methods of conducting business via the Internet continue to evolve, and the tension between the economic desire to rationalize compensation arrangements, on the one hand, and the uncertainty as to where the regulatory lines are drawn, on the other, continues to grow.

D. Disclosure

Regulatory concerns commonly associated with transaction-based compensation are typically expressed in terms of protecting investors from high pressure sales tactics. These abusive or high pressure sales tactics are most likely to occur where there is a personal and ongoing relationship between the customer and the broker-dealer (or unregistered party in question). As previously discussed, the absence of this type of relationship between portals and their users and the fact that the role of the portal is limited to providing access and information mitigate these concerns.

In the context of electronic commerce, the more compelling investor protection concern may be that, if portals enter into compensation arrangements under which they may receive transaction-based compensation, they will position or promote their content and advertisements in such a way as to channel users to the

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[28] *See Unger Report* at Section IX.C.1.

[29] *See Schwab I* (citing Section 11A of the Exchange Act and Exchange Act Release No. 21383 (Oct. 9, 1984)).

particular broker-dealers that will generate the most revenue for the portal. Any potential conflicts of interest, to the extent they exist, are best dealt with through disclosure – the principle underpinning much of our federal securities laws. Disclosure – not substantive regulation – is the approach taken by the SEC in the case of solicitation arrangements between registered investment advisers and "solicitors." Specifically, the Advisers Act permits unregistered investment advisers to receive compensation for their solicitation activities so long as the client receives disclosure identifying the compensation arrangement so the customer may weigh the potential bias of the solicitor.[30] If flexibility in adviser solicitation arrangements has been permitted without need for subjecting solicitors to adviser registration requirements, then it is unclear why advertising arrangements involving broker-dealers should be subject to far greater restrictions. This is particularly so given that investment advisers are fiduciaries, and broker-dealers – while they may take on a fiduciary role – frequently act in a lesser capacity.[31]

In the enforcement context, the SEC has been aggressively monitoring and enforcing the federal securities laws against those people who attempt to commit fraud over the Internet.[32] Many of these cases involve the anti-touting provisions of Section 17(b) of the Securities Act of 1933, which makes it unlawful for any person to use interstate commerce to publish, publicize, or circulate any "notice, circular, advertisement, newspaper, article, letter, investment service, or communication which, though not purporting to offer a security for sale, describes such security for a consideration received or to be received, directly or indirectly, from an issuer, underwriter, or dealer, without *fully disclosing* the receipt, whether past or prospective, of such consideration and the amount thereof." (Emphasis added.) The fraudulent activity under Section 17(b) is not the receipt of compensation, *per se*, but the failure to disclose that compensation. To the extent that portal arrangements raise similar conflicts, the SEC and its staff should consider borrowing this concept of disclosure, a concept that is already thoroughly ingrained in the federal securities laws. By analyzing compensation arrangements between broker-dealers and portals in terms of disclosure, instead of the form of compensation, the SEC and its staff should be able to provide a mechanism that allows the broker-dealers to enter into flexible compensation arrangements that can evolve as electronic commerce develops while protecting investors from potential abuses.

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[30] *See* Advisers Act Rule 206(4)-3.

[31] Although the NASD generally has opposed the payment of so-called finders fees by its member firms, in the early 1990s the NASD considered adopting the Rule 206(4)-3 approach but, apparently, decided not to proceed after apparently receiving unfavorable feedback from the SEC staff. Discussion, dated September 25, 1991, between Steven W. Stone of Morgan, Lewis & Bockius LLP and Frank J. McAuliffe, Vice President, Qualifications and Membership of the NASD.

[32] *See Use of Electronic Media*, Securities Act Release No. 7856, n. 4 (April 28, 2000) (noting that the SEC has brought approximately 120 Internet-related enforcement actions through March 2000); *SEC Steps Up Nationwide Crackdown Against Internet Fraud, Charging 26 Companies and Individuals for Bogus Securities Offerings*, SEC Press Release 99-49 (May 12, 1999); *SEC Continues Internet Fraud Crackdown*, SEC Press Release 99-24 (Feb. 25, 1999); *SEC Charges 44 Stock Promoters in First Internet Securities Fraud Sweep*, SEC Press Release 98-117 (Oct. 28, 1998).

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We appreciate the opportunity to share our views regarding the need to develop a regulatory structure that gives portals and broker-dealers the flexibility to structure sensible and efficient business arrangements consistent with the protection of investors.