State of Utah
DEPARTMENT OF COMMERCE
DIVISION OF SECURITIES

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December 19, 1997

Mr. Paul. D. McGrady, Esq.
TruServ Corporation
Law Department
8600 W. Bryn Mawr Avenue
Chicago, IL 60631-3505

Re: **TruServ Corporation**
Request for Interpretive Opinion
File # B00015067

Dear Mr. McGrady:

This letter is in response to your request for an interpretive opinion from the Utah Division of Securities ("Division"). You asked the Division to opine whether shares of Class A Common Stock (the "Stock") issued by TruServ Corporation ("TruServ") to its hardware, lumber and builders' supplies retailers ("Members") are securities within the meaning of Utah Code Ann. § 61-1-13(24) (1997). The Division understands the relevant facts to be as follows:

- In conjunction with an application to become a Member of TruServ, prospective Members must purchase 60 shares of TruServ Stock at a price of $100 per share. TruServ will allow each Member to purchase one unit consisting of 60 shares per retail establishment owned by the Member, up to a maximum of 5 retail establishments or 300 shares per Member.

- Members seek membership in TruServ to reduce merchandise costs by purchasing inventory and services collectively in large volume which results in an economic benefit to them and not with the expectation that the Stock will appreciate.

- TruServ distributes to its Member-shareholders patronage dividends based upon their respective purchases of merchandise from TruServ and not from income generated by TruServ and distributed in proportion to each Member's share holdings.

- The shares of Stock confer voting rights in proportion to the number of shares owned.

- The Stock is not traded on any securities exchange or over-the-counter market, but is sold exclusively by TruServ. The Stock is not transferable by the Member except with the

consent of TruServ, and in that event, it would only be transferred to another retailer of hardware whom TruServ accepts as a Member.

- Upon termination of a Member's membership with TruServ, all of the Member's shares of Stock are repurchased by TruServ at approximately $1.00 more than the issuing price.

On the basis of the foregoing facts and for the reasons stated below, it is the opinion of the Division that the Class A Common Stock is not a security under Utah Code Ann. § 61-1-13(24) (1997).

The Division recently issued an opinion *In re: Ace Hardware Corporation*, ¶ 57,480 Blue Sky L. Rep. (CCH 1997), which presented a merely identical set of facts. In *Ace Hardware*, the Division looked to *United Housing Foundation v. Forman*, 421 U.S. 837, 44 L.Ed 2d 621 (1975), to determine when stock may not be considered a security regardless of the inclusion of the term "stock" within the list of terms found in the statutory definition. The Division did not consider the stock of *Ace Hardware* to be a security for several reasons. First, although shareholders received annual dividends, the dividends were distributed in relation to the business produced for Ace by the individual, not pro rata in accordance to the number of shares held by each shareholder. Second, the stock was not negotiable and could only be transferred back to the Ace or to another shareholder which was opening a franchise. Third, although the shareholders were entitled to voting rights, the preponderance of the economic characteristics were not those which are generally associated with a stock that is also a security.

In comparing the Class A Common Stock to the stock issued in *Ace Hardware*, Tru Serv's stock should likewise not be classified as a security. Although TruServ does allow its Members to vote their shares, the dividends are not distributed pro rata according to the number of shares held by each Member. Instead, dividends are distributed in relation to the business produced for TruServ by the individual Member.

Additionally, like the non-security stock in *Ace Hardware*, TruServ's stock is not negotiable, nor can it be pledged or hypothecated. The stock is not traded on any market, nor can the stock be transferred unless the transferee is a Member of TruServ and the transfer is approved by TruServ, or in a repurchase back to TruServ when the Member leaves TruServ. When TruServ does repurchase the stock, it does so at $1.00 more than the offering price of $100.00. This is does not seem to be a meaningful gain from the sale of shares due to appreciation in value. Members are not motivated to purchase TruServ stock for the profit they expect to generate from the subsequent resale of the stock, rather purchase of the stock is incidental to the opportunity of realizing reduced merchandise costs, with profit to be derived from their own efforts of retailing the merchandise.

In short, even though TruServ's Stock contains some characteristics of stock that is

governed under the Utah Uniform Securities Act, the preponderance of the economic characteristics suggests that TruServ's Stock is not the type of instrument that the Utah Legislature meant to be covered by the Act and therefore should not be considered a security.

Please note that this opinion relates only to the Class A Common Stock discussed above and shall have no value for similar stock. It should be further noted that any different facts or conditions of a material nature might require a different conclusion.

Very truly yours,

S. Anthony Taggart
Assistant Director

SAT.

TRU★SERV™
LAW DEPARTMENT

August 21, 1997

VIA FACSIMILE: 801 530 6980
Ms. Sharon Abbott
Utah Division of Securities
160 East, 300 South
Salt Lake City, UT 84114-6760

RE: NO ACTION REQUEST

Dear Ms. Abbott:

Thank you for speaking with me on the telephone regarding TruServ Corporation Class A stock. As you know, TruServ Corporation is the cooperative wholesale distributor for True Value®, ServiStar® and Coast to Coast® Hardware stores and various rental outlets ("the Company"). The Company respectfully requests that the Utah Securities Division issue a NO-ACTION LETTER, or similar interpretive opinion, determining that the Company's Class A Common Stock is not a "security" within the meaning of Utah Code Ann. Section 61-1-13(24). The Company's structure is extremely similar[1] to that of Ace Hardware Corporation which has previously been granted such an interpretive opinion.

STATEMENT OF FACTS

Since its inception in 1948, the Company has conducted business as a cooperative buying association for the benefit of its Members. As of August 1, 1997, the Company has over 10,000 Members doing business in all 50 states and in several foreign countries. The Company is the largest cooperative distributor in the world.

All holders of the Company's Class A Common Stock are individuals, partnerships, corporations, or limited liability companies who sell hardware, lumber or builders' supplies at retail ("Members"). Ownership of Class A Common Stock ("Common Shares") in the Company is expressly limited to

[1] One significant difference is the fact that the vast majority of TruServ's Members are not franchises.

such retailers. Each shareholder holds 60 or more Common shares, issued at $100.00 per share. The Company will allow each Member to purchase one unit of 60 shares per retail establishment owned by the Member, up to a maximum of 5 *retail establishments.*

Purchase of the Common Shares is an incident to Membership in the Company. Proceeds provide necessary working capital for the Company, helping to fund the purchase of inventories of goods and merchandise needed to supply the Members, and to support the general operation of the Company.

The "securities" offered for sale are authorized but unissued Common shares of the Company, and will be issued at $100.00 per share.

Each holder of Common Shares who carries on business at multiple locations will be required to purchase 60 Common shares ($6,000) for each location. Members of the Company will operate approximately 10,300 retail stores.

The Company engages in mass purchasing from approximately 5,105 *different sources.* The Company will operates 22 warehouses (Springfield, Oregon; Portland, Oregon; Woodland, California; Kingman, Arizona; Brookings, South Dakota; Mankato, Minnesota; Fort Smith, Arkansas; Kansas City, Missouri; Denver, Colorado; Corsicana, Texas; Charleston, Illinois; Harvard, Illinois; Indianapolis, Indiana; Greenville, South Carolina; Henderson, North Carolina; Atlanta, Georgia; Butler, Pennsylvania; Cleveland, Ohio; Parkersburg, Pennsylvania; Allentown, Pennsylvania; Westfield, Massachusetts and Manchester, New Hampshire). Each warehouse stocks nearly 80,000 different line items of merchandise for the Company Members. The merchandise is delivered to the Members by private trucks on weekly scheduled routes.

The Company, based upon the volume of, and the margins applicable to merchandise and services purchased by a Member during a given year, pays Members a yearly dividend out of the revenues from business done with or for the Members deducting expenses, reasonable reserves for corporate purposes, taxes, bad debt, casualty losses, and reasonable reserves of working capital necessary for the operation of the Company. These refunds are called "patronage dividends".

The Company does not pay "dividends" in the usual sense. Only patronage dividends are distributed to shareholders, based on patronage with the Company and not on shareholdings.

Due to a number of resale restrictions in the Company's Certificate of Incorporation and By-Laws, it is, as a practical matter, impossible for the

Company's Units to be transferred to non-Members. Upon ceasing to be a Member of the Company, the ex-Member's Class A Common Stock ordinarily must be re-sold to the Company. The Company's Units are not listed on any stock exchange nor traded on the NASDAQ system. Thus, there is *no secondary market* for the Company's shares. The Company also repurchases Class B shares from member-shareholders who desire to terminate their shareholder relationship with the Company, subject to legal limitations for protection of the Company's financial condition.

ARGUMENT

COMPANY "SHARES" ARE NOT A SECURITY SUBJECT TO REGISTRATION

At issue is whether the Common Shares which each customer of the Company is required to purchase for Membership in the Company, are in fact, a "security". The Utah Act defines security as, among others, any "Stock."

While the statute defines "security" in sufficiently broad terms to include within its definition the vast variety of instruments that in the course of commercial activity fall within the ordinary concept of "security", it is also true that courts have recognized that "Congress never intended the securities laws to apply to all sales; otherwise the detailed reporting provisions and other requirements would seriously clog everyday commerce." *Van Huss v. Associated Milk Producers, Inc.,* 415 F.Supp. 356 (N.D. Tex. 1976).

In the text of the Securities Act of 1933, within which the issue is most frequently considered, are the identical phrases of Section 2(1) of that Act: "...certificate of interest or participation in any profit-sharing agreement" or "investment contract." The fundamental premise of an investment contract is that a person is induced to part with money with the expectation that he or she will obtain "profits" by virtue of the investment. As stated in *SEC v. W.J. Howey Company,* 328 U.S. 293 (1946):

"The test is whether the scheme involves an investment of money in a common enterprise with profits to be derived from the entrepreneurial or management efforts of others."

Similarly, the Supreme Court has placed heavy emphasis in subsequent cases on the need for the *profit expectation,* notwithstanding the fact that ownership interests in cooperatives do, by a strict reading of the statute, resemble securities. The Court was clearly stating that, form should be disregarded for substance and that the emphasis should be on economic reality when determining whether an instrument is, in fact, a security.

The Company submits that a member of a cooperative, being a customer of the Company, views the mandatory purchase of "shares" as a necessary incident to doing business with the cooperative and not in any way related to an initial "investment" which is expected to generate income. Members expect a return from their own labors, and from their purchases of merchandise from the cooperative, not from their investment of capital.

In *United Housing Foundation, Inc. v. Forman,* 421 U.S. 837 (1975), the Supreme Court held that the share of common stock which entitled the purchaser to lease an apartment in a New York State subsidized non-profit cooperative housing project did not constitute a "security" within the meaning of the federal 1933 and 1934 Acts. In reversing a prior decision by the U.S. Court of Appeals (the Second Circuit), which held that because the instruments were labeled "stock", the definition section (2(1)) of the 1933 Act applied, the Court said:

> We reject at the outset any suggestion that the present transaction, evidenced by the sale of shares called "stock", must be considered a security transaction simply because the statutory definition of a security includes the words 'any...stock'. Common sense suggests that people who intend to acquire only a residential apartment in a state-subsidized cooperative, for their personal use, *are not likely to believe that in reality they are purchasing investment securities* simply because the transaction is evidenced by something called a share of stock (emphasis added).

The relationship between Members and the Company, is, in many respects similar to the relationship in *Forman* between the housing cooperative and its stockholder-tenants. First, in *Forman*, the tenants could not transfer, assign or pledge their common stock. As stated previously, there is no secondary market for the Member's shares of Company stock. The Company repurchases all shares at the behest of the Member.

Second, in the housing cooperative case, the tenants who desired to sell their shares were required to offer the stock to the housing co-op at its initial issue price. Similarly, the Company's Certificate of Incorporation and By-Laws require that the when the Company repurchases the shares of any terminating member it repurchases them at approximately $1.00 more than the issue price. There is no opportunity for a Member of the Company to realize any meaningful gain from the sale of the shares due to appreciation in value.

A third and striking similarity between the housing cooperative and its tenant Members and the Company and its Members is that under the housing arrangement, the tenants purchased the stock for the economic benefit of

subsidized low-cost housing and not with the expectation of making a profit. Likewise, hardware, home center, and lumber retailers seek Membership in the Company in order to realize reduced merchandise costs by purchasing inventory and services collectively in large volume which results in an economic benefit to them. That benefit, however, is not tantamount to a "profit" relating to purchase of a security because the price of the security itself does not appreciate and profits depend solely on the individual Member's own hard work, and business acumen.

In an identical case, but involving a private cooperative housing arrangement, rather than public, the Second Circuit applied the economic realty test enunciated in *Forman* and found that the Membership instruments were not an "investment security" as defined in the 1933 and 1934 Acts, and therefore not a proper subject for registration. The fact that *Forman* involved a public entity and not a private concern was deemed to be of no significance.

The critical distinction between the Company and business corporations whose securities must be registered lies in the fact that financial benefits which accrue to the Members of the Company are directly related to their *patronage activity,* (i.e. the amount and type of their purchases from the Company) while the financial benefits of a business corporation are returned to shareholders in direct proportion to their investment in that corporation. Additionally, business corporations securities pay-out based upon the success of the corporation rather than the individual. The Company does not operate to produce profits, but like other cooperatives, conducts its business on a cost basis and returns to its Members in the form of patronage dividends any excess of receipts over expenses. These are not "profits" within the meaning of federal and state securities laws. A true security associated with a business corporation, on the other hand, enjoys the opportunity for potential gain or profit. The profit referred to is either capital appreciation resulting from the initial investment, or participation in earnings resulting from the use of the investors' funds. Clearly, a retailer's decision to associate with the Company is not predicated on a chance to realize some investment gain, but rather is the result of critical evaluation of the economic benefits of lower cost for merchandise through cooperative buying and distributing.

In the present case, the benefits derived from ownership of the Company's Common Shares result almost exclusively from the managerial efforts of the owner of the retail establishment, not the Company. The Members of the Company succeed or fail on the basis of their own business acumen. The patronage refunds are actually a reduction in purchase price for the hardware good merchandise purchased during the previous year. Of course, no

patronage refunds would be paid to an owner of shares who purchased no merchandise from the Company.

The Company's shares are not properly thought of as securities. The buyers of the shares are not motivated by the profit the shares are expected to generate as the possibility of a patronage refund due to the shares generates no meaningful profits for the holders. Further, the Company only sells sixty (60) shares per Member store location, to a maximum of five retail locations per Member; no one is allowed to "invest" extra money in the Company *through purchasing* additional Common Shares because such "investing" would be without return, as the Company pays no interest or share-proportional dividends.

The Company's shares are not publicly traded and thus, no market exists. Only hardware retailers may own the shares. Members do not purchase the Common Shares as a speculative investment. Membership in the Company is limited to hardware retailers who qualify for Membership; the public may not purchase the Company's shares. The expectations of the retailers who purchase the shares involve solely the prospect of buying goods and services from the Company.

Finally, because each of the purchasers is typically a sophisticated and experienced business person, the need for the protection of the securities laws is absent. The shares are not sold to the investing public; the Company requires the shares to be purchased by prospective Members who are hardware retailers.

All sales of the Company's Common shares are made directly by the Company to the prospective Members by field representatives of the Company or other agents of issuer, and no underwriters or broker-dealers are employed. The field representative or issuer's agent receives no compensation or commission from the sale of shares in the Company. Sales of shares are merely an incident to Membership in the cooperative and are effected only after the Company has approved the applicant for Membership in the Company.

Generally speaking, the registration requirements of both the federal and state securities laws are aimed primarily at disclosure of information needed to determine whether to make an investment by looking at such factors as prospective yield and appreciation. The Company's prospective Members gather their information about whether to join a cooperative corporation from trade and business needs. The Company's Members must make business judgments regarding the availability and cost of merchandise and services based upon competitive pricing and availability in the market place. They do not require an offering circular to make an informed judgment on such

matters. *In fact, the offering circular is no help to a retailer in making the* basic business decisions on whether to "join" the Company. Nevertheless, the Company discloses information through filing with the Securities and Exchange Commission and distributing those filings to prospective Members despite the absence of legal mandate.

The financial burdens of registration and compliance with agent registrations are substantial. The internal and outside expenses of legal counsel, independent accountants, and printing total thousands of dollars per year. This added cost of doing business for the Company and its Members must be paid out of the margins normally distributed by the Company to the Members *as patronage dividends.*

Additionally, the perfunctory compliance in the new Member solicitation and agreement setting, with the formalities of a securities sale, is awkward, inappropriate and essentially distracting from the subject of providing retailers with a better source for services and merchandise to help them, as Members of the cooperative group, to make more profit as retailers and to better serve retail customers.

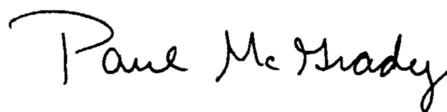
Enclosed is a check in the amount of $60.00 to cover the remainder of the fee required.

CONCLUSION

From the foregoing, it is clear that the "shares" of the Company, which hardware, lumber and building materials retailers are required to purchase to become "Members", lack the characteristics of an investment security, are required merely as an incident of Membership in the Company, have no marketability, and are not the type of instrument which the securities laws were designed to regulate. We, therefore, respectfully request that an appropriate no-action letter which declares that the "shares" issued by the Company are not securities within the meaning of Utah Code Ann. Section 61-1-13(24).

Should you have any questions or concerns regarding the above request, I can be reached at 773/695-5451 or via facsimile at 773/695-5465. Thank you.

Very truly yours,



Paul D. McGrady
Attorney

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