ARIZONA CORPORATION COMMISSION

SECURITIES DIVISION
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August 18, 1992

Miles C. Gerberding, Esq.
Barnes & Thornburg
600 One Summit Square
Fort Wayne, IN 46802

RE: Hardware Wholesalers, Inc.
A.R.S. § 44-1801(22)

Dear Mr. Gerberding:

On the basis of the facts set forth in your letter of July 17, 1992, and in reliance upon your opinion as counsel, the Securities Division (the "Division") will not recommend enforcement action for violation of the Securities Act of Arizona (the "Act") should the transactions take place as set forth in your letter. In concurring with your opinion that the shares offered by Hardware Wholesalers, Inc. do not constitute "securities" for purposes of the registration requirements of the Act, the Division has noted particularly your representations that Hardware Wholesalers, Inc. is a buyers' cooperative and its common stock merely evidences membership in the cooperative and the common stock does not possess most of the characteristics of a security, such as transferability, ordinary dividend rights, and the potential for appreciation in value.

As this position is premised upon the facts set forth in your letter, it should not be relied on for any other set of facts or by any other person.

To the extent that the transactions do not take place as set forth in your letter of July 17, 1992, or a material change in circumstances cause these cooperative shares to be deemed "securities" for purposes of the Act, then the anti-fraud provisions of the Act would be applicable ab initio.

1200 WEST WASHINGTON, PHOENIX, ARIZONA 85007 / 400 WEST CONGRESS STREET, TUCSON, ARIZONA 85701

We have attached a photocopy of your letter. By doing this we are able to avoid having to recite or summarize the facts set forth therein.

Very truly yours,

DEE RIDDELL HARRIS
Director of Securities

DRH:MGB:ck

Attachment

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July 17, 1992

Mr. Dee R. Harris
Director, Securities Division
Arizona Corporations Commission
1200 W. Washington Street
Suite 201
Phoenix, Arizona 85007

Re: Hardware Wholesalers, Inc.

Dear Mr. Harris:

On behalf of Hardware Wholesalers, Inc., an Indiana Corporation, (hereinafter referred to as the "Company") we respectfully request that the Arizona Corporations Commission issue a NO-ACTION LETTER, or similar interpretive opinion determining that the shares of the Company are not a "security" within the meaning of Section 44-1801.22 of the Arizona Blue Sky Law.

STATEMENT OF FACTS

Since its inception in 1945, the Company has conducted business as a cooperative buying association for the benefit of its members and currently has over 2,700 members doing business in approximately 47 states and several foreign countries.

All the holders of Common shares of the Company are individuals, partnerships, or corporations who sell hardware, lumber or builders' supplies at retail. Ownership of shares in the Company is expressly limited to such retailers. Each holder of shares of the Company holds 20 or more Common shares which are issued at a price of $50 per share. The shares are sold only in units of 20 shares for each retail establishment of a shareholder which is serviced by the Company.

Sale of the Common shares is an incident to membership in the Company. Proceeds are used in the general operation of the Company and to help fund the purchase of inventories of goods and merchandise needed to supply the members.

The "securities" offered for sale are authorized but unissued Common shares of the Company issued at $50 per share.

Each holder of Common shares who carries on business at two or more places having different locations, even though in the same town or city, which places of business are served by the Company, is required to purchase 20 Common shares ($1,000) for each location. Members of the Company operate approximately 3,100 retail stores.

The Company buys merchandise at jobber's and distributor's prices from nearly 2,000 different sources. It operates large warehouses (300,000 to 500,000 square feet, at Waco, Texas; Medina, Ohio; Cape Girardeau, Missouri; Columbia, South Carolina; Woodburn, Oregon and Dixon, Illinois). Each warehouse stocks nearly 40,000 different line items of merchandise for the retailer-members of the Company. This merchandise is delivered to the retailer-members by private trucks on weekly scheduled routes. This merchandise is sold to the retailer-members and to a few non-members at prices which are competitive.

The Company keeps a record of the purchases made by each member-shareholder and during each fiscal year the Company notes the gross profit on the merchandise so sold. At the end of each fiscal year the Company is obligated to refund to its member-shareholders the gross profit earned less operating expenses and any deficits from a prior period. Refunds are made to each member-shareholder in the proportion to which the gross profit on purchases made by that member bears to the total gross profit on all purchases by members.

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

The Articles of Incorporation also provide that shares of the Company are transferable only to the Company or an eligible successor retailer. Almost no transfers have occurred other than to the Company. Thus, there is no market for the shares of the Company.

The Company is required by its Articles of Incorporation to repurchase its Common and Non-Voting Common shares at the lesser of issue price or book value from any holder on demand. It also repurchases Preference 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

HARDWARE WHOLESALERS, INC., "SHARES" ARE NOT A SECURITY SUBJECT TO REGISTRATION

At issue is the question of whether or not the Common shares which each customer of the Company is required to purchase for membership in the Company is, in fact, a "security". Section 44-1801.22 of the Act defines "security" as:

> "Security" means any note, stock, treasury stock, bond, commodity investment contract, commodity option, debenture, evidence of indebtedness, certificate of interest or participation in any profit-sharing agreement, collateral-trust certificate, preorganization certificate or subscription, transferable share, investment contract, voting-trust certificate, certificate of deposit for a security, fractional undivided interest in oil, gas or other mineral rights, real property investment contract or, in general, any interest or instrument commonly known as a "security", or any certificate of interest or participation in, temporary or interim certificate for, receipt for, guarantee of, or warrant or right to subscribe to or purchase, any of the foregoing.

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 resemble securities. The Court was clearly stating that in determining whether an instrument is, in fact, a security, form should be disregarded for substance and that the emphasis should be on economic reality.

The Company submits that a member of a cooperative, such as 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". Rather, 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 definitional 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 Hardware Wholesalers, Inc., 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, the Company's members cannot sell, assign, transfer, encumber or otherwise dispose of their shares.

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 Articles of Incorporation and By-Laws require that the Company repurchase the

shares of any terminating member, at the lower of its issue price or book value. The Company has in the past always repurchased the shares of its terminating members at the issue price. There is no opportunity for a customer-shareholder of the Company to realize any gain from the sale of the shares due to appreciation in value.

A third similarity between the housing cooperative and its tenant members and Hardware Wholesalers, Inc. 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 does result in an economic benefit to them. That benefit, however, is not tantamount to a "profit" relating to purchase of a security.

In an identical case, but involving a private cooperative housing arrangement, 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 customer-shareholders 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. 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.

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 member-retailers 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 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; the shares generate no profits for the holders. Purchase of merchandise from the Company may result in patronage refunds. Further, the Company only sells twenty shares per store location served by it; no one is allowed to "invest" extra money in the Company 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. The Company is not aware of any of its shareholders who purchased the Common shares as a speculative investment.

The member-shareholders are limited to hardware retailers; the public may not purchase the Company's shares. The expectations of the retailers who purchase the shares involve the prospect of buying goods and services from the Company.

Finally, because each of the purchasers typically is already a successful business owner, 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, and no underwriters or broker-dealers are employed. The field representatives receive 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 really is no help to a retailer in making the basic business decisions on whether to "join" the Company. Nevertheless, the Company discloses information to prospective members despite the absence of legal mandate (forty-five states and the SEC have granted no-action or exemption letters).

The financial burdens of registration and compliance with agent registrations are substantial. The internal and outside expenses of legal counsel, independent accountants, and printing totals thousands of dollars each year. This added cost of doing business for the Company and its members must be paid directly out of the margins normally retained by the Company for distribution as patronage dividends to the member-dealers.

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.

The United States Securities and Exchange Commission has issued a "no-action" letter to the Company (Exhibit "A") and 45 states have already responded favorably in like rulings or exemption letters to the Company.

Enclosed is a check in the amount of $200.00 to cover the fee required by Section 44-1861.L of the Act.

CONCLUSION

From the foregoing, it is clear that the "shares" of Hardware Wholesalers, Inc., which hardware, lumber and building materials retailers are required to purchase to become "members", lack the qualities 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 be issued which determines that the "shares" issued by the Company are not securities within the meaning of Section 44-1801.22 of the Act.

In the event there are questions about this request, the courtesy of a conference is respectfully requested. Please feel free to call us with any questions, collect if you wish. You may ask for the writer or Mark D. Levick.

Most sincerely yours,

Miles C. Gerberding

MCG/MDL/ses
Enclosures
cc: Michael J. McClelland
David W. Dietz
Mark D. Levick, Esq.