

OPINION OF THE COMMISSION ON DISCOUNT MEMBERSHIP PLANS

I. Introduction

In recent times, there has been a radical increase in the number of clubs, plans, cooperatives, corporations, etc., providing the public with the opportunity of pooling its buying power to obtain goods at wholesale prices. The question has arisen before this Commission whether the offer and sale of such an opportunity is the offer and sale of a security. The purpose of this opinion is to give some guidelines to those offering such an opportunity as to whether the offering is a security and is therefore subject to regulation by this Commission.¹

A. Purpose of Securities Regulation

The purpose of securities regulation is twofold; (1) to provide full and fair disclosure to investors, and (2) to prevent use of fraudulent devices. While the Commission believes that some discount plans offer a worthwhile service to the public, only full disclosure will enable the public to distinguish between those which are worthwhile and those which are fraudulent. Our jurisdiction to require full disclosure extends to those plans which are found to be offering securities.

B. Selling Tactics as Securities Fraud

What has particularly concerned the Commission is that some of these plans appear to be selling their memberships as though they were securities; i.e., emphasizing that there is an investment on which the purchaser may expect a fair return, comparing buying a membership to purchasing certificates of deposit and other standard investments, etc. If the plan is offering an investment, it must either register with this Commission or claim an exemption from

¹ These guidelines are merely the Commission's opinion and are not to be considered as binding.

registration. If it is not offering an investment, sales tactics such as those just mentioned may well constitute a fraudulent device. The plan may not claim to the public that its membership is an investment comparable to those ordinarily defined as securities and then claim before the Commission that it is not offering an investment contract. The plan has the option of choosing the format for its operation, but once it has chosen that form, it cannot then claim that its substance is not what the form indicates.

II. Characteristics of Discount Membership Plans

A. Fully Corporate Plans

These plans are corporations which are registered to do business in the State of Utah. They have issued shares to shareholders who elect the directors to oversee management of the corporation. The corporation then provides a service to the public in the form of discount purchasing. The purpose of offering this service is to generate a profit which will then be distributed to its shareholders.

The distinction between this type of plan and the others is that here the shareholders and members are separate groups with separate interests. In these plans, shareholders are not required to be members and are given full disclosure as to corporate information prior to purchasing their shares. The members have no interest in the corporation's profits and are not purchasing an investment, but a service.

B. Cooperative-Like Plans

Section 61-1-14(1)(h) provides an exemption from registration for securities issued by non-profit groups and for agricultural cooperatives. Non-profit cooperatives for other than agricultural purposes are to be incorporated under Section 16-6-108 of the Utah Code. This exemption is from registration and not from the basic requirement of full disclosure inherent in Section 61-1-1. Section 61-1-1 states:

"False statements unlawful.--It is unlawful for any person, in connection with the offer, sale, or purchase of any security, directly or indirectly

(1) to employ any device, scheme, or artifice to defraud,

(2) to make any untrue statement of a material fact or to omit to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they are made, not misleading, or

(3) to engage in any act, practice, or course of business which operates or would operate as a fraud or deceit upon any person."

Cooperatives which issue memberships entitling the member to vote and providing for a distribution of its monies to its members may well be offering a security and are, therefore, subject to Section 61-1-1.

C. Pyramid-Like Plans

The Commission has also come across plans which emphasize a pyramid-like provision of membership. This provision provides that members get a larger discount, free gifts, or other bonuses for bringing in new members. The form of the plan, whether it be corporate or cooperative, is less significant here than the essential characteristic of member's bonuses for increasing membership. In these instances, the member's profit is tied to the plan's promotional scheme; this indicates that the memberships are, in fact, securities.²

III. Characteristics of an Investment Contract

An investment contract is a form of security in which the following elements are present: (1) an investment of money; (2) in a common enterprise; (3) with a reasonable expectation of profit; (4) to come from the managerial skill or expertise of others.

² See SEC v. Koscot Interplanetary, Inc., 497 F. 2d 473 (1974 5th Cir.) i.e., where the Court distinguished ordinary consumer transactions from those transactions from those transactions intended to be covered by the securities laws.

A. An Investment of Money

This element is satisfied by the transfer of cash, promissory notes or some other liquid asset to the enterprise.

B. Common Enterprise

A common enterprise is one in which the results of the investments are "interwoven with and dependent upon the efforts and success" of those organizing and promoting such investment.³

C. Expectation of Profits

The courts have recognized "profits" either from appreciation or from a participation in earnings. These "profits" may either be actual or merely claimed: it is the investor's reasonable expectations which are decisive. Therefore, the sales scheme, the literature given out, and the actual sales pitch may determine a contract to be a security, simply because the emphasis is on investment profits rather than on the sale of goods or services.

D. Managerial Skill or Expertise of Others

This element considers whether the expected profits are dependent upon, although not solely dependent upon, the skill or expertise of one person or a group of such people who form the nucleus in organization, promotion and management of the enterprise. The skill required need not be a professional one. The question is simply whether the enterprise would be viable without this core group.

IV. Opinion of the Commission

It is the opinion of the Commission that some discount membership plans presently being offered in the State of Utah cross the line from being merely a purchase of goods or services to an investment contract which is subject to the securities laws.

³ SEC v. Glenn W. Turner Enterprises, 474 F. 2d 476, 482 Note 7.

A. Fully Corporate Plans

Plans which we have termed "Fully Corporate" have the distinct characteristic of a complete separation of profits and discounts; i.e., the shareholders and members are two separate and distinct groups. We feel that these plans, at least the ones without any other characteristics of an investment contract, are clearly not subject to the jurisdiction of this Commission.

B. Characteristics Which May Indicate Registration

1. Bonus Discounts and Merchandise. Plans which offer increased discounts, free merchandise and the like, for a member who introduces another member to the plan are offering members an opportunity to increase "profits" through a promotional scheme and may be offering a security.

2. Appreciation. Plans whose memberships are transferable are offering members an opportunity to invest in a contract which may well increase in value over time and may be offering a security. This holds true, as well, for plans which redeem their memberships at a price greater than cost and for plans offering "cost of living" increases based on inflation.

3. Promotional Schemes. Plans whose promotional schemes, verbal or written, include material comparing memberships to traditional investments such as certificates of deposit, bonds, or corporate stock are selling their memberships as though they were a security, are producing in investors an expectation of profits and, therefore, may be offering a security. It must be made clear to prospective members that they are purchasing a consumer service, not making an investment for the future, in order for the offering to be clearly beyond the jurisdiction of this Commission.