

1987 SEC No-Act. LEXIS 2561

Securities Act of 1933 -- Section 2(1)

Oct 14, 1987

[*1] Funeral Services of Iowa, Inc.

TOTAL NUMBER OF LETTERS: 2

SEC-REPLY-1: SECURITIES AND EXCHANGE COMMISSION
WASHINGTON, D.C. 20549
September 14, 1987

RESPONSE OF THE OFFICE OF CHIEF COUNSEL
DIVISION OF CORPORATION FINANCE

Re: Funeral Services of Iowa, Inc. ("FSI")
Incoming letter dated July 2, 1987

On the basis of the facts presented, this Division will not recommend any enforcement action to the Commission if FSI, in reliance upon your opinion as counsel that registration is not required, offers and sells pre-need funeral contracts as described in your letter without compliance with the registration requirements of the Securities Act of 1933.

The Division of Investment Management has asked us to advise you that, based on the facts and representations contained in your letter, it would not recommend any enforcement action to the Commission under the Investment Company Act of 1940 ("1940 Act") against FSI or the First Interstate Bank of Des Moines, N.A. ("Trustee") if the Trustee maintains a common trust fund, into which proceeds from the sale of pre-need funeral contracts are deposited as described in your letter, without registering the common trust fund as an investment company in reliance upon your opinion of counsel [*2] that this arrangement would be excepted under Section 3(c)(3) of the 1940 Act from the definition of "investment company." See Drexel Trust Company (pub. avail. Oct. 12, 1983).

Because these positions are based upon the representations made in your letter, it should be noted that different facts or conditions might require different conclusions. Further, this response only expresses the Divisions' position on enforcement action and does not purport to express any legal conclusion on the questions presented.

Sincerely,
Cecilia D. Blye
Special Counsel

INQUIRY-1: LAW OFFICES
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July 2, 1987

Office of Chief Counsel
Divisions of Corporation Finance and Investment Management

Securities and Exchange Commission
450 Fifth Street N.W.
Judiciary Plaza
Washington, D.C. 20549

Re: Participation by Funeral Directors in Pre-Need Master Trust

Gentlemen:

We are writing on behalf of Funeral Services of Iowa, INC. ("FSI") to request the staff's concurrence in the conclusion expressed herein, namely that the registration requirements of the Securities Act of 1933 (the "1933 Act") and the Investment Company [*3] Act of 1940 (the "1940 Act") do not apply to a state-regulated trust, wherein the proceeds from the sale of pre-need funeral contracts ("Pre-need Funeral Contract") are deposited by state-licensed funeral directors or funeral services establishments ("Funeral Director") in to a common trust fund administered by a federally insured bank acting as trustee. The proceeds are comingled by the trustee with other similar Pre-need Funeral Contract proceeds for investment purposes.

FSI is a general business corporation organized under the Iowa Business Code and a wholly owned subsidiary of the Iowa Funeral Directors Association. Pursuant to Chapter 523A of the Iowa Code Annotated (1987), FSI has established a pre-need funeral trust ("Master Trust") with First Interstate Bank of Des Moines, N.A., ("Trustee"). FSI proposes to offer to Iowa Funeral Directors the opportunity to participate in the Master Trust by entering into a participation agreement ("Participation Agreement").

From time to time, a participating Funeral Director will enter into a Pre-need Funeral Contract with one of his customers. A Pre-need Funeral Contract is an agreement between the Funeral Director and the consumer [*4] for the sale of funeral services, funeral merchandise, or a combination of services and merchandise, pursuant to a prearranged funeral plan. Under Chapter 523A, at least 80% of the proceeds of a Pre-need Funeral Contract must be placed in a trust with a state or federally insured bank, savings and loan association, or credit union, or a trust department thereof. The terms of the Pre-need Funeral Contract must set forth, inter alia, the specific funeral services, funeral merchandise, or both, to be provided, and the cost of each service and merchandise item; the total purchase price and the terms under which it is to be paid; whether the contract is a guaranteed price or a nonguaranteed price contract; whether the contract is revocable, and by whom it may be revoked; and the amount or percentage of the contract price to be placed in trust.

FSI has created two forms of the Pre-need Funeral Contracts that Funeral Director participants in the Master Trust program are strongly urged to use. Although these contracts are highly recommended to the participating Funeral Directors, it should be noted that individual Funeral Directors are permitted to use their own contracts if prior approval [*5] of the forms is obtained from the Iowa Commissioner of Insurance.

The contract forms designed by FSI are revocable or irrevocable. As the names imply, the revocable contract permits the consumer to cancel the agreement; the irrevocable contract does not. Both forms permit a cancellation or default charge. Upon cancellation of a revocable contract, the consumer is entitled to a refund of payments made under the contract and any accrued interest or earnings thereon, less the contractually determined cancellation or default charge. The irrevocable contract form is designed to comply with old-age assistance, welfare, social security, or other public assistance eligibility requirements. Upon default under an irrevocable contract, the consumer will be entitled to no refund and the amounts paid under the contract and any interest earned thereon will be disbursed as required by applicable law.

Additionally, each of the two forms contains two pricing options. The consumer may select the "guaranteed price" option where, for the amount paid on the contract, plus any earnings thereon, the Funeral Director guarantees to provide at any future date the funeral merchandise and services specified [*6] in the contract. The consumer may also choose a "nonguaranteed price" option, which provides that if the amount paid under the contract plus accrued interest exceeds the total cost of the funeral service at the time of the customer's death, the excess is to be refunded to the consumer's personal representative or next-of-kin. But, if the amount paid under the contract terms, including accrued interest, is insufficient at the time of death to pay for the funeral merchandise and services specified in the contract, the Funeral Director is obligated to provide a funeral of that quality which the amount paid on the contract will allow. In the alternative, the consumer's personal representative or next-of-kin may elect to pay the additional cost. Thus, the consumer has a choice between guaranteeing the price and level of service, or selecting the non-guaranteed price and

assuming the risk that the amount contributed under the contract plus accrued earnings may not be sufficient to provide the level of funeral services specified in the contract.

In compliance with the trusting requirements of Chapter 523A, each participating Funeral Director will deposit into the Master Trust 80% of [*7] the Pre-need Funeral Contract proceeds, or such greater amount as is stated in the contract. Such funds will be held in the name of the participating Funeral Director for the benefit of the consumer. Under the terms of the Master Trust and the Master Trust Participation Agreement, the Funeral Director may select from among several investment fund options within the Master Trust into which the proceeds of the Pre-need Funeral Contract are deposited. At six month intervals, the Funeral Director may opt for a different fund within the Master Trust. The total amount deposited by all participating Funeral Directors in a given investment fund within the Master Trust is then pooled by the Trustee and invested in suitable financial instruments as determined by the Trustee or an investment manager selected by the Trustee.

When deposited into the Master Trust, Pre-need Funeral Contract proceeds usually remain in the trust until the customer's death, at which time the funeral director is authorized by the Pre-need Funeral Contract and the Master Trust documentation to withdraw all or a portion of the funds contained in the Master Trust as compensation for the funeral services provided. [*8] As authorized by Chapter 523A and the Master Trust documentation, the Funeral Director may also withdraw on an annual basis so much of the interest or income earned on the Master Trust account balance as represents the difference between the annual interest and income earned on the trust balance and the amount needed to adjust the trust balance for inflation, as determined by the Iowa Insurance Commissioner. In no event, however, will such withdrawals exceed 50 percent of the total interest or income earned during the preceding year. Moreover, such early withdrawals will not affect the consumer's right to a full refund or credit of such principal, interest, or income in the event that amount originally deposited in trust and income thereon are released to the consumer upon revocation of the contract or in the event that such sums exceed the actual cost of merchandise and services under a non-guaranteed price contract. Each Funeral Director must maintain accurate records of all receipts, expenditures, interest or earnings, and disbursements relating to funds held in the Master Trust. These records must be made available for examination by the Iowa Insurance Commissioner. The Funeral [*9] Director must file with the Commissioner a detailed annual report setting forth specific information on each Pre-need Funeral Contract entered into in the preceding year. The Trustee must also file with the Commissioner an annual report of all funds deposited into the Master Trust.

It is our opinion that the transactions described above do not involve a "security" as defined under Section 2(1) of the 1933 Act. In *SEC v. W. J. Howey*, 328 U.S. 93 (1946), the Supreme Court defined as "investment contract" under Section 2(1) of the 1933 Act as an investment of money in a common enterprise with profits to come solely from the efforts of others. Although it is conceivable that the amount of Pre-need Funeral Contract proceeds placed in trust could increase in value beyond the full contract price, the intent of the consumer is to purchase a funeral and not to invest capital in a common enterprise with an expectation of profit solely from the efforts of others. Similarly, the Funeral Director's primary motivation is to sell funeral merchandise and services and not to create an investment vehicle for the benefit of the consumer.

In *United Housing Federation, Inc. v. Foreman*, [*10] 421 U.S. 837 (1985), the Supreme Court held that shares in a cooperative housing project purchased by a resident of the project were not securities, because the buyer was not purchasing the shares with the intention of profiting from the investment. Rather, he was purchasing the shares as an incident of residency in the project and consequently he was, in reality, purchasing personal living space for his own use. The court looked principally to the substance of the transaction with respect to the buyer's intent. That case is substantially similar to the present situation wherein funeral customers are purchasing a personal service without intending to profit from the purchase. Therefore, we conclude that the sale and the purchase of a Pre-need Funeral Contract and the subsequent deposit of the contract proceeds into the Master Trust do not involve a security.

It is also our opinion that if participation in the Master Trust could be construed as a security as defined by section 2(1) of the 1933 Act, the Master Trust would still be exempt from registration under Section 3(a)(2) of the 1933 Act, which provides that the provisions of the 1933 Act shall not apply to "any interest or [*11] participation in any common trust fund or similar fund maintained by a bank exclusively for the collective investment and reinvestment of assets contributed thereto by such bank as trustee, executor, administrator or guardian." In the present case, First Interstate Bank of Des Moines, N.A. will act as Trustee of the Master Trust and will have primary responsibility for the deposited funds. Thus, the Master Trust should be exempt from registration because it will be administered by a bank in accordance with the provisions of section 3(a)(2).

The staff has on at least two prior occasions opined that various types of trust arrangements between a Funeral Director and his customer did not constitute a security and did not therefore require registration under the 1933 Act. In *Rancadore and Alameda, Inc., SEC No-action Letter, Fed. Sec. L. Rep. (CCH) P81,249* (April 8, 1977, available May 9, 1977), the staff responded to an inquiry by a California funeral director on facts substantially similar to the Iowa Master Trust. The funeral director proposed to sell Pre-need Funeral Contracts to his customers and to deposit all proceeds from these sales into a revocable trust account established [*12] according to state statutes and regulated by a state agency. An affiliate to the director was to serve as trustee. The trustee was permitted for investment purposes to comingle the proceeds of the Pre-need Funeral Contracts placed in trust. The staff chose not to recommend enforcement action to the Commission requiring registration under the 1933 Act (or the 1940 Act).

Similarly, in *Interment Ass's of California, SEC No-action Letter, (Available September 22, 1979) (LEXIS, Fedsec library, Noact file)*, the staff agreed not to recommend an enforcement action to require registration under the 1933 Act where, pursuant to California statute, payments on pre-need funeral contracts made to funeral directors were placed in trust in a banking or trust institution. These trusts were subject to regulation by the State Board of Funeral Directors and Embalmers. Among the restrictions placed on such trusts were that the consumer had the right to revoke the pre-need funeral contract and to receive a refund of all payments and income less specified costs, and that the trustee was limited to certain specified investments.

The Iowa Master Trust as described above is sufficiently similar to [*13] both of the trusts described in the above-noted no-action letters to merit the same treatment. In addition to the factual similarities between the operation of these trusts, the state regulatory environments are also similar. As in *Rancadore* and *Interment Ass'n*, the appropriate regulatory agency in Iowa places stringent operating, recordkeeping, and reporting requirements on the Funeral Director and the Trustee, as well as restrictions on the terms of the Pre-need Funeral Contract itself, which are designed to protect the consumer. Moreover, the Trustee is also subject to federal banking and state fiduciary law. Because of the already substantial regulation of this activity on both state and federal levels, it would be redundant to require the registration of the Master Trust under the 1933 Act.

Finally, it is our opinion that the Master Trust described herein does not require registration as an Investment Company under the 1940 Act. In support of this opinion, we refer to the language set forth in Section 3(c)(3) of the 1940 Act which states:

. . . none of the following persons is an "investment company" within the meaning of this title: . . . any common trust fund [*14] or similar fund maintained by a bank exclusively for the collective investment and reinvestment of moneys contributed thereto by the bank in its capacity as a trustee, executor, administrator, or guardian.

It is clear from this language that the 1940 Act excepts from the definition of investment company, as set forth in Section 3(a) of the act, any common trust fund maintained by a bank exclusively for the collective investment and reinvestment of fund contributed thereto by the bank while acting in one of its traditional, fiduciary capacities, and not as a mere vehicle for general investment by the public. *Bank of Delaware, S.E.C. No-Action Letter, [1972-1973 Transfer Binder] Fed. Sec. L. Rep. (CCH) P79,292 at 82,824* (December 8, 1972).

In these circumstances, the Trustee bank is exercising substantial investment responsibility with respect to the administration of the Master Trust. Further, the Trustee bank is not acting merely as a custodian for the collective trust fund, but rather has primary responsibility for all investment decisions. Based on the relationship between First Interstate Bank of Des Moines, N.A. as Trustee and the Master Trust itself, it is our opinion [*15] that the Master Trust need not be registered under the 1940 Act.

If, for any reason, you do not concur in the views expressed herein, we respectfully request an opportunity to confer with members of the staff by telephone or in person prior to any written response to this letter. If you have any questions or need further information, please telephone the undersigned collect at (414) 271-8210.

Very truly yours,
WHYTE & HIRSCHBOECK S.C.
By John R. Heitkamp, Jr.

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