STATE OF WASHINGTON
DEPARTMENT OF FINANCIAL INSTITUTIONS
SECURITIES DIVISION

IN THE MATTER OF DETERMINING Whether there has been a violation of the Securities Act of Washington by: CLS Financial Services, Inc. and Gerald C. Vanhook, Respondents	SDO 99-10 CONSENT ORDER REVOKING EFFECTIVENESS OF PERMIT NUMBER C-51104 AND SUSPENDING Q-03505 AND BROKER-DEALER LICENSE BD4554 AND GERALD C. VANHOOK'S SECURITIES SALEPERSON LICENSE, AND CONDITIONING EXEMPTIONS Case No. 99-02-045

THE STATE OF WASHINGTON TO: Gerald C. Vanhook, President
CLS Financial Services, Inc.
4720 200th Street SW, Suite 200
Lynnwood WA 98036

STATEMENT OF CHARGES

The Securities Division of the Department of Financial Institutions, pursuant to the Securities Act of Washington, as a basis for this Consent Order, makes the following Findings of Fact and Conclusions of Law:

FINDINGS OF FACT

I.

CLS Financial Services, Inc. (CLS) is a Washington Corporation with its principal place of business at 4720 200th Street SW, Suite 200, Lynnwood, WA 98036. Gerald C. Vanhook (Vanhook) is the president of CLS and a licensed securities salesperson. Puget Sound Investment Group, Inc. (PSIG), an affiliate of CLS by virtue of common ownership, is a Washington Corporation with the same principal place of business as CLS.

II.

CLS may engage or is engaged in the business of investing, reinvesting, owning, holding, or trading in: (a) notes, or other debt obligations, whether or not secured by real or personal property; (b) vendors' interests in real estate contracts; (c) real or personal property to be leased to third parties; and/or (d) real or personal property.

III.

CLS sells unsecured notes called “debentures” and notes secured by mortgages or trust deeds on real or personal property (mortgage paper securities) to residents of the state of Washington. CLS uses the money received from the sale of debentures as capital or operating funds.

IV.

CLS is currently registered (Permit No. C-51104), pursuant to RCW 21.20.180, to publicly offer and sell debentures to residents of the state of Washington. CLS has also filed a claim of exemption pursuant to RCW 21.20.320(1) and WAC 460-44A-506 (No. E-17017) for the non-public offering of debentures. It is also registered, pursuant to RCW 21.20.210 and WAC 460-33A (Permit No. Q-03505), to publicly offer and sell mortgage paper securities. CLS is licensed as a broker-dealer pursuant to RCW 21.20.040 (License No. BD 4554).

V.

Between December 1995 and October 1996, CLS made three loans totaling $3,000,000 to Donald J. MacKenzie and the MacKenzie Properties Limited Partnership (hereafter collectively referred to as MacKenzie and the MacKenzie loans). These loans were secured by deeds of trust on real property in King County. CLS subsequently sold mortgage paper securities in the form of participation interests in two of these loans to Washington residents.

VI.

In April 1997, CLS declared a default on MacKenzie loans, alleging the failure to make certain payments.

VII.

MacKenzie filed for bankruptcy protection in late 1997. MacKenzie brought an adversarial proceeding in bankruptcy court against CLS and other parties alleging fraud, negligent misrepresentation, breach of contract, breach of fiduciary duties, unfair business practices and other counts. Trial on these counts began on October 6, 1998. On October 27, 1998, the court made its oral ruling.

VIII.

In a letter addressed to its investors dated January 15, 1999, CLS described the oral ruling and its impact on CLS as follows:

A. CLS had been sued in bankruptcy court by a disgruntled borrower;

B. The judge had ruled against CLS and ordered CLS to pay "plaintiff's attorney fees and a 'lost profits' award amounting to $2,000,000;"

C. CLS's attorneys fees for the litigation exceeded $500,000;

D. CLS had decided not to appeal;

E. While a settlement might save the business, "drastic belt tightening" would be necessary;

F. CLS was "prepared to hunker down and try to keep the business going;"

G. CLS was attempting to "avoid the company being placed in the hands of a receiver (bankruptcy);" and

H. Monthly payments to certain investors would be reduced by 50%.

CLS did not send a copy of this letter to the Department of Financial Institutions, Securities Division (Division).

IX.

As part of its registrations for debentures and mortgage paper securities noted in Finding of Fact IV, CLS files with the Division disclosure documents to be delivered to prospective investors. On April 20, 1998, CLS filed a disclosure document called a prospectus dated April 6, 1998, relating to its offer and sale of debentures. That prospectus did not disclose the MacKenzie bankruptcy or any other material litigation involving CLS or its affiliates and states CLS's involvement in collection actions is, in its counsel's opinion, "routine litigation incidental to its business." On January 15, 1999, the same date as its letter to investors describing the MacKenzie lawsuit discussed in Finding of Fact X, CLS filed with the Division a disclosure document called a general offering circular relating to its offer and sale of mortgage paper securities. That general offering circular did not disclose the MacKenzie bankruptcy, the oral ruling made by the court in the adversarial proceeding, or any other material litigation involving CLS or its affiliates. The general offering circular states that CLS's involvement in collection actions is, in its counsel's opinion, "routine litigation incidental to its business."

X.

In July, September, and October 1998, the Division conducted a field examination of CLS pursuant to RCW 21.20.700. During the July 27, 1998, opening interview for that examination, Vanhook was asked whether CLS had been involved in any litigation since the previous examination. He responded that CLS was involved in several actions, including foreclosures, lawsuits brought by former employees concerning commissions, and landlord-tenant disputes, none of which were material. An additional interview of Vanhook by Division Staff took place on October 2, 1998, at the close of the examination. Despite the fact that the trial described in Finding of Fact VII was to begin in four days, Vanhook did not mention any pending material litigation.

XI.

During the Division's examination of CLS described in paragraph X of the Findings of Fact, the Division detected several areas of non-compliance of the Securities Act by CLS. For example, the Division determined CLS violated of RCW 21.20.710(1)(c), which requires a debenture company to maintain cash or comparable liquid cash assets of at least 50% of its required net worth. As of June 30, 1998, CLS was required to have cash or comparable liquid assets of $288,536, yet CLS had only $132,338 in cash or comparable liquid assets as defined by WAC 460-64A-010. In another example, the Division determined that CLS violated RCW 21.20.820(1), which states that a debenture company shall not loan to any one borrower more than 2½% of the debenture company's assets without prior written consent of the Director. As of June 30, 1998, CLS had outstanding, unsecured loans to its affiliate, Puget Sound Investment Group (PSIG), totaling $3,494,320 or 44.1% of its assets. In another example, the Division noted that CLS violated RCW 21.20.830(1), which states that a debenture company shall not invest more than 20% of its assets in unsecured loans. As of June 30, 1998, CLS had unsecured loans outstanding to PSIG totaling $3,494,320 or 44.1% of its assets. As a result of these violations, the Division requested CLS to take steps necessary to cure its non-compliance with the Securities Act.

XII.

CLS responded to the violations described above in paragraph XI of the Findings of Fact in a letter dated January 29, 1999. In this letter, CLS represented to the Division that it intended to stop the sale of debentures with the goal of ceasing to exist as a debenture company. In addition, CLS represented to the Division that it would perfect a security interest in the PSIG loans by February 15, 1999. CLS also represented to the Division that it was CLS's intent to comply with every aspect of the applicable rules and regulations.

XIII.

On October 29, 1998 and January 21, 1999, the Division received quarterly reports signed by Vanhook for the quarters ending September 30, 1998, and December 31, 1998, respectively. Those reports stated that, with respect to CLS's mortgage paper securities general offering circular, no material changes had occurred. Included with those reports were copies of CLS's financial statements. For the 8 months ended August 31, 1998, the financial statements indicated legal fees of $5,233 had been accrued. For the 9 months ended September 30, 1998, the financial statements indicated legal fees of $13,759 had been accrued. As of September 30, 1998, the financial statements showed a net worth of $1,432,172.40.

XIV.

CLS is required to file quarterly reports on Form 10-Q with the Securities and Exchange Commission. These reports are due 45 days after the end of each quarter. CLS has not filed a quarterly report for the quarter ended September 30, 1998.

XV.

Vanhook met with Division staff on February 10, 1999. When asked about CLS's failure to file the Form 10-Q for the third quarter of 1998, Vanhook stated that the MacKenzie bankruptcy and trial had led him to believe that the CLS's financial statements for that period were inaccurate and that he was reluctant to disseminate those financial statements. At that meeting, Vanhook also produced a copy of the September 30, 1998 financial statements referenced in Finding of Fact XIII, above. Vanhook admitted that he believed those financial statements were inaccurate in light of the MacKenzie bankruptcy.

XVI.

The Securities Administrator finds that the continued offering of debentures and mortgage paper securities described above presents a threat to the investing public.

Based upon the above Findings of Fact, the following Conclusions of Law are made:

CONCLUSIONS OF LAW

I.

The prospectus and general offering circular described in Finding of Fact IX, in failing to disclose the MacKenzie Bankruptcy and lawsuit discussed in Findings of Fact VII and VIII, and the potential effects of that lawsuit on CLS's solvency, makes untrue statements of material fact and/or omits to state material facts necessary in order to make the statements made, in the light of the circumstances under which they are made, not misleading in violation of RCW 21.20.010 and RCW 21.20.350.

II.

By failing to disclose the MacKenzie bankruptcy and litigation described in Findings of Fact VII and VIII to the Division during an examination, by stating in the quarterly reports discussed in Finding of Fact XIII that no material changes had occurred since the filing of the last prospectus, and by misrepresenting the accrued legal fees in its financial statements that accompanied those reports, CLS has made statements which were, at the time and in light of the circumstances under which they were made, materially false and/or misleading in violation of RCW 21.20.350, which states that it is unlawful to file materially false and misleading statements with the Division.

III.

CLS is a "debenture company" as defined by RCW 21.20.705(1).

IV.

CLS has violated RCW 21.20.710(1)(c), as described in paragraph XI of the Findings of Fact, by failing to maintain cash or comparable liquid assets of at least 50% of its required net worth.

V.

CLS has violated RCW 21.20.820(1), as described in paragraph XI of the Findings of Fact, by lending to one borrower more than 2½% of the debenture company's assets without prior written consent of the director.

VI.

CLS has violated RCW 21.20.830(1), as described in paragraph XI of the Findings of Fact, by investing more than 20% of its assets in unsecured loans.

CONSENT ORDER

The Securities Division and CLS Financial Services, Inc. have agreed upon a basis for resolution of the matters found and concluded herein. CLS Financial Services, Inc. agrees to the entry of this Consent Order pursuant to the Securities Act of Washington without admitting or denying the Securities Division's findings and conclusions. CLS Financial Services, Inc., acknowledges the Securities Division's jurisdiction over this matter and its authority to enter this order.

Based upon the foregoing:

IT IS AGREED AND ORDERED as of the date of entry of this Consent Order that:

A. Permit C-51104 for the offer and sale of debentures withdrawn by CLS on February 12, 1999, is, therefore, revoked and terminated. CLS, Vanhook, or any affiliate or successor of CLS or Vanhook shall not make application for a permit to offer and sell securities as a debenture company for a period of five years from the date of this Consent Order.

B. Three permits and licenses, specifically, Q-03505 – Mortgage Paper Securities, BD 4554 – Security Broker-Dealer, and Gerald C. Vanhook's Securities Salesperson License, are hereby suspended until a new application, or the renewal application of permit Q-03505, under the provisions of RCW 21.20.210 and ch.

460-33A WAC, including financial statements audited by an independent CPA, is filed and made effective by the Securities Administrator, such application to be made effective, if at all, on or after April 28, 1999.

IT IS ALSO AGREED AND ORDERED that the availability of certain exemptions under RCW 21.20.320 to CLS, if the exemption is available and CLS meets the conditions of the exemption, are for a period of five years from the date of entry of this Consent Order hereby conditioned upon the following:

A. CLS shall, pursuant to any claim of exemption under RCW 21.20.320(1), (5), (9), (10), (11), or (17), offer and sale its securities only to "accredited investors" as defined by WAC 460-44A-501(1) as currently written or hereafter amended, unless:

(1) CLS files an offering circular with the Securities Administrator ten business days prior to making any offer to sell any security and the Securities Administrator does not disapprove the offering;

(2) CLS delivers to each non-accredited investor, at or prior to the time of sale of each security, an offering circular accompanied by CLS's financial statements audited by an independent CPA; and

(3) In the event that the securities to be offered by CLS are "mortgage paper securities" as defined by WAC 460-33A-015 as currently written or hereafter amended, CLS files as required by subsection (1) and delivers as required by subsection (2), a general offering circular and a specific offering circular in accordance with ch. 460-33A WAC.

B. CLS may rely on RCW 21.20.320(8), which provides an exemption for "any offer or sale to a bank, savings institution, trust company, insurance company, investment company as defined in the Investment Company Act of 1940, pension profit-sharing trust, or other financial institution or institutional buyer, or to a broker-dealer, whether the purchaser is acting for itself or in some fiduciary capacity," where "institutional buyer", for purposes of this Consent Order, shall be defined by Securities Act Interpretive Statement 11 as currently

written or hereafter amended or superseded, and "pension or profit-sharing trust" shall be defined by Securities Act Interpretive Statement 10 as currently written or hereafter amended or superseded.

IT IS ALSO AGREED that CLS has terminated the offering evidenced by exemption acknowledgment E-17017 prior to or as of the date of entry of this Consent Order.

IT IS ALSO AGREED AND ORDERED that CLS, Gerald C. Vanhook, and their employees, agents, and representatives, shall each cease and desist from offering and selling securities in any manner in violation of RCW 21.20.010, the anti-fraud section of the Securities Act of Washington.

IT IS ALSO AGREED AND ORDERED that CLS, Gerald C. Vanhook, and their employees, agents, and representatives, shall each cease and desist from violations of RCW 21.20.350.

IT IS ALSO AGREED that CLS shall deliver by March 31, 1999, copies of this Consent Order to all persons to whom CLS sold securities and who are presently investors in CLS, and provide the Division with proof of such delivery.

IT IS ALSO AGREED AND ORDERED that CLS shall provide the following information to the Division:

A. CLS shall file quarterly financial statements including a balance sheet, and statements of income, cash flows, and stockholders' equity, for the quarter-ended December 31, 1998, by March 15, 1999. These statements shall be prepared in accordance with generally accepted accounting principles (GAAP) and include appropriate footnotes;

B. CLS shall file with the Division, by April 30, 1999, audited financial statements for the year ended December 31, 1998, to include a balance sheet, and statements of income, cash flows, and stockholders' equity;

C. CLS shall file quarterly financial statements compiled by an independent CPA, prepared in accordance with GAAP. These statements shall be filed with the Division within 15 days after the end of the month. The first report shall be due on April 15 for the month ended March 31, 1999; and

D. CLS shall file such other information as may be requested by the Division to evaluate CLS's financial condition and compliance with the debenture company provisions of the Securities Act of Washington.

In consideration of the foregoing, CLS Financial Services, Inc., waives its right to a hearing on this matter.

WILLFUL VIOLATION OF THIS ORDER IS A CRIMINAL OFFENSE.

DATED this _____ day of February, 1999:

Approved as to form:

_____
Gerald C. Vanhook, President
CLS Financial Services, Inc.

_____
Douglas M. O'Coyne, Sr.
Attorney for CLS Financial Services, Inc.

DATED AND ENTERED this _____ day of February, 1999.

_____
Deborah R. Bortner
Securities Administrator

Presented by:

_____
Marlo DeLange
Securities Examiner

Approved by:

_____
Michael E. Stevenson
Chief of Compliance