

INDEPENDENT CONSULTANT
INITIAL REPORT

IN THE MATTER OF HANTZ FINANCIAL
SERVICES, INC.

NATIONAL ASSOCIATION OF SECURITIES DEALERS, INC.
LETTER OF ACCEPTANCE, WAIVER AND CONSENT
NO. EAF-0400060001

January 9, 2006

Initial Report of Independent Consultant

Background

On August 11, 2005, following an investigation by the National Association of Securities Dealers, Inc. (“NASD”) Enforcement Department, Hantz Financial Services, Inc. (“HFS” or the “Firm”) submitted a Letter of Acceptance, Waiver and Consent (“AWC”).¹ The AWC required an undertaking from the Firm that included, among other things:

Section II, Paragraph C.e.

HFS shall retain, within 60 days of the date of Notice of Acceptance of this AWC, the services of an Independent Consultant not unacceptable to NASD Staff. The Independent Consultant (“IC”) shall, at HFS’ expense, review and make recommendations concerning the adequacy of HFS’s policies, procedures and disclosures as they relate to matters described in this AWC.

Kevin A. Carreno and the firm Experts Counsel Inc., a Florida corporation (“we”) have been retained by HFS, with the consent of the NASD, to act as the Independent Consultant in accordance with the terms of the AWC. In connection with the undertaking, we have reviewed the corrective action implemented by HFS, including procedures, policies and disclosures as more fully set forth in this report. This report constitutes the Initial Report and Recommendation as required by Section II, Paragraph C.f. of the AWC.

HFS was founded by John Hantz in 1998. The Firm became an SEC registered Broker/Dealer and NASD member in 1999. Since its original founding, neither John Hantz nor HFS has had any reported disciplinary history. HFS markets its services through a branch

¹ NASD Letter of Acceptance, Waiver and Consent No. EAF-0400060001, 11 August 2005 at Tab A

network of 16 offices located in Michigan and Ohio. HFS promotes itself as a financial planning firm offering comprehensive planning, investment, insurance, tax and business services. HFS utilizes a unique financial planning approach with clients that includes a comprehensive peer review through a case study method.

The investigation that culminated in the AWC began in 2003. According to HFS, the initial investigation focused on allegations that HFS was recommending or suggesting that clients refinance their primary residence and utilize a portion of the equity for investment purposes. While the initial investigation did not reveal any violations with respect these issues, the investigation was expanded to review the relationships that HFS had with various third-party mutual fund and insurance vendors. The investigation culminated in the settlement and entry of the AWC in mid-2005.

Scope

The objective of our engagement as Independent Consultants has been to evaluate the corrective action implemented by HFS in complying with the terms of the AWC and to make any additional recommendations that will assist in the detection and prevention of future, repeat violations of NASD Conduct Rules. Our review focused on the factual findings and violations outlined in the AWC. Each of the findings is dealt with as a separate section in this report. We reviewed the corrective action implemented by HFS, including, amended written supervisory procedures, promotional materials and disclosure documentation, training procedures and financial records as they relate to the findings and violations. We performed analyses and testing designed to evaluate the adequacy of the corrective action implemented by HFS. Further, we conducted interviews of certain key members of HFS' management team, compliance and supervisory and sales and marketing personnel. We also interviewed sales personnel of third party vendors to assess the effect, if any, on HFS' continued use of preferred vendors and the agreements currently in existence.

We did not, however, review supervisory procedures concerning areas not identified in the AWC. Specifically, we did not review supervision or compliance matters of HFS' retail securities business, other investment services, financial controls, or back office operations, except as they related to the findings in the AWC. Our review focused solely on the implementation of corrective action, amendments to written supervisory procedures, and preventative controls implemented HFS in response to the violations outlined in the AWC.

Methodology

The methodology utilized during the review and analysis of the corrective action taken by HFS consisted of the following:

1. Review AWC and HFS files to identify factual basis supporting findings by NASD;
2. Review preventative and corrective policies and procedures implemented by HFS following the settlement;
3. Interview key staff and selectively test the effectiveness of new procedures, corrective measures, controls, and supervision in the areas identified; and
4. Recommend additional corrective action or best practices for implementation by HFS.

Our report summarizes the findings, supporting evidence and corrective action taken by HFS. Where appropriate, we have made additional recommendations for corrective action.

The results of our review were presented to HFS management on January 6, 2006. At that time, management was provided an opportunity to respond to findings and to provide additional feedback on the corrective action and additional recommendations. Any comments provided by management have been incorporated in the final report.

Compliance Culture of the Firm

As part of our review, we evaluated the compliance culture of the Firm. Management is genuinely committed to maintaining a high standard of compliance. In interviews, management acknowledged the violations and committed to fully implementing corrective action. John Hantz, who had no prior disciplinary history, is the principal shareholder and named founder. He has a high degree of personal commitment to the business reputation of HFS. He acknowledged during interviews that while he has significant business experience, at the time of the investigation, he had no prior experience with enforcement proceedings or regulatory investigations.

HFS consented to findings and violations after a 2½ year investigation by the NASD. The violations for fraud and negligent misrepresentation were all non-scienter based violations. During our review, we did not reveal any information to conclude that the violations were intentional on the part of any HFS personnel or management. Our review, however, identified the root causes of the violations being attributable to:

1. Significant shifts in the regulatory environment industry-wide, in particular with regard to requirements to disclose potential conflicts of interest including preferred vendor relationships.
2. The experience of senior management and the Firm's compliance department in anticipating and responding to changes in the regulatory environment and, to a lesser extent, dealing with regulatory investigations.
3. Poor communication to clients and within the Firm's training programs of the Firm's operating philosophy as it related to the selection of preferred vendors.

4. Poor internal documentation of the due diligence process utilized for the selection and approval of preferred vendors and negotiation of marketing agreements.

The Firm's management has demonstrated a strong commitment to regulatory compliance in general and, more specifically, to implementing corrective action for the violations set out in the AWC. Furthermore the operating philosophy of the Firm suggests a reduced risk in terms of failed customer expectations or violations of sales practice standards (suitability, excessive trading, mutual fund switching). The Firm's comprehensive client needs analyses, data gathering, analysis and preparation of written financial plans for every client are all evidence of a robust financial planning process that reduces the risk of failed client expectations. Further, the Firm maintains comprehensive written procedures for both its Broker/Dealer and Investment Advisor compliance programs that address significant risks.

The Firm's operating philosophy of relying extensively, albeit not exclusively, on the use of a limited number of preferred investment and insurance product providers, we believe, has two consequences. First of all, it reduces or eliminates the need for its Financial Advisors ("FA"s) to conduct the due diligence to select appropriate product to recommend to clients which we believe reduces risk. Second, it allows the Firm to develop better training and to maintain comprehensive sales and marketing support for a limited number of selected products. This operating philosophy is "independent" in the sense that HFS is not a product manufacture and does not sell its own proprietary product. However, that independence does not extend to FAs exercising exclusive control for investment selection and recommendations. We believe that, subject to appropriately disclosing and communicating this operating philosophy to the Firm's clients as outlined in the Recommendations below, HFS reduces the

risk associated with FAs independently selecting investments without any firm imposed standards or criteria. HFS should, and the recommendations in this report require the Firm, to more clearly communicate its operating philosophy to clients and to insure that its marketing materials and sales training material accurately reflect the operating philosophy of the Firm.

Finally, during our review the NASD's Chicago District Office conducted an on-site, cycle examination. According to the examiner, the audit included a review of the violations in the AWC. The cycle examination did not reveal any repeat violations or any other significant deficiencies.

Review of Violations and Corrective Action

The AWC identified seven violations. Four of the seven violations dealt with appropriate disclosure of the conflicts of interest with preferred providers. One of the violations dealt with the appropriate disclosure of the payment of referral fees for mortgage business introduced to Tranex, a HFS affiliated company. The remaining two violations dealt with the procedures for recommending direct participation investments and approval of advertising. The central theme of the most significant violations was (1) payments or compensation paid to HFS for products or services distributed through its Broker/Dealer; (2) the appearance of a conflict of interest and, (3) the lack of adequate disclosure to HFS clients of the relationship and payments received by HFS. A detailed discussion of each of the violations is included below.

VIOLATION 1

HFS made misleading claims of “independence”: violations of Section 17(a)(2) of the Securities Act of 1933 and NASD Conduct Rule 2110.

NASD SUPPORTING EVIDENCE

1. Sales Scripts and training material
2. Internal sales presentations to vendors
3. Advertising and Sales Literature furnished to clients

REVIEW AND ANALYSIS

We reviewed the materials that HFS utilized for broker training. We also reviewed advertising and sales literature and any information HFS has furnished to third party vendors. The purpose of the review was to identify statements asserting the “independence” of the Firm and its FAs. Additionally, we reviewed training materials and participated in training sessions with FAs to evaluate the training materials and communication of HFS’ operating philosophy. Additionally, we interviewed FAs and sales management staff to assess their understanding and communication of the Firm’s independence.

Our review required a detailed understanding of the broker training and development process utilized by HFS. Our objective was to evaluate the sales process with respect to communication by FAs of HFS’ independence to clients. HFS utilizes a comprehensive financial planning process to identify client investment needs. The process also identifies tax, estate planning and insurance needs. Clients are furnished with a detailed financial plan at the conclusion of an internal review process that includes a peer review with other HFS advisors, tax

and estate planning specialists. Clients, who choose to implement all or any portion of the plan, are furnished with additional information about specific investments options, including mutual fund prospectuses, variable annuity disclosure documents and insurance information. Alternatively, clients may choose to implement the recommendations through another service provider or may choose to do nothing. In those instance where the client chose HFS to implement the recommendations, viturally all of the recommendations included recommendations for either mutual funds or variable insurance product form a preferred vendor. In interviews with senior management, we were advised that the Firm has had a long standing policy that its FAs are trained to utilize HFS approved product vendors. Senior management believes that HFS FAs should rely on the Firm to undertake investment product selection. Consequently, the Firm conducts its due diligence and assumes responsibility for product selection. The FAs remain responsible for understanding a client's specific needs and objectives and for making recommendations that are appropriate to the client's specific circumstances in accordance with NASD Conduct Rules. According to management, the Firm believes that by undertaking the investment selection process for its FAs, it can improve the quality of the investments for its clients.

In reviewing the Firm's experience with customer complaints related to unsuitable investments, there were only three reported instances in the last 24 months. In each instance, the Firm had extensive client background information, including the detailed financial plan that the FA relied upon in making recommendations of Firm approved investments in mutual funds. None of the complaints resulted in any financial settlement or arbitration award. Consequently, the process employed by HFS to select investment products appears to be a factor in significantly reducing the incidence of customer complaints.

During our review, we determined that HFS FAs are not restricted from utilizing mutual funds, variable or fixed product from non-preferred vendors. Any requests to utilize non-preferred vendors must be approved by sales management and supported by a justification. Final approval of an FAs use of non preferred vendors rests with the Firm's sales management.

During our review, we concluded that HFS has one preferred vendor for mutual funds, 2 preferred vendors for variable insurance product and 4 for fixed insurance and other investment product. Each of the preferred vendors has entered into a distribution agreement with HFS. Final approval of vendors is the responsibility of John Machcinski, the President of HFS. Once a product is approved, HFS will provide FAs with product specific sales and training materials. The Firm's sales and marketing staff will provide training on product features, pricing and benefits. The Firm's sales management will periodically review distribution agreements and, where appropriate, renegotiate terms or, as in one case, terminate the relationship.

CORRECTIVE ACTION IMPLEMENTED BY HFS

1. Revised Training Materials have removed any references to the "independence" of HFS.
2. Revised sales literature and advertising to more accurately reflect HFS investment selection methodology and its reliance on "best of breed" investments.
3. Any future presentations to vendors will communicate the operating philosophy of the Firm.

ADDITIONAL RECOMMENDATIONS

1. HFS training materials should emphasize, for the benefit of clients, the disclosure of any conflicts of interest. In addition, the training materials should make clear the existence of

relationships with 3rd party vendors, including Tranex, and the payment of marketing fees and other remuneration received by HFS and its FAs for the sale of preferred product.

2. HFS training materials and sales literature should more clearly define the operating philosophy of the Firm specifically with regard to investment product selection.

VIOLATION 2

HFS Entered into Revenue Sharing Arrangements that Created Conflicts of Interest, Without Disclosing the Arrangements to its Clients; Violations of Section 17(a)(2) of the Securities Act and NASD Conduct Rule 2110.

NASD SUPPORTING EVIDENCE

1. Client agreements and marketing material
2. HFS Website.
3. Hantz disclosure documents
4. Vendor selling agreements

ANALYSIS

Our analysis focused on HFS marketing material, client agreements, preferred provider marketing agreements and the HFS website. During interviews, we questioned management about the method of selecting preferred providers. We also reviewed the terms of the marketing agreements with representatives of the product providers. While marketing agreements of the type that HFS had with its preferred providers is a common industry practice, management acknowledged that the potential conflicts of interest should be fully disclosed.

We reviewed the additional disclosures mandated by Section C (Sanctions) of the AWC, including the following provisions:

- 3. In the AWC, Hantz consented to all of the following corrective action aimed at providing full disclosure to Hantz clients:**
 - 1. its preferred supplier relationships, including:**
 - a. the existence of the preferred suppliers;**

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- b. the names of the preferred supplier firms and the products for whom they serve as the preferred supplier;
 - c. the amount of revenue sharing payments that HFS receives from each of the preferred suppliers based on a reasonable estimate from historical experience, expressed in basis points or dollars;
 - d. the total amount of revenue sharing payments (expressed in dollars) that HFS receives annually, starting with the amount received in 2005 as of the date of the...AWC and updated each year thereafter;
 - e. that the equity owners of the Firm may benefit financially from the revenue sharing payments HFS receives; and
 - f. that HFS does not receive revenue sharing payments from any non-preferred suppliers; and
2. the details of the relationship between HFS and Tranex Financial Services, Inc. including
- a. the common ownership and control;
 - b. the specific tasks conducted by the HFS FA's in the mortgage loan process;
 - c. the fact that the FAs collect 25% of the yield spread premium that Tranex earns on the mortgage loans referred by the FAs.
4. HFS shall send the information contained in paragraph a above:
- 1. to its current customers within 60 days of the date of ... the AWC.
 - 2. to new customers upon the opening of an account
5. HFS shall devise and implement within 60 days of the date...of the AWC a policy and set of procedures to ensure that HFS is complying with its obligations under this AWC, the federal securities laws, and NASD rules.
6. HFS shall devise and implement within 60 days of...the AWC a policy and set of procedures for training of its FAs regarding
- 1. Disclosures of the financial incentives that
 - a. HFS receives from its preferred suppliers; and
 - b. that the FAs receive for mortgage referrals to Tranex; and
 - 2. Disclosures to customers regarding the "independence" of HFS and/or its FAs.

CORRECTIVE ACTION IMPLEMENTED BY HFS

- 1. As specified in the AWC, the Firm was required to furnish written disclosure of all conflicts of interest. The additional required disclosures were provided to all existing HFS clients in a letter dated October 20, 2005. A copy of the letter is enclosed as Tab B. A second letter with updated figures for calendar year 2005 is in the process of being prepared and will be sent to HFS clients within 30 days.

2. The HFS website (<http://www.hantzgroup/conflictinterest.html>) was updated with the required disclosures as specified in the AWC. The updates to the website were completed in early October. Copies of the relevant web pages are enclosed at Tab C.
3. The Firms written procedures have been amended to provide that all new HFS clients will receive, at the time the account is opened, a disclosure document substantially similar to the October 20 letter.

ADDITIONAL RECOMMENDATIONS

1. HFS advertising and marketing material should continue to be reviewed for compliance with revised disclosure requirements.
2. HFS client account agreements should include a provision regarding the Firm's relationships with preferred vendors and the payment of marketing fees.
3. The disclosure of payments from preferred vendors should be incorporated into an annual disclosure document to be furnished to clients once per calendar year.
4. The corrective action and additional recommendations should be incorporated in the firms written procedures.

VIOLATION 3

HFS and John Hantz Failed to Establish and Follow a Supervisory System to Monitor its Revenue Sharing Arrangement and Related Disclosures: Violations of NASD Conduct Rules 3010 and 2110.

NASD SUPPORTING EVIDENCE

1. Client disclosures.
2. Hantz Compliance Manual and written supervisory procedures.
3. Hantz organizational diagrams.

ANALYSIS

We reviewed the Firm's supervisory structure and policies and procedures to review and approve preferred vendor relationships. Prior to August 2005, John Hantz had the ultimate responsibility for the selection, negotiation, and approval of preferred vendor relationships. Due diligence of preferred vendor relationships was performed by John Machcinski ("Machcinski"), who reported to John Hantz. Although John Hantz believed due diligence was performed regarding these preferred vendor relationships, he was not aware the due diligence was not documented. Further, the Firm did not have written procedures to specify any particular due diligence or documentation required before approving any preferred vendor relationships. The Firm's written procedures did not specify any standards for the provisions of any marketing or distribution agreements with preferred vendors.

In part, due to the lack of adequate procedures, the sanctions imposed in the AWC included a 30 day suspension for John Hantz from acting in a supervisory capacity. As a result of the AWC and other corporate actions, HFS has undertaken a reorganization of its supervisory structure. Machcinski, HFS President, has assumed responsibility for the management and

supervision of HFS. Machcinski will ultimately be responsible for the selection, negotiation and approval of all preferred vendors.

Additionally, HFS has agreed to appoint a Board of Directors to oversee the management of HFS. Machcinski will be accountable to and report to the Board of Directors of HFS. Machcinski will have responsibility for delegation and apportionment of management and supervisory responsibility within HFS.

CORRECTIVE ACTION IMPLEMENTED BY HFS

1. HFS will implement the reorganization of its management and supervisory structure as discussed above.
2. HFS modified its written supervisory procedures to include procedures for the selection, negotiation and approval of preferred vendors. The procedures will, at a minimum, specify the information included in the Additional Recommendations below.
3. With input from the Firm's sales management, finance and compliance functions, Machcinsky has assumed responsibility for the supervision and implementation of policies and procedures related to selection, negotiation and final approval of any preferred vendor marketing agreements.

ADDITIONAL RECOMMENDATIONS

1. The reorganization of the supervisory structure of HFS, should include the following:
 - a. Creation of a Board of Directors responsible for the corporate governance of HFS. The composition of the Board should include at least one person that is not an employee or officer of HFS.

- b. Machcinski should report to and be accountable to the newly formed Board of Directors.
 - c. Machcinski should be delegated, by the appointed Board, responsibility for establishing and maintaining a system of supervision in accordance with NASD Conduct Rule 3010.
2. HFS will implement and document its product due diligence process. Further, the firm will amend its written supervisory procedures to include written policies and procedures for the selection, negotiation and approval of preferred vendor marketing agreements, including:
- a. Summary of product characteristic
 - b. Pricing
 - c. Reasons for selection
 - d. Summary of provisions of any marketing fees
 - e. Confirmation of prospectus disclosure provisions provided to product providers
 - f. Disclosures to be made to clients

VIOLATION 4

HFS Received Special Undisclosed Special Cash Compensation for NAV Transfers of Mutual Funds – Violations NASD Conduct Rules 2830(I), 3010 and 2110

NASD SUPPORTING EVIDENCE

- Account transfer documentation
- Hantz financial and accounting records

ANALYSIS

HFS records indicate a single instance where account balances were transferred between two mutual funds at NAV. In conjunction with the transfer, the new product provider paid a portion of the costs to transfer the funds. The payment of the Special Cash compensation was not disclosed to affected HFS clients.

CORRECTIVE ACTION

1. Hantz management has agreed that in the future any special payments for NAV transfers will be fully disclosed to clients.

ADDITIONAL RECOMMENDATIONS

None.

VIOLATION 5

HFS Business Practices in the Mortgage Area Generated Undisclosed Conflicts of Interests – Violations of Conduct Rule 2110.

NASD SUPPORTING EVIDENCE

1. Tranex Loan Documentation
2. HFS Written Supervisory Procedures
3. Affiliated Business Arrangement Disclosure Statement

ANALYSIS

HFS has an affiliated subsidiary that is engaged in originating mortgages as a mortgage broker. Tranex processes loans exclusively for clients of HFS. When a client's financial plan dictates it, the financial advisor will refer that client to Tranex for the purposes of arranging a mortgage or refinancing an existing mortgage. The FA may assist the client in completing loan documentation, in particular with respect to the clients assets, liabilities, income and net worth. Additionally, the FAs may assist clients with a determination of the most appropriate loan terms for a mortgage.

The AWC faulted HFS for failing to disclose the extent of the relationship between HFS, its FAs and Tranex. It also cited HFS for failing to disclose compensation received by FAs for those clients utilizing Tranex. Since 2003, Tranex and HFS have provided clients with disclosure documents both as part of the financial plan provided by HFS FAs and in loan closing documents from Tranex that disclose the existence of an affiliated business relationship and the payment of compensation to FAs. Since the entry of the AWC, HFS has applied with the State of Michigan to act as a mortgage broker. As a mortgage broker, HFS may be paid compensation for originating mortgage loans. Both HFS and Tranex will continue to furnish clients with disclosure documents.

CORRECTIVE ACTION

1. In 2003, Tranex and HFS implemented procedures to furnish a related party disclosure document as part of a client's financial plan and in loan closing documents.
2. In the letter dated October 20, 2005 sent to all HFS clients, HFS disclosed its relationship and payments made by Tranex.

ADDITIONAL RECOMMENDATIONS

1. HFS should, as part of an annual disclosure document, furnish ongoing disclosure of the relationship with Tranex and the payment of compensation to HFS FAs.

VIOLATION 6

HFS Sold Limited Partnerships to Clients for Whom They Were Unsuitable – Violations of NASD Conduct Rules 2310, 3010 and 2110.

NASD SUPPORTING EVIDENCE

1. Direct Participation Sales Documents
2. Client Statements
3. Written Supervisory Procedures

ANALYSIS

HFS solicited investments in limited partnerships and other direct investments. These investments generally require the client to meet income, net worth and other suitability criteria. In determining the suitability of recommending these investments in limited partnerships, the FAs relied on information provided on client questionnaires. In certain cases, the FAs obtained incomplete or inaccurate information from the clients. As a consequence, HFS sold investments to clients that were based on incomplete or inaccurate information resulting in recommendations that, on the basis of the information relied upon by the FA, were unsuitable.

CORRECTIVE ACTION

1. HFS has revised its procedures for collecting and maintaining client suitability information.
2. The Firm's Compliance Department reviews all subscription agreements for limited partnerships to insure that clients meet suitability standards.

ADDITIONAL RECOMMENDATION

None.

HFS Failed to Obtain the Required Approval of an advertisement – Violation of NASD Conduct Rules 2210 and 2110.

NASD SUPPORTING EVIDENCE

1. Hantz advertising and sales literature files

ANALYSIS

The investigation revealed a single instance where HFS failed to obtain NASD approval of an advertisement. We were advised by HFS that the advertisement is no longer in use. HFS prepares a very limited number (less than 20 last year) of advertisements for use by its FAs. Our review of the current advertising files revealed that all of the current advertisements had been, where required, properly approved by the NASD Advertising Department.

CORRECTIVE ACTION

1. Submit advertising to NASD Advertsing Dept. for review.

ADDITIONAL RECOMMENDATIONS

None.