

BEFORE THE SECURITIES COMMISSIONER  
OF THE STATE OF DELAWARE

IN THE MATTER OF:

VANDERBILT SECURITIES, INC.,  
and HEYWOOD G. BRODY,

Respondents.

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Case No. 89-10-11

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W. Michael Tupman, Esquire, Deputy Attorney General,  
Department of Justice, Wilmington, Delaware,  
attorney for the State of Delaware.

Heywood G. Brody, respondent, pro se.

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OPINION AND ORDER

Date: September 18, 1991  
Wilmington, Delaware

Charges were issued by the Delaware Securities Division on January 29, 1990, against respondents Vanderbilt Securities, Inc. ("Vanderbilt"), and Heywood G. Brody ("Brody"), a former agent of Vanderbilt. The firm, a registered broker-dealer in Delaware, and Mr. Brody were charged with willful violations of the Delaware Securities Act (6 Del. C. ch. 73) in connection with the sale of common stock and warrants in a company called "Fun Foods, Inc." to \_\_\_\_\_, a Delaware resident. The following violations were alleged: (1) willful misrepresentations and omissions of material fact in violation of 6 Del. C. section 7303(2) and section 7316(a)(2); (2) dishonest and unethical conduct in violation of section 7316(a)(7); (3) sale of an unregistered, non-exempt security in violation of section 7304 and section 7316(a)(2); (4) sale of a security by an unregistered agent in violation of section 7313 and section 7316(a)(2); and (5) with respect to Vanderbilt only, failing to supervise reasonably its agent, Mr. Brody, in connection with the offer and sale of a security, in violation of 6 Del. C. section 7316(a)(10). Subsequently, at the hearing, the charge of dishonest and unethical conduct was withdrawn by the prosecutor for the State.

Although Vanderbilt initially requested, through its attorney, Mr. James M. Carabina, a hearing on the charges, Mr. Carabina subsequently withdrew due to a lack of communication by Vanderbilt's principals. Nothing further was heard from Vanderbilt by the Securities Division. The other respondent, Mr.

Brody, requested a hearing and appeared at the hearing, on June 26, 1991, to contest the charges.

The State's case was presented through two witnesses: Denise Herron, a Securities Division investigator, and \_\_\_\_\_, the investor. Ms. Herron testified that the security (Fun Foods, Inc. common stock and warrants) and Mr. Brody were unregistered at the time of the sale, on or about September 17, 1987. Ms. Herron also identified and authenticated a copy of a registration statement for Fun Foods, Inc. ("Fun Foods"), that she had received from the U.S. Securities and Exchange Commission upon her request. The registration statement contained the prospectus for Fun Foods used at the time of the initial public offering. (State's Ex. S-10).

\_\_\_\_\_, the investor, then testified that he had purchased the security in September 1987 upon Mr. Brody's recommendation. \_\_\_\_\_ testified that Brody's telephone call into Delaware, offering to sell the security, was unsolicited.

\_\_\_\_\_ testified that Brody described the Fun Foods securities as a "unique opportunity," and Brody said that Vanderbilt was offering the units at a "special price." (Each unit consisted of one share of common stock and two warrants). Brody said that Fun Foods was selling for five cents per share but that he (Brody) had shares available at three cents per share. Brody described the security in apparently positive terms, emphasizing a patented piece of machinery owned by Fun Foods that blended candies with ice cream. He also said that Fun Foods ice cream stores were

expanding into shopping malls and that, with each new franchise sale, the franchise operators were required to buy a certain number of shares of the security.                      recalled no discussion of risk by Brody, and                      never received a prospectus. He purchased 85,000 units of Fun Foods for \$2555 and subsequently learned that his investment was worthless. (State's Ex. S-9).

Mr. Brody denied that he had done anything wrong. He denied that he told                      that the security was selling for five cents per share. He said that if the market had been five cents per share, then he would have sold the shares at that price because he was not a market maker<sup>1</sup> and it was not within his power as a broker to run tickets at a price other than the market. Mr. Brody said that he adequately conveyed the risk of the purchase to                      by telling him the security was speculative. However, Brody testified, the stock was "not IBM" but merely a "three cent penny stock." Mr. Brody said that he himself had lost money in the market, and there were "no guarantees." Brody thought he had not misled                      as to the prospects of the company, and                      had not requested a

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<sup>1</sup>A "market maker" is a broker-dealer that holds itself out as willing to buy or sell a particular security at its quoted bid and ask prices. For a customer, the significance of a broker-dealer that is a market maker in a security recommended to the customer is that the broker-dealer is the principal on the opposite side of the transaction, selling the security to its customer out of its inventory, as opposed to acting in an agency capacity and being in the middle between two customers. Where it acts as agent, the broker-dealer charges a commission on the sale. Where it acts as principal, the broker-dealer profits by an undisclosed mark-up over its own cost.

prospectus. Brody testified that he told that Vanderbilt made a market in Fun Foods, contradicting earlier testimony that he had not been so informed.

As to the registration violations, Brody testified that these were the responsibility of Vanderbilt's management. He had relied upon Vanderbilt's president, Bonnie Kantrowitz, and its compliance officer, Richie Bonnecour, to ascertain whether he (Brody) was registered in Delaware. These two company officials initialed the Fun Foods sale ticket after Brody turned it in, an action which they should not have taken since neither Brody nor the security was registered in Delaware.

Brody went on to say that his concerns about Vanderbilt caused him to leave that employment. Specifically, he said he heard Ms. Kantrowitz say that "long is wrong," and he learned that her husband was a trader for a competing firm, Nash Weiss, that also made a market in Fun Foods. (The statement "long is wrong" implies that the speaker is selling securities short, an activity that is ethically incompatible with a retail brokerage firm's recommendation to clients that they purchase such securities).

In response to my questions, Mr. Brody testified that he had taken and passed the Series 63 examination that addresses the area of State securities regulation. A fundamental rule of State securities regulation is that broker-dealer agents must be registered in a State before they may offer or sell securities there. Mr. Brody also acknowledged that an agent must sign the

Form U-4 that accompanies any registration application to a State, including amendments to the Form U-4 that are used to change an agent's registration status in any State. When asked whether he kept a record of the Form U-4 and its amendments, Mr. Brody said, "Apparently not as closely as I should have at Vanderbilt."

Also in response to my questions, Mr. Brody testified that he did recommend that                      invest in Fun Foods. Asked what risks he disclosed to                      , Mr. Brody said that he told                      it was a start-up venture and a speculative security. Apparently, that was the extent of Brody's discussion of risk. However, Brody admitted in his testimony that there was a "tremendous float" in Fun Foods stock, and the financial statements of the company "had problems." Asked how a company with hundreds of millions of shares outstanding and only \$275,000 in gross revenues (at the time of the offering) was going to dramatically increase its revenues so as to justify the price being paid by public investors, Mr. Brody said that he had seen stocks with no sales and no revenues trading on NASDAQ (National Association of Securities Dealers Automatic Quotations system) at \$26 per share. He added that his employer following Vanderbilt, Whale Securities Company, L.P., had underwritten such an offering.

My review of the Fun Foods registration statement satisfies me that this security was an investment with dismal prospects at best that could not have been recommended in good faith by a

competent, experienced securities broker without an extensive list of caveats. The most significant fact about this offering was that it would result in 355 million to 375 million shares outstanding with the public owning only about 15-20% of the shares.<sup>2</sup> The offering itself was for 55 to 75 million shares, with two warrants per unit creating an additional overhang of 150 million shares. Prior to the offering, there were 300 million shares of stock already in the hands of the promoters and company principals. As Mr. Brody stated, this was a tremendous float.

As a matter of simple arithmetic, if one assumes constant book value and earnings, the more shares that are issued by a company the value of each share is correspondingly reduced. Thus, a company with an asset value of one hundred million dollars would be worth, on a book value basis, \$100 per share if one million shares were outstanding but only \$1 per share if one hundred million shares were outstanding. In the case of Fun Foods, the company had a negative net book value prior to the offering.

Since Fun Foods had no operating history of its own, an investor would have to examine the operating history of its

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<sup>2</sup>The promoters of Fun Foods would retain majority ownership despite having paid relatively little for their shares. Allen Barry Witz, the principal shareholder and a onetime Securities and Exchange Commission attorney, paid \$22.50 for \$2,250,000 shares of common stock. In another transaction, four individuals paid \$210 for 21,000,000 shares of common stock. Three of the four individuals subsequently transferred and assigned their shares to Allen Barry Witz. On another occasion, Fun Foods issued 181,000,000 shares of common stock to Witz "for a total consideration of \$14,480." (State's Ex. S-10 at 31). The prospectus was silent as to whether the consideration was paid in cash or in services, as Witz was for a while counsel to the company.



predecessor corporation, Wizards Ice Cream & Confectionery Shoppe, Ltd. ("Wizards"). Prior to the public offering, Fun Foods entered into an agreement to purchase the assets and certain liabilities of Wizards in exchange for 93,750,000 shares of Fun Foods common stock. Among the liabilities Fun Foods would acquire from Wizards was a long term debt in the amount of \$535,262 on a loan guaranteed by the Small Business Administration. The agreement became effective upon the consummation of the closing of the minimum offering.

Wizards itself incurred substantial losses from its inception and was insolvent by June 30, 1986, its liabilities exceeding its assets by \$138,399. In its fiscal year prior to the offering, FY 1986, Wizards suffered a net loss of \$663,368 on total revenues of \$362,151. The offering proceeds, after the underwriter's compensation and other costs, were to be between \$338,000 and \$511,000, depending on the success of the offering. Fifty thousand dollars of the proceeds were to go to an installment payment on the \$535,262 SBA-guaranteed loan.

The management of Fun Foods at the time of the offering was headed by Jerry D. Isaacson, 26 years old, also the chief executive officer and chairman of the board of Wizards. Mr. Isaacson had about two years of experience managing Wizards. He was an accountant by training. Of the various directors and principals, only Mr. Isaacson intended to devote full time to the company. Most of the others would devote less than 10 percent of their time. In fact, at the time of the offering the company had



only 10 full-time employees, only four of whom worked at the store level.

In view of the extraordinary number of shares outstanding, the tiny size of the company, the unsuccessful financial history of the operation, and the apparent lack of a full-time management team with substantial experience in the ice cream parlor business, it is difficult to believe that any sober person who had read the prospectus and had a grasp of the facts would regard this investment as something worth considering. The company's patented blending machines could mix 600,000 possible combinations of flavors, according to the prospectus, but that fact did not portend financial success. In fact, one would expect that anyone with an industrial blender could mix an infinite number of flavors by continuing to throw different foods into the mix. The important question was whether enough people would be willing to pay for the ice cream mixture to make Fun Foods financially successful. To judge from Wizards' prior history, they were not.

Mr. Brody argued at the hearing that a company's stock price could rise regardless of the company's economic fundamentals. It is certainly true that with thinly traded penny stocks the effect of a dominant market maker's sales effort can be to run the price of a stock up. However, since the market maker can ask and offer whatever price it chooses, the rise in a company's stock price may be artificial and temporary. Often with penny stocks, when the dominant market maker decides to make a market no longer in a

particular security, the value of the security drops to zero because there are no buyers. Penny stocks are an inherently illiquid investment, and especially when the stock is that of an economically worthless or nearly worthless company such as Fun Foods, prospective investors must be told there is a substantial likelihood that they may never be able to sell the security and their investment may prove to be worthless.<sup>3</sup> Telling a prospective investor that the stock is "speculative" is not enough (even if Brody said that to , which I doubt).

Even if the penny stock market is such that prices of some securities have little relation to the economic fundamentals of the underlying companies (a point I would not dispute), that fact does not make the economic fundamentals any less material to the recommended purchase. Rather, it suggests that prices in this market are often inflated and will tend to collapse when the market makers withdraw their support.

I find that Vanderbilt and Brody violated 6 Del. C. sections 7303 and 7316(a)(2) by willfully making misrepresentations of material fact in the sale of Fun Foods to . Brody told that units of Fun Foods were available at a special low price of three cents per share rather than five cents per share, when in fact there was no special low price. I also find that Vanderbilt and Brody violated 6 Del. C. sections 7303 and

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<sup>3</sup> However, where the broker does not recommend the security but merely acts as an order-taker, this duty may not exist.

7316(a)(2) by willfully omitting to disclose material facts that were necessary under the circumstances to avoid misleading the investor, , in the context of the sale of Fun Foods securities. Vanderbilt and Brody failed to disclose the conflict of interest that exists when a market maker recommends to a customer a security in which it makes a market. Vanderbilt and Brody failed to disclose the dismal economic prospects of Fun Foods, including the prior losses and insolvency of Wizards, the predecessor company.

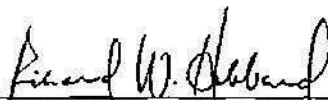
I also find that Vanderbilt and Brody violated 6 Del. C. sections 7313 and 7316(a)(2) by willfully selling securities in Delaware when the agent was not licensed to do so. Moreover, I find that Vanderbilt and Brody violated 6 Del. C. sections 7304 and 7316(a)(2) by selling an unregistered, non-exempt security in Delaware to .

Additionally, Vanderbilt violated 6 Del. C. section 7316(a)(10) by failing to supervise reasonably Mr. Brody, its agent. Indeed, rather than function as a restraint on Mr. Brody's improper actions, Vanderbilt's management seems to have encouraged him to sell Fun Foods regardless of method. Vanderbilt's management chose to make a market in Fun Foods, a company with poor prospects whose stock was a poor investment, and then had its agents recommend the security to their customers. Thus, Vanderbilt is directly liable on each of Brody's violations as well as being liable for its failure to supervise reasonably.

The violations here are numerous and egregious, and I find it is in the public interest that the registrations of Vanderbilt and Brody be permanently revoked. (Brody's subsequent registration as an agent of Whale Securities Company, L.P., is hereby revoked, though his prior registration with Vanderbilt is time-barred from revocation). Vanderbilt is hereby fined in the amount of \$5,000, and Brody is hereby fined in the amount of \$4,000.

These sanctions shall become effective on November 18, 1991, in the absence of a court-ordered stay. Respondents have 60 days from the date of this opinion and order to appeal this decision to the Delaware Court of Chancery.

SO ORDERED.

  
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Richard W. Hubbard  
Securities Commissioner

Date: September 18, 1991