

**BEFORE THE
NATIONAL ASSOCIATION OF SECURITIES DEALERS**

In the Matter of the Arbitration Between:

AA Lighting and Electrical, Inc.

Claimant,

v.

The Trading Desk, Inc. and Joseph R. Earle

Respondents

No. 96-00224

ARBITRATION AWARD

The Parties

The Claimant in this matter is AA Lighting and Electrical, Inc. (hereinafter referred to as "Claimant"), a corporation with its principal place of business located in San Jose, California. All of the shares of stock of Claimant are owned by Jay R. Schriefer (hereinafter referred to as "Schriefer").

The Trading Desk, Inc., one of the Respondents in this matter is or was a corporation, and is or was engaged in the business of operating a securities brokerage firm.

Respondent, Joseph R. Earle, is an individual with offices located in San Jose, California, and was a registered representative of Respondent, The Trading Desk, Inc.

Claimant was represented by Investor's Recovery Service, Inc., through Richard Sacks; Respondent, Joseph R. Earle, was represented by John A. Bender, Jr., Esquire; and Respondent, The Trading Desk, Inc., appeared through its principal, Jerry Manning. Hearings were held on October 16-17, 1996 (two sessions each day), and November 11, 1996 (two sessions), before Arbitrators Charles E. Farnsworth, Daniel A. Panitz, and Thomas J. Schuchert. The Hearings were held in San Francisco, and on November 14, 1996, the Panel met in Executive Session and made the following determinations and awards.

The Pleadings

The Claim

Claimant brought this matter before NASD Arbitration, alleging that Respondents violated a variety of Common Law and Statutory duties which they owed to the Claimant. Included among the allegations were State and Federal securities claims and Common Law claims for negligence, breach of contract, and breach of fiduciary duty.

Responsive Pleadings and Allegations

The Defenses of Respondent Earle

Respondent, Joseph R. Earle, asserted that the losses suffered by Claimant were due to the misconduct of the issuer, which misconduct (involving the operation of

the "Ponzi" scheme) was neither known to nor could been known by Respondent Earle, and, consequently, Respondent Earle could not be held responsible on Claimant's theory of negligent misrepresentation or breach of fiduciary duty. The second defense presented was that no negligent misrepresentations were made or any breaches of fiduciary duty committed by Respondent Earle inasmuch as he had engaged in extensive due diligence on a personal level, to an extent far in excess of that required by any registered representative of a broker-dealer. Respondent Earle also defended on the basis that the Claimant, through its owner, Schreifer, was a sophisticated as well as an accredited investor.

The Defenses of Respondent, The Trading Desk, Inc.,

The defenses of Respondent, The Trading Desk, Inc., were identical to those raised on behalf of Mr. Earle. In both instances, the assertions of fact alleged by the Claimant were denied.

Motions of the Parties

Respondent, The Trading Desk, Inc., filed a Motion to Dismiss this case because of the pendency of a related class action suit, which proceeding apparently is seeking the disgorgement of commissions earned by Respondent, The Trading Desk, Inc.; that Motion was withdrawn. A Motion to Dismiss was also filed on behalf of Respondent, Joseph R. Earle, essentially alleging that the statute of limitations had passed with respect to the causes of action asserted in the Statement of Claim. The Panel granted the Motion to Dismiss with respect to various theories of recovery;

however, it denied the Motion to Dismiss with respect to the claims of breach of fiduciary duty and negligent misrepresentation.

Under California law, claims for breach of fiduciary duty must be brought within four years after discovery of the breach. CCP Section 343; Eisenbaum v. Western Energy Resources, Inc., 218 Cal. App.3d 314 (1990). The test is that the statute begins to run when a reasonably prudent plaintiff would be placed on notice of the breach of fiduciary duty. The Panel found that the Claim was filed well within the applicable four-year period. The Claim was filed in January of 1996, and Claimant first learned of the possible breach of fiduciary duty in February of 1993, when he learned that his investments had become essentially valueless. Moreover, the claim of negligent misrepresentation (CCP Section 338(d)) begins to run three years from the time a reasonably prudent plaintiff would have known of the negligent misrepresentations. The Panel concluded that with respect to both breach of fiduciary duty and negligent misrepresentation, the Claimant was not placed on notice until less than three years prior to the filing of its Claim.

Investors Recovery Service, Inc., through Mr. Sacks, requested that Mr. Schriefer's personal, unasserted and unfiled claim be included for determination by the Panel on the theory that administration of the claim of Mr. Schriefer by the Panel would essentially deal with the same facts and circumstances as the Claimant, AA Lighting and Electrical, Inc. (Mr. Schriefer had personally purchased securities in the amount of \$25,000.00, which corresponded to the amount of securities of the issuer purchased by

the Claimant). Upon due process considerations, the Motion to Amend Claimant's action to include Mr. Schreifer's claim was denied.

Operative Facts

Claimant is a corporation engaged in the business of electrical contracting in San Jose, California. Claimant, through its sole shareholder, Schreifer, had a relationship with Respondent Earle for several years, and in 1991, discussed with Mr. Earle the possibility of investing some of the Corporation's funds. Respondent Earle suggested and recommended investment in certain purportedly secured notes of Towers Financial Corporation or its affiliates. The notes each had a face value of \$100,000.00, and Claimant purchased a one-quarter interest in such a note in 1991. The note carried an interest rate of 14% for one year, and paid a commission of 4% to broker-dealer. At the conclusion of one year, the interest on Claimant's note had been fully paid, and, after consultation with Mr. Earle, Claimant "rolled over" the \$25,000.00 investment, and Mr. Schreifer invested \$25,000.00 of his own personal funds in a new issue of a similar, but not identical, investment. Within a few months after the investment, the issuer declared bankruptcy, and it was discovered that the principals of the issuer had been engaged in the long-term operation of a "Ponzi" scheme of significant proportion. All of Claimant's investment in the Towers' note was lost.

Discussions and Conclusions of the Panel

The Panel has considered all of the assertions of the Claimant and the defenses of the Respondents, and has concluded that Respondent, Joseph R. Earle, is not responsible for the losses sustained by Claimant; however, the Panel has determined that Respondent, The Trading Desk, Inc., failed to meet its fiduciary obligations to Claimant, and the Panel makes this Award against Respondent, The Trading Desk, Inc., and in favor of Claimant. This discussion deals with several issues the Panel deems to be significant.

The Issue of Due Diligence

As a broker-dealer, Respondent, The Trading Desk, Inc., had an obligation to conduct reasonable due diligence of Towers and its notes before offering the notes for sale to its customers. This duty is particularly critical where, as here, no underwriter existed to perform preliminary due diligence which the broker-dealer could partially rely upon. Instead, Respondent, The Trading Desk, Inc., dealt directly with Towers, the issuer of the notes.

It appears from the evidence that all of the risk factors and other disclosures of material matters in the 1992 Offering Memorandum were not investigated by Respondent, The Trading Desk, Inc., nor did The Trading Desk, Inc. adequately consult independent sources for information on Towers, as due diligence requires. See Weinberger v. Jackson, Fed. Sec. L. Rep. (CCH), para 95,693 (N.D.Cal. October 11, 1990). At a minimum, Respondent, The Trading Desk, Inc., should have made such independent inquiries and investigated such disclosures; its failure to do so constitutes a breach of fiduciary duty to its customers.

Respondent, The Trading Desk, Inc., did virtually nothing to investigate the "Litigation" disclosures in the Offering Memorandum, not even the significant case brought (and "confidentially" settled) by the State of Illinois in 1992. According to Manning, Respondent, The Trading Desk, Inc.,'s compliance officer (Purcell) did nothing more than "review the prospectus" in carrying out his due diligence functions.

An account executive has a lesser obligation of due diligence and may rely upon the due diligence done by his broker-dealer. Respondent Earle, although not required to do so on behalf of his customers, performed certain due diligence inquiries, which accrue to the benefit of his employer, as well. Respondent Earle visited Towers' offices and reviewed certain outside rating documents (not including the Duff & Phelps letters however, which were not offered into evidence). While commendable, these efforts did not satisfy Respondent, The Trading Desk, Inc.'s, broker-dealer duty to make a reasonably thorough review of Towers from independent sources and to inquire deeper into the Litigation disclosures.

Both Respondents assert that Claimant was a sophisticated and accredited investor. These are two distinct attributes. The Panel, after considering all of the testimony and documents, finds that AA Lighting and Electrical, Inc., through Mr. Schreifer, was not a sophisticated investor. Mr. Schreifer apparently had only one broker who represented him in money market and mutual fund investments, and in virtually no securities other than the subject notes. Claimant had never engaged in the trading of stock, had no experience in the stock market, had never dealt in options or other products traditionally offered by retail broker-dealers. Mr. Schreifer was quite an

unsophisticated investor, who relied upon Respondent Earle and Respondent, The Trading Desk, Inc., in making his investment decisions with respect to the 1992 Towers' note.¹

The issue of whether or not Claimant was an accredited investor is more troublesome. As part of the subscription documents, the purchaser is required to provide the issuer with a financial statement in order to establish that he meets the legal criteria for accredited investors. The definition of an accredited investor set forth in the Offering documents is essentially identical to the statutory requirements, and the Offering documents themselves make it clear that if one is not qualified as an accredited investor, then the investment and the notes would be unsuitable. It is extremely bad practice for an account executive to fill out the financial statement on behalf of the customer as was done in this case. Moreover, the irregularities in the information on the balance sheet prepared by Respondent Earle give rise to substantial questions about Respondent Earle's credibility in this regard. Moreover, while the Panel concludes that Claimant may have met the requirements as an accredited investor, it would be inappropriate to decide the case on this issue, given the uncertainty of the financial information. The Panel determined that Claimant failed to establish that AA Lighting and Electrical, Inc. was not an accredited investor; further, sufficient facts were elicited, both testimonial and documentary, to enable the Panel to conclude that AA

¹ Respondents assert that since Towers directly communicated with Schreifer concerning the roll-over of Claimant's note and his own personal investment, that such transactions were "unsolicited." Respondents admitted that they received commissions from the issuer for these transactions, and, further, admitted that Respondent Earle discussed the transactions with Schreifer before he made the investment decision. Schreifer sought Respondent Earle's advice, and Respondent Earle advised Schreifer that he knew of no reason why Schreifer should not roll-over the Claimant's note or make a new investment. Under these circumstances, these transactions can hardly be deemed to be unsolicited and the Panel has so found.

Lighting and Electrical, Inc. may have met the requirements for qualification as an accredited investor.

Failure to disclose material facts to Claimant and/or the making of misrepresentations of material facts, both of which may have led to the investment decision by Claimant, were insufficiently established to permit the Panel to decide this issue against Respondent Earle.

The Award

The Panel awards Claimant, AA Lighting and Electrical, Inc., the sum of \$25,000.00 as actual damages, plus simple interest at the rate of 7% per annum from February 1, 1993, against Respondent, The Trading Desk, Inc., for the foregoing breach of fiduciary duty. Claimant's request for punitive damages is denied; there is no clear and convincing evidence of any intentional breach of fiduciary duty, amounting to despicable conduct, that would justify such an award for breach of fiduciary duty. See Civil Code Section 3294; Sequoyia Vacuum Systems v. Stransky, 229 C.A.2d 281 (1964). Forum fees are assessed against Respondent, The Trading Desk, Inc., in accordance with the parties' stipulation, this Award may be signed in counterpart by the Arbitrators.

Dated: 12/2/96

Dated: _____

Dated: _____



Charles E. Farnsworth, Chairman

Thomas J. Schuchert

Daniel A. Panitz

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Dated: _____

Charles E. Farnsworth, Chairman

Dated: _____

Thomas J. Schuchert

Dated: 11/23/96



Daniel A. Panitz