NASD OFFICE OF HEARING OFFICERS

DEPARTMENT OF ENFORCEMENT, Complainant v. DOUGLAS A. RAUH (CRD No. 1465225), Respondent.	Disciplinary Proceeding No. C02040044 Hearing Officer – RSH **Hearing Panel Decision** November 9, 2005

Respondent was fined $118,495 and barred from associating with any member firm in any capacity for willfully failing to disclose material information on a Form U-4, in violation of Conduct Rule 2110 and IM-1000; exercising discretion without prior written authority in two clients' accounts, in violation of Conduct Rules 2860(b)(18), 2510(b) and 2110; and making unsuitable recommendations in violation of Conduct Rules 2310, 2860(b)(19) and 2110.

Appearances

Joel T. Kornfeld and Sylvia M. Scott, Los Angeles, CA (Rory C. Flynn, NASD Chief Litigation Counsel, Washington, DC, Of Counsel) for the Department of Enforcement

Edward S. Gelfand, Esq., Los Angeles, CA, for Douglas A. Rauh

DECISION

I. Procedural Background

The Department of Enforcement ("Enforcement") filed a Complaint against Douglas A. Rauh ("Rauh" or the "Respondent") on November 18, 2004. The six-cause Complaint charged that Rauh: (i) willfully failed to disclose on his Uniform Application for Securities Registration or Transfer ("Form U-4") that he was the subject of a civil lawsuit that alleged that he had been involved in misappropriation and conversion of funds or securities (first and second causes); (ii) exercised discretion without written

authorization in JC and CS's Linsco Private Ledger Corp. ("Linsco") accounts (third and fourth causes); (iii) from May 1999 through December 2000, made unsuitable recommendations in JC's Linsco account (fifth cause); and (iv) from March 2000 through October 2000, made unsuitable options recommendations in JC's Linsco account (sixth cause). The Complaint alleged that this misconduct violated NASD Conduct Rules 2110, 2860 and 2510, and Membership and Registration Rules Interpretive Material ("IM") 1000-1.

Rauh filed an Answer on December 13, 2004 in which he denied the charges and requested a hearing.

The hearing was held on June 14 and 15, 2005 at NASD's offices in Los Angeles before a Hearing Panel composed of the Hearing Officer and two current members of NASD's District 2 Committee. Enforcement called the Respondent and four witnesses: customer JC; Michele Comarsh-Hein, assistant vice president of internal compliance at Linsco; MM, a financial advisor; and Mary Whelan, the NASD investigator on this case.[1] Enforcement also introduced 107 exhibits in evidence.[2] The Respondent introduced 42 exhibits into evidence.[3]

The parties were ordered to file post-hearing submissions by August 15, 2005. Enforcement filed timely post-hearing submissions. Respondent's counsel withdrew from his representation of Respondent on July 22, 2005. Respondent did not obtain new counsel or file post-hearing submissions.

[1] The hearing transcript is referred to as "Tr."
[2] Exhibits CX1 through CX106 and Report of Fact Witness Mary Whelan, by stipulation of the parties.
[3] Exhibits RX1 through RX42, by stipulation of the parties.

II. Findings of Fact

A. The Respondent

Rauh has been employed in the securities industry since 1985 and obtained his Series 7 license (General Securities Representative) in 1986 while employed at Prudential Securities, Inc. for six months.[4] He has been associated with Brookstreet Securities Corp. since February 2002.[5] Rauh left Prudential Securities in 1986 and between then and 1998, he was employed by numerous banks and was registered with their affiliated broker-dealers in the Los Angeles and San Diego areas.[6] He was physically located in the banks and sold, primarily, mutual funds and variable and fixed annuities to customers of the banks that employed him.[7] He sold equities rarely; they were not a regular part of his business.[8] Since 1985, Rauh has been employed by the following banks and brokerage firms: Prudential Securities, Inc. (1985 through 1986); Pamco Securities and Insurance Services and GAF Financial and Insurance (1986 through 1990); Fidelity Federal Bank and Protective Equity Services, Inc. (1990 through 1993); Cen Fed Bank and American General Securities, Inc./Marketing One Securities, Inc. (1993 through 1998); Linsco (1998 through 2001); Royal Alliance Associates ("Royal Alliance") (2001 through 2002); and Brookstreet Securities Corp (2002 through the present).[9]

Rauh became associated with Linsco in May 1998[10] and, having obtained a Series 24 (General Securities Principal) license in 1993,[11] operated an Office of Supervisory Jurisdiction ("OSJ"). Operating an OSJ for Linsco allowed Rauh to maintain his own

[4] CX 92 at 10.
[5] CX 92 at 7; CX 93 at 19-20.
[6] CX 92 at 8.
[7] Tr. at 360-364.
[8] Tr. at 361,362.
[9] CX 92 at 8.; Tr. at 360-364.
[10] CX 92 at 8.
[11] Id.

branch office and be, in effect, his own branch manager. For example, he approved the opening of his own client accounts.[12] Rauh admitted that although he had obtained a Series 24 license in 1993, before joining Linsco he had served as a principal for only about four months.[13] Rauh was discharged from Linsco in January 2001 for "failing to obtain written authorization from a client and the firm prior to exercising discretion in a client account."[14]

B. Form U-4 Disclosures

1. EH Lawsuit

On April 28, 1995, EH, an 81 year-old widow whom Rauh met when she was a customer of the bank that then employed Rauh, filed a lawsuit in Orange County Superior Court that alleged multiple claims against Rauh, including (i) breach of fiduciary duty, (ii) conversion and (iii) fraud. EH alleged that Rauh befriended her after her husband's death. He then convinced her to sell her conservative investments to purchase other products, including variable annuities and life insurance that named Rauh as beneficiary. The lawsuit also alleged that Rauh borrowed and stole hundreds of thousands of dollars from EH. The lawsuit sought compensatory damages of over $1.3 million as well as unspecified punitive damages.[15]

Rauh retained an attorney, Bill Hart, to represent him in the lawsuit.[16] In Rauh's investigative testimony in July 2004, he testified that in 1995, he read the complaint and understood its allegations.[17] At the hearing, Rauh testified that he read and understood

[12]Tr. at 366-367.
[13] Tr. at 365-366.
[14] CX 92 at 5.
[15] CX 4 at 49-51.
[16] CX 93 at 45; Tr. at 396-397.
[17] CX 93 at 51.

the part of the complaint alleging that he had been involved in trading between two Franklin funds for no apparent reason, and understood that the allegations concerned EH's investments.[18] Rauh admitted, both at the hearing and during his NASD investigative testimony, that he understood in 1995 that EH sought over $1.3 million in compensatory damages as well as punitive damages for the alleged fraud.[19]

2. Rauh's Bankruptcy

Rauh filed for Chapter 13 bankruptcy on March 4, 1996.[20] He testified that one of the reasons he filed for bankruptcy was to discharge the EH lawsuit.[21] Schedule F of Rauh's bankruptcy petition identified EH's claims as two unsecured promissory notes valued at $100,000 and a "[d]isputed and unliquidated claim for damages for breach of fiduciary duty, constructive and resulting trusts, conversion, fraud, negligent misrepresentation and fiduciary abuse."[22] Under Rauh's bankruptcy plan, he made monthly payments to his creditors over a 36-month period, including payments totaling $21,082 to EH, as payment on the promissory notes.[23] EH dismissed her lawsuit on June 21, 1999,[24] and Rauh received a Chapter 13 Bankruptcy Discharge on March 10, 2000.[25]

3. Rauh's Failure to Update his Form U-4

When Rauh was served with the EH lawsuit in 1995, and when he filed for bankruptcy in 1996, he was employed by Marketing One Securities ("Marketing One").[26] In connection with his application for employment with Marketing One, Rauh had filled

[18] Tr. at 374-375.
[19] CX 93 at 56-57; Tr. at 373-374.
[20] CX 1; Tr. at 377.
[21] Tr. at 376.
[22] CX 1 at 14-15.
[23] CX 3 at 2; CX 93 at 41-43; Tr. at 383-384.
[24] CX 4B.
[25] CX 2.
[26] CX 92 at 6.

out and submitted a Form U-4 dated August 4, 1994, which, among other things, asked whether Rauh had certain investment-related lawsuits and bankruptcies.[27] By signing the Form U-4, Rauh agreed to comply with a written provision that he "update [the] form by causing an amendment to be filed on a timely basis whenever changes occur to answers previously reported."[28] Nevertheless, Rauh did not disclose the EH lawsuit or his bankruptcy to Marketing One and he did not amend his Form U-4 to disclose them.[29] Rauh testified that despite having a Series 24 license, he was unaware at that time of his obligation to update his Form U-4.[30] Rauh stated that his bankruptcy attorney advised him that he "likely" would have to report the bankruptcy the next time he changed firms.[31] Enforcement has not charged Rauh with failing to amend his Marketing One Form U-4.

4. Rauh's Form U-4 Application to Linsco

Rauh applied for employment at Linsco and submitted a Form U-4 on March 11, 1998.[32] In connection with his Linsco application, Rauh received a Linsco registration packet that included a memorandum whose subject was "Accurate Completion of Form U-4."[33] The memorandum warned:

> Linsco/Private Ledger has been advised by the NASD that an increasing number of applications for registration have been found to be inaccurate or incomplete…Examples of inaccurate filings include failure to disclose…major complaints or legal proceedings when responding to questions 22A through 22J and 22M on Form U-4…"[34]

[27] CX 5 at 3.
[28] CX 5 at 3.
[29] Tr. at 398-400.
[30] Tr. at 398-400.
[31] Tr. at 398-400.
[32] CX 12; Tr. at 390-391.
[33] CX 11; Tr. at 389-390.
[34] CX 11; Tr. at 389-390.

Rauh reviewed and signed the memorandum on March 10, 1998.[35] Nevertheless, Rauh answered "No" in response to question number 22-H(1), which asked, "Have you ever been named as a respondent or defendant in an investment-related, consumer-initiated…civil litigation which alleged that you were involved in one or more sales practice violations and which is still pending…?"[36] He did, however, disclose his bankruptcy in response to question 22L on the Form U-4. In providing a summary of the bankruptcy on the Form U-4, Rauh wrote, "Due to my divorce. My divorce attorney suggested the Chapter 13 plan." Rauh made no mention of the still-pending EH lawsuit on his Form U-4.[37]

Rauh testified that he interviewed with several people at Linsco, including Michelle Comarsh-Hein, then the firm's manager of compliance; however, he did not discuss the EH lawsuit during his interviews with anyone there.[38] Linsco was unaware of the EH lawsuit when it extended an offer of employment to Rauh.[39] Rauh was registered at Linsco as of May 1, 1998.[40]

Rauh gave a variety of conflicting explanations for why he did not disclose the lawsuit on his Forms U-4 or during his Linsco interviews. Rauh stated that he did not report the lawsuit because EH was no longer his client when she filed the lawsuit; he had referred her to Russell Smith, a friend of Rauh's who was a broker at another brokerage firm. Smith, who was also named in EH's lawsuit, directed approximately 90% of his commissions on EH's trades back to Rauh. Rauh claimed these were "referral fees."[41] At

[35] CX 11; Tr. at 389-390.
[36] CX 12 at 3; Tr. at 392. *See also,* CX 12A at 5.
[37] CX 12 at 3, 6.
[38] Tr. at 19, 384-385, 388.
[39] Tr. at 19-21.
[40] CX 92 at 5.
[41] Tr. at 421; CX 6; CX 93 at 59.

various times Rauh stated that two of his attorneys advised him that he was required to report only his bankruptcy, and not the EH lawsuit.[42] Rauh testified that he therefore provided bankruptcy documents to Linsco and relied on Linsco to determine whether he needed to additionally disclose the lawsuit.[43] Finally, Rauh testified that he believed that the EH lawsuit "vanished" immediately when he filed for bankruptcy in 1996.[44]

The Hearing Panel, having observed Rauh's demeanor and considered the other evidence offered, did not find his explanations to be credible or persuasive. Rauh's extensive experience in the industry belies his claim that he was unaware of his obligation to disclose the lawsuit. Rauh had changed firms four times before applying to Linsco and each time he had filed a Form U-4.[45] In addition, he held both a general and a principal's license.[46] Rauh's claim that he was not required to disclose the lawsuit because EH was not his client was not credible. The Form U-4 asked whether Rauh had ever been named as a defendant in an investment-related lawsuit which was still pending. Rauh knew that he had been named in such a lawsuit and whether or not EH was his client at the time of the lawsuit was irrelevant to the question of whether he had an obligation to disclose the lawsuit on his Form U-4. The Hearing Panel did not credit Rauh's claim that he believed the lawsuit disappeared upon the filing of his bankruptcy petition. Two of Rauh's explanations merit further discussion.

Rauh's claim that two attorneys had advised him that he did not need to disclose the EH lawsuit was unsupported by any evidence and was contradicted by Rauh during his testimony. Bill Hart, who represented Rauh in the EH lawsuit, and Richard Heston,

[42] Tr. at 396; CX 6.
[43] Tr. at 402-404; CX 7 at 4.
[44] Tr. at 393-394.
[45] Tr. at 404.
[46] CX 13 at 1.

who filed Rauh's bankruptcy petition, each submitted declarations stating that due to the passage of time, they no longer had any notes of their discussions with Rauh. They could not recall any advice they may have given him with respect to "his association with the NASD"[47] or his "NASD obligations to report lawsuits disclosed in his bankruptcy petition."[48] Rauh testified that he was unable to locate any document from either lawyer advising him that he did not need to report the EH lawsuit on his Form U-4.[49] Rauh further testified that he never showed either of his lawyers a Form U-4 and admitted that Hart probably "does not even know what a U-4 is".[50] Rauh also said that he doesn't know if Heston had ever seen a Form U-4.[51]

Rauh testified that he submitted to Linsco copies of bankruptcy documents that contained information about the allegations in the EH lawsuit. He said that he expected that Linsco would review the documents and determine whether the EH lawsuit should be disclosed on his Form U-4.[52] Even assuming that it was reasonable to rely on Linsco to make such a determination, no bankruptcy documents were found in Linsco's application files, and Comarsh-Hein testified that, to her knowledge, Rauh had never submitted any bankruptcy documents to Linsco.[53] During his testimony, Rauh was shown a copy of the bankruptcy documents he claimed to have submitted and conceded that they did not describe the allegations in the EH lawsuit.[54]

Rauh's various explanations depend on his own professed ignorance of his disclosure obligations, blaming others for not discovering the EH lawsuit, unreasonable

[47] RX 8.
[48] RX 7.
[49] Tr. at 400; CX 48 at 2.
[50] Tr. at 397-400.
[51] Tr. at 397-400.
[52] Tr. at 402-404.
[53] Tr. at 15-16.
[54] Tr. at 386-387.

reliance on counsel or hyper-technical distinctions that defy common sense. The Hearing Panel, having observed Rauh's demeanor, as well as the totality of the evidence, did not find Rauh credible on this issue.

5. Rauh's Form U-4 Application to Royal Alliance

On January 19, 2001, Linsco discharged Rauh for "failure to obtain written authorization from a client and the firm prior to exercising discretion in a client account."[55]

Less than one month later, Rauh applied to Royal Alliance and submitted a Form U-4 dated February 8, 2001. Once again, he answered "No" in response to question number 23I(1) which, while re-numbered, asked the same question concerning pending lawsuits as its predecessor, 22H(1).[56] By this time, however, EH had dismissed her lawsuit (June 21, 1999)[57] and Rauh had received a discharge of his bankruptcy (March 10, 2000)[58].

C. Customer JC's Account

1. JC

JC was an emergency room doctor and family physician for more than twenty years. His solo medical practice took up virtually all of his time; he worked 16-hour days, five days a week, and half days on the weekends, 365 days a year."[59] He sold his medical practice and retired from full-time practice in 1996.[60] His wife is a homemaker and they have three children, born in 1974, 1976 and 1981.[61] JC was a pre-med biology

[55] CX 92 at 5, 18.
[56] CX 13; Tr. at 407.
[57] CX 4B.
[58] CX 2.
[59] Tr. at 140-141 and 143.
[60] Tr. at 140-141 and 143.
[61] Tr. at 176-177 and 143.

major in college, never took any business or financial classes and does not read business or financial publications.[62] JC is financially conservative. He has an aversion to debt and avoids purchasing anything on credit. When he retired from his medical practice, his home, which he had purchased in 1978, was mortgage-free.[63]

Prior to meeting Rauh in 1992, the vast majority of JC's assets were invested in bank certificates of deposit ("CDs").[64] JC made approximately 5 other investments[65] based on recommendations from patients and colleagues whom he trusted. Rauh attempted to characterize these investments as "high-risk" and evidence of JC's financial sophistication.[66] The Hearing Panel, after listening to JC's testimony as well as that of MM, his friend and financial advisor[67], did not find JC to be a sophisticated, risk-tolerant investor. Instead, they found JC to be an extremely conservative investor who, perhaps naively, made investment decisions based on the recommendations of people he trusted and who he believed to be knowledgeable in their areas of expertise.[68]

2. JC and Rauh

JC's wife met Rauh in 1988 when she was renewing a CD at Great American Bank and was referred to Rauh for investment advice.[69] Rauh understood that Mrs. JC's investment experience was limited to bank CDs.[70] In 1992, Mrs. JC arranged a meeting between JC and Rauh, who was then employed at Fidelity Federal Bank.[71] At that time,

[62] Tr. at 146-147.
[63] Tr. at 144.
[64] Tr. at 144-145.
[65] Three start-up companies, including two that held patents on specialized medical devices; a silver mine and some commodities trades made by a broker at another firm.
[66] Tr. at 153-171; Respondent's Pre-Hearing Brief at 11.
[67] Tr. at 48, 130-132.
[68] Tr. at 153-171.
[69] Tr. at 140, 410-411.
[70] Tr. at 410-411.
[71] Tr. at 140 and 410-411.

JC's personal portfolio, i.e., money that was not in pension or retirement accounts, was worth approximately $1 million and was invested almost entirely in bank CDs.[72] In their initial meeting, Rauh recommended that JC purchase shares in a tax-free municipal bond fund. JC followed Rauh's recommendation and during the following several years, purchased, through Rauh, $718,000 of Franklin tax-free municipal bond fund shares from the proceeds of CDs that were in his personal portfolio.[73]

JC and Rauh formed a close personal and professional relationship. Rauh and his wife became JC's patients. Beginning in 1993 and continuing for the next seven years, Rauh met with JC for counseling sessions for two hours every Saturday morning. They discussed Rauh's family life and marital and business problems.[74] Beginning in 1998, JC and Rauh joined a bible study group that met every Tuesday evening from September through June. JC was the best man at Rauh's wedding in 1997 and in May 1998, JC, Rauh and their wives vacationed together.[75]

By 1998, Rauh's recommendations constituted 80-90% of JC's total portfolio. His personal, non-retirement accounts contained approximately $700,000 of a Franklin tax-free municipal bond fund and $700,000 in CDs. JC's pension account contained three or four annuities and a CD totaling between $1.1 and 1.2 million. The remainder of JC's assets consisted of two municipal bonds totaling $110,000 that he had purchased through another broker.[76] At this time, JC's annual income was approximately $100,000

[72] Tr. at 144-145.
[73] Tr. at 148.
[74] Tr. at 149-150, 413-414
[75] Tr. at 148-149, 151, 162 and 181-182.
[76] Tr. at 163-165.

and consisted of interest from the CDs, dividends from the Franklin fund and the municipal bonds and continuing payments from the sale of his medical practice.[77]

In 1998, Rauh moved to Linsco and suggested that JC move his Franklin tax-free fund to Linsco and exchange it for equity mutual funds. Rauh told JC that it was foolish to stay in the fund because the yield was declining. Rauh told JC that he could turn $600,000 into $1 million within five years.[78] Because JC was retired and concerned about taking a risk with the fund, from which he derived a substantial portion of his income, he declined to make the exchange.[79]

Later in 1998 or early in 1999, JC began working part-time by taking 24-hour shifts in the urgent care/emergency room of a hospital in order to pay for unexpectedly high college costs for his three children.[80] In May or June of 1999, JC decided to open an account with Rauh at Linsco. JC's Franklin mutual fund had continued to decline and Rauh had assured him that he could "way outperform" the fund and could "make money no matter what the market did because he watched it every minute".[81] JC opened two accounts at Linsco. One account, whose investment objective was marked "growth", contained approximately $680,000 from the Franklin tax-free fund and was to be invested in equity mutual funds of Rauh's choosing.[82] JC had orally agreed that Rauh could invest $100,000 of this money as he saw fit, with the objective of earning enough money to buy Mrs. JC a used car.[83] Rauh testified that he segregated $100,000 in a second account,

[77] Tr. at 155, 164 and 178.
[78] Tr. at 171-172.
[79] Tr. at 172.
[80] Tr. at 173.
[81] Tr. at 173-175.
[82] CX 99 at 1; Tr. at 174-175.
[83] Tr. at 174-175.

whose investment objective he designated, "aggressive growth".[84] Account records show that this "aggressive growth" account was initially funded with a check for $65,000 and that an additional $114,658 was transferred from the "growth" account.[85] JC testified that Rauh never discussed JC's investment objectives, other than that JC "expected to do well". Rauh never discussed the concepts of "aggressive growth" or "speculation" with JC. JC testified that, at that time, he did not even realize that Rauh had opened a second account.[86]

3. Rauh's Use of Discretion

JC gave Rauh oral authorization to use discretion with $100,000 of his money (which Rauh had placed in the "aggressive growth" account);[87] however, Rauh did not have written authorization to exercise discretion in either of JC's accounts.[88] Linsco did not allow discretionary brokerage accounts. This policy was published in its procedure manual and Linsco notified its registered representatives of this policy through monthly communications.[89] Rauh admitted that he had read Linsco's entire compliance manual when he began working there, including the portion that prohibited discretionary trading. He claimed not to have been aware of Linsco's discretionary trading policy because he "probably skimmed through that information a little too quickly."[90] He testified that, despite having Series 7 and 24 licenses, he was not aware of any NASD rules requiring written authorization for discretionary accounts.[91]

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[84] Tr. at 178, 180, 435-436.
[85] CX 95 at 1; CX 96 at 1.
[86] Tr. at 177-180.
[87] Tr. at 174.
[88] Tr. at 433 and 436.
[89] Tr. at 21-23.
[90] Tr. at 444.
[91] Tr. at 445.

From the outset, JC was unaware of the trading in his Linsco accounts. JC believed and trusted Rauh. He did not open account statements, believing that since he saw Rauh at least weekly, Rauh would tell him whatever he needed to know about his accounts and would alert him if there were any problems. Rauh did not discuss the purchase or sale of any particular stocks with JC and never sought JC's permission before trading stocks in JC's accounts. JC testified that he had never heard of many of the stocks in his accounts and did not recognize most of the transactions. With respect to trading of individual stocks, Rauh told JC that he could "estimate [a profit of] five to ten percent per month," regardless of how the market performed. Rauh also promised JC that transaction costs would be minimized; since JC provided free medical care to Rauh and his wife, Rauh said he would only charge JC what it cost Rauh to trade.[92] JC often signed blank forms for Rauh. Typically, Rauh would go to JC's home to have him sign forms.[93]

Although JC had given Rauh permission to use the money from his government bond funds to purchase equity mutual funds, Rauh bought only $300,000 worth of three different Hartford mutual funds within the first few months.[94] After September 1999, all of the subsequent transactions involved individual equities and options.[95] From its opening through the end of September 1999, Rauh made twenty four trades in JC's "aggressive growth" account, all of which involved the purchase and sale of individual equities.[96]

[92] Tr. at 182-187.
[93] Tr. at 187-188.
[94] CX 95 at 1-2;CX 69 at 9, 16-17.
[95] CX 95; CX 96.
[96] CX 96 at 1-3.

JC became gravely ill in August 1999 and was bedridden and unable to work for several months.[97] Medical tests showed that by January 2000 he had lost most of his kidney function and he was diagnosed with a rare disease originating in the bone marrow that acts like cancer.[98] In February 2000, JC's physician told him that he had only three to six months to live. In an effort to slow the progress of his disease, JC was given massive doses of steroids and thalidomide. The drugs affected his emotional and physical state--he was depressed, inattentive and his face was swollen. He was unable to function in any normal manner.[99] On May 15, 2000, JC entered the City of Hope Hospital to undergo a bone marrow transplant. He suffered life-threatening complications and was hospitalized for 23 days, until June 6, 2000.[100] JC was very weak after leaving the hospital and was unable to return to work. It was September 2000 before he began to feel better and was able to return to his weekly bible study.[101]

Rauh did a significant portion of the trading in JC's account while JC was ill and in the hospital. In October 1999, after JC became ill, Rauh recommended, and JC signed, a margin agreement for his "growth" account. JC, who did not even buy cars on credit, had no understanding of margin and Rauh never discussed it with him. JC was unaware that he had signed a margin agreement. He stated that he often signed, without reading, the forms that Rauh presented to him.[102]

In January 2000, Rauh prepared an options agreement, completing the entire form other than JC's signature.[103] Nearly all of the substantive information on the form was

[97] Tr. at 51-53, 190.
[98] Tr. at 201-202.
[99] Tr. at 53-54, 201-204.
[100] Tr. at 211-212.
[101] Tr. at 216-217.
[102] Tr. at 187-188.
[103] Tr. at 195-197; 455-457.

false and overstated JC's income, net worth and experience with options and stocks.[104] JC had no options experience whatsoever and did not intend to authorize Rauh to trade options in his account.[105] On the options agreement, Rauh had checked all of the listed possibilities for JC's investment objectives: "income", "income and appreciation", "speculation", "growth", "hedging" and "preservation of capital".[106] Rauh explained that he "checked all the boxes" to avoid constraints on his discretion. In Rauh's investigative testimony, he said, "The option agreement had to be approved by the Option Department. And you can have approval for various levels of activity. If you want it for income, you're approved to write covered calls. If you want to speculate, you can probably buy an option on anything. So, I just checked them all, I don't know, for that purpose, and the approval on the account for options. I think that looking back at that now, it's probably kind of silly to do that…"[107] At the hearing, however, Rauh claimed that JC had stated that he had all of those objectives at the same time.[108] JC testified, credibly, that Rauh had never discussed trading options with him.[109]

During the hearing, Rauh admitted that beginning in December 1999, he began treating JC's "growth" account as though it were a discretionary account and began trading exclusively NASDAQ tech stocks. He testified that although he discussed "probably all" trades with JC, he did not discuss or obtain JC's approval *before* making the trades.[110]

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[104] Tr. at 196-199.
[105] Tr. at 196-197.
[106] CX 19; CX 93 at 202.
[107] CX 93 at 202-203.
[108] Tr. at 461-462.
[109] Tr. at 196-197.
[110] Tr. at 449-451.

4. Unsuitable Trading

Rauh attempted to portray JC as an experienced, sophisticated investor who followed his investments closely and approved of the trading in his accounts. He testified that he explained the use of margin to JC and that JC wanted to purchase individual equities on margin. He also testified that he discussed all of the trades in JC's account, at least after they were made. Rauh testified that it was JC's idea, not Rauh's, to open an options account.[111] As described above, JC's testimony directly contradicted Rauh's. In this "he said/he said" contest, the Hearing Panel did not find Rauh to be credible. In addition to JC's testimony, the Hearing Panel had the benefit of hearing the testimony of a third party, MM, who is a financial planner and friend of JC's from his church. MM does not handle JC's assets and the Hearing Panel found him to be credible and free of bias. MM's testimony corroborated JC's version of events and contradicted Rauh's.

MM testified that he helped JC get his financial affairs in order before JC's bone marrow transplant and arranged for an attorney to draw up an estate plan. MM found JC to be financially very conservative and completely ignorant of the trading in his Linsco accounts. MM testified that JC had no understanding of margin or options and appeared "stunned" when he learned of the amount of margin interest he owed. JC was completely unfamiliar with most of the stocks in his accounts.[112]

The Hearing Panel found that Rauh was aware, or should have been aware, of JC's conservative financial nature and aversion to risk from the outset of their relationship. He knew that virtually all of JC's assets were invested in CDs. He knew

[111] Tr. at 440, 448-450, 455.
[112] Tr. at 61-64.

that JC was retired and that JC and his family depended on his investments for income.[113] Nevertheless, Rauh disregarded JC's investment objectives, financial situation and risk tolerance and began aggressively trading speculative technology stocks in JC's accounts, thereby generating large commissions and margin interest. In December 1999, Rauh executed 26 trades and by the end of the month the gross commissions in the account were $16,748[114] and the margin balance was $304,938.[115] In January and February, JC's health deteriorated and he had no substantive discussions with Rauh. He was completely unaware of the activity in his Linsco accounts.[116] Yet, Rauh's trading in JC's accounts continued; he made 15 trades in January and 25 trades in February.[117] The cost was substantial. In February 2000, commissions and margin interest totaled over $25,000, with Rauh's commissions being over $18,000.[118]

In late February of 2000, JC's doctors told him that he had only three to six months to live and that his only hope for recovery was a bone marrow transplant.[119] JC's wife arranged a meeting with MM to draw up an estate plan.[120] On March 6, 2000, in preparation for his meeting with MM, JC called Rauh to discuss his Linsco accounts. He told Rauh that his condition was terminal and that his insurance was not adequate to cover the cost of the bone marrow transplant. He stressed how important it was for Rauh to preserve the assets in his accounts, saying, "We can't lose any money. This is the money that Beth and the boys are going to live on and pay bills with…We can't afford to lose a penny. I am trusting you. Beth doesn't …have a clue about our finances.

[113] Tr. at 140-145.
[114] CX 100.
[115] CX 69 at 33.
[116] Tr. at 205.
[117] CX 100.
[118] CX 100.
[119] Tr. at 204.
[120] Tr. at 53 and 205-206.

Fortunately, I have you and you can bring her along." Rauh reassured JC that his accounts were worth at least $1.2 million.[121] Rauh denied having this conversation with JC; however, after being impeached with his prior inconsistent investigative testimony, he admitted that he had learned in March 2000 that JC would die without a bone marrow transplant.[122] The Hearing Panel found that JC's testimony regarding the conversation was credible; Rauh's denial was not.

Despite this conversation with JC, Rauh continued trading aggressively in JC's accounts. In March 2000, Rauh made 28 trades in JC's "growth" account, generating commissions and margin interest of more than $27,000, while JC's equity in the account declined nearly $400,000. By the end of March, JC's margin balance was almost $600,000. Meanwhile, Rauh earned over $18,000 in commissions in March.[123]

One example of the types of stock Rauh purchased in JC's "growth", i.e., less aggressive account, merits further discussion. Rauh could not recall the source of his information about 724 Solutions, but he knew it was a newly public company that had a history of losses, anticipated continuing losses, had never been profitable and was dependent on a single product.[124] On March 2, 2000, Rauh purchased 1,000 shares of 724 Solutions for approximately $230,000. Six days later—two days after JC had told him about his terminal prognosis—Rauh purchased an additional 1000 shares, bringing JC's total investment in 724 Solutions to $435,000.[125] JC knew nothing about 724 Solutions[126] and Rauh admitted that he did not discuss the stock with JC and conceded

[121] Tr. at 206-208.
[122] Tr. at 469.
[123] CX 69 at 71; CX 100.
[124] Tr. at 472-473; CX 77 at 2, 14 and 16.
[125] CX 99; Tr. at 473.
[126] Tr. at 210.

that the purchases were inappropriate.[127] JC lost $371,769 when Rauh sold the 724 Solutions stock on July 8, 2000.[128] There are many other examples of trades in similar speculative stocks in JC's accounts.[129]

Between March 2000 and September 2000, JC and Rauh did not discuss the Linsco accounts and JC did not realize that his accounts were losing money.[130] In November 2000, JC opened a September 2000 statement for his "growth" account and was shocked to see that his account was worth only about $208,000. He didn't realize that he also had a margin balance of $261,974.[131] When JC called Rauh in November for an explanation, Rauh did not tell him that the account was worth even less than it had been in September and did not tell him about the margin balance.[132]

In early December 2000, JC asked Rauh how he had lost so much money in his accounts. According to JC, Rauh responded, "I don't know. It happened. But it will double by the end of the year and it will double again by the following year, so you will have your money back." JC remained unaware that his accounts had a margin balance and that Rauh had traded options.[133]

Finally, on December 24, 2000, JC showed MM his November 30, 2000 account statements. He was stunned when MM explained that he had been borrowing to purchase

[127] Tr. at 473-474.
[128] CX 99; CX 69 at 76, 78, 85, 86 and 104.
[129] CX 95; CX 96.
[130] Tr. at 217-218.
[131] Tr. at 221-222; CX 69 at 112.
[132] Tr. at 223.
[133] Tr. at 226-227.

stock, traded options and had a margin balance of approximately $260,000.[134] Overall, JC lost approximately $389,000 in both of his accounts.[135]

On December 29, 2000, JC wrote to Linsco and sought compensation for his losses.[136] On January 19, 2001, Linsco terminated Rauh.[137] On March 23, 2001, JC filed a statement of claim in an NASD arbitration proceeding and sought damages against Rauh and Linsco.[138] In January 2002, the parties reached a settlement that called for payment to JC of $893,000.[139] Rauh did not pay any of the settlement; Linsco's insurance carrier paid it.[140]

D. Rauh's Use of Discretion in CS's Account

CS did not testify at the hearing. These findings of fact are based on his declaration and account statements and Rauh's testimony.

In September 1999, CS met Rauh through their mutual friend, JC. CS's pension plan and family trust accounts were invested in money market accounts and he was seeking a better return but wanted to avoid high risk.[141] On October 22, 1999, CS opened two accounts at Linsco with Rauh as his broker. He deposited $350,000 in the accounts, whose investment objectives were marked "growth".[142]

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[134] Tr. at 61-63.
[135] This number was not presented to the Hearing Panel, but is derived from CX 95 and CX 96, which analyze the trading in JC's accounts. CX 95 shows a deposit of $680,000, a withdrawal of $50,000 and a transfer to JC's "aggressive growth" account of $114,658, for a net investment of $515,342. The ending account equity in December 2000 was $126,215, for a net loss in the account of $389,127. CX 96, reflecting the trading in JC's "aggressive growth" account, shows a transfer of $114,658 from JC's "growth" account, additional deposits totaling $165,000, for a net investment of $279,658. JC withdrew $275,000 and in December 2000 had an ending account equity of $4,439. His net loss was $219.
[136] CX 53; Tr. at 236-237.
[137] CX 92 at 5; CX 93 at 17-18.
[138] CX 42A.
[139] CX 20; CX 92 at 16; Tr. at 484.
[140] Tr. at 484.
[141] CX 79 at Par. 6.
[142] CX 22; CX 25.

CS verbally told Rauh that he could use discretion in the accounts within the "no high risk" limitation they had discussed; however, he never gave Rauh written discretionary authority.[143] Rauh testified that he believed he had unlimited authority to exercise discretion in CS's accounts. Between October 1999 and December 2000, Rauh made over 200 trades in CS's accounts. Rauh exercised his discretion to use margin, and to trade equities and options.[144] The value of CS's accounts declined by 93%. By the end of December 2000, his initial equity of $350,000 had diminished to $23,948.[145]

In October 2001, CS settled his arbitration claim against Linsco and Rauh for $163,000.[146] Rauh did not pay any portion of the settlement; Linsco's insurance carrier paid the full amount.[147]

E. The NASD Investigation

In February 2001, NASD was initially notified of potential misconduct because of Linsco's Form U-5 filing that reported its termination of Rauh for use of discretion without written authority in JC's account. That investigation ultimately involved allegations of unauthorized trading, unsuitable transactions, excessive trading and selling away. In August 2001, NASD received a complaint from one of Rauh's customers alleging various trading violations and opened another investigation. At about the same time, NASD received information that Rauh may have falsified information on Form U-4s and opened a third investigation into that conduct. In February 2002, Linsco

[143] CX 79 at Par. 7; Tr. at 489.
[144] Tr. at 489-490; CX 7 at 1-2; CX 94 at 174-175; CX 104; CX 105.
[145] CX 106.
[146] CX 92 at 2.
[147] Tr. at 539.

amended Rauh's Form U-5 to disclose that CS had instituted an arbitration against Rauh alleging trading violations. The NASD opened a fourth investigation one month later.[148]

The four investigations required multiple formal requests for information, multiple witness interviews, and analysis of account documentation and numerous other records.[149] The examiner also created schedules involving hundreds of transactions.[150] Rauh's formal testimony was taken in July and August 2004 and the Complaint was filed in November 2004.[151]

III. Conclusions of Law

A. Rauh Violated NASD Conduct Rule 2110 and IM-1000-1 by Willfully Failing to Disclose Material Information on a Form U-4 (First Cause of Complaint)

The EH lawsuit was material information that Rauh was required to disclose on his Form U-4 when he applied to Linsco for employment. A member of the public, in deciding whether to hire Rauh as his broker, would most likely want to know that Rauh had been accused of investment fraud by a former customer. Linsco's former director of compliance testified that if Linsco had known about the EH lawsuit, it is unlikely that Rauh would have been hired. And the information might reasonably have caused an employer to impose conditions or enhanced supervision on Rauh.[152]

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[148] Tr. at 559-568.
[149] Tr. at 544-545; 561-563; 565-566 and 568-569.
[150] Tr. at 544, 557, 563 and 568; CX 95-97 and CX 99-106.
[151] Tr. at 555.
[152] *DOE v. Perez*, 1996 NASD Discip. LEXIS 51 at *6 (NBCC Nov. 12, 1996).

In questioning Rauh about his Form U-4 disclosures, Enforcement mistakenly focused only on Question 22G, rather than 22H.[153] Regardless, Rauh has been charged, not with failing to answer a particular Form U-4 question properly, but with violating Conduct Rule 2110 by failing to disclose the EH lawsuit *anywhere* on his Form U-4. Rule 2110 provides that, **"**A member, in the conduct of his business, shall observe high standards of commercial honor and just and equitable principles of trade." IM-1000-1 alerts registered representatives that, "The filing with [NASD] of information with respect to membership or registration as a Registered Representative which is incomplete or inaccurate…may be deemed to be conduct inconsistent with just and equitable principles of trade…." The NASD required Rauh to complete a Form U-4, disclosing, among other things, whether he had ever been named as a defendant in an "investment-related, consumer-initiated, civil litigation which alleged that [he] was involved in one or more sales practice violations and which [was] still pending."[154]

Rauh was clearly named as a defendant in the EH lawsuit. The Explanation of Terms, attached to the Form U-4 in effect in 2001, defined certain of the terms contained in Question 22H(1).[155] The allegations in the EH lawsuit were clearly "investment-related,"[156] EH was a consumer, and had initiated the lawsuit. The lawsuit also alleged

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[153] Question 22G asked, "Within the past 24 months, have you been the subject of an investment-related, consumer-initiated, written complaint, not otherwise reported in 22 H(1) or 22 H(2)…?" Question 22G is limited to "written complaints" initiated (*See*, "Form U4 and U5 Interpretive Questions, www.nasd.com at Question 14I(3)) within the previous 24 months that were not disclosed in response to Question 22H, which clearly asks whether the applicant has "ever been named in a …lawsuit…" Even assuming the EH lawsuit would have qualified as a "written complaint" under 22G, the complaint was over three years old by the time Rauh filed his Form U-4 with Linsco. Because 22G covers only complaints lodged "within the past 24 months," he would have been correct in answering "no" to Question 22G at that time.

[154] CX 12, Question 22H(1). *See also*, CX 12 A.

[155] NASD Manual, April 2000 at 472-473.

[156] *Id.*, "Investment-related pertains to securities, commodities, banking, insurance or real estate…"

that Rauh was "involved"[157] in "sales practice violations"[158]--fraud in connection with investment recommendations he made to EH and wrongfully directing trading and receiving commissions for that trading from a broker at another member firm. The allegations of the EH lawsuit clearly met the requirements for disclosure under Question 22H(1). In addition, despite being part of Rauh's bankruptcy, the lawsuit was not dismissed until 1999, and so was still "pending" when Rauh applied to Linsco. The concept that the automatic stay provisions of the bankruptcy code merely suspend, but do not extinguish, a lawsuit is basic and well founded in the law.[159] Despite Rauh's claims that his bankruptcy petition caused the EH lawsuit to "disappear", he knew very well the dates of his bankruptcy filing and discharge as well as the date the EH lawsuit was actually dismissed.

The Hearing Panel finds that as a matter of law, Rauh was required to disclose the EH lawsuit on the Linsco Form U-4 by answering "yes" to Question 22H(1) and then should have described the lawsuit.[160] Rauh's "no" answer was clearly false and that is sufficient to violate Rule 2110 and IM-1000-1.[161] Rauh's claims that he did not

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[157] *Id.*, "doing an act or aiding, abetting, counseling, commanding, inducing, conspiring with…another in doing an act"

[158] *Id.*, "includ[ing] any conduct directed at or involving a customer which would constitute a violation of any rules for which a person could be disciplined by any self-regulatory organization; any provision of the Securities and Exchange Act of 1934; or any state statute prohibiting fraudulent conduct in connection with the offer, sale or purchase of a security or in connection with the rendering of investment advice".

[159] *See, Hill v. Harding*, 107 U.S. 631 (1882), 1882 U.S. LEXIS 1259 ("The stay does not operate as a bar to the action, but only as a suspension of proceedings until the question of the bankrupt's discharge shall have been determined in the United States court sitting in bankruptcy. After the determination of that question in that court, the court in which the suit is pending may proceed to such judgment as the circumstances of the case may require. If the discharge is refused, the plaintiff, upon establishing his claim, may obtain a general judgment."); *In re Related Asbestos Cases*, 23 B.R. 523 (N.D.CA, 1982), 1982 U.S. Dist. LEXIS 16117 ("The automatic stay provision merely suspends those proceedings to which it applies and does not divest the court of jurisdiction".).

[160] *See* fn. 153.

[161] *DBCC v. Prewitt*, 1998 NASD Discip. LEXIS 37 (NAC Aug. 17, 1998); *DOE v. Zdzieblowski*, 2005 NASD Discip. LEXIS 3 (NAC May 3, 2005).

understand that he was required to disclose the EH lawsuit are relevant only to deciding whether his conduct was willful and what sanctions should be imposed.[162]

The Hearing Panel also finds that Rauh's failure to disclose the EH lawsuit on the Linsco Form U-4 was willful. The Form U-4 question was clear and unambiguous and Rauh was fully aware of the EH lawsuit and its allegations. His multiple explanations for failing to disclose the lawsuit were contradictory and rather than evidencing confusion, indicated to the Hearing Panel that Rauh knew he should have disclosed the EH lawsuit and deliberately failed to do so.

Rauh's reliance on counsel defense is unpersuasive. To establish a reliance on counsel defense, "a person must show that he (1) made complete disclosure to his counsel of the intended action; (2) requested counsel's advice as to the legality of the intended action; (3) received counsel's advice that the conduct was legal; and (4) relied in good faith on that advice."[163] Rauh failed to satisfy any of the elements of this defense.

Rauh's efforts to claim that his firm and supervisors were responsible for the accuracy of his Form U-4 are also unavailing. "As a registered representative, [Rauh] is responsible for his actions and cannot shift that responsibility to the firm or his supervisors."[164]

Based on testimony and exhibits offered at the hearing, the Hearing Panel finds that Rauh violated NASD Conduct Rule 2110 and IM-1000-1 by willfully failing to disclose material information on the Form U-4 that he submitted to Linsco.

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[162] *DBCC v. Prewitt, supra.*
[163] *Hal S. Herman*, Exchange Act Release No. 44853, 2001 SEC LEXIS 2173 at *13 (2001).
[164] *DOE v. Lu*, 2004 NASD Discip. LEXIS 8 (NAC May 13, 2004), *aff'd*, 2005 SEC LEXIS 117 (2005).

B. The Form U-4 Submitted to Royal Alliance

The Hearing Panel concludes that Rauh was not required to disclose the EH lawsuit on the Form U-4 that he submitted to Royal Alliance in 2001. By that time, the EH lawsuit, having been dismissed in 1999, was no longer "pending". The Second Cause of the Complaint is therefore dismissed.

C. Rauh Violated NASD Conduct Rules 2510 and 2860(b)(18) by Exercising Discretion Without Written Authorization (Third and Fourth Causes)

NASD Conduct Rule 2510(b) provides that "No member or registered representative shall exercise any discretionary power in a customer's account unless such customer has given prior written authorization to a stated individual…and the account has been accepted by the member …." Similarly, NASD Conduct Rule 2860(b)(18)(A) prohibits a registered representative from exercising discretion in making options trades unless the written authorization required by Rule 2510 specifically authorizes options trading in the account and the account is accepted in writing by a Registered Options Principal.

Although JC and CS gave Rauh verbal authorization to exercise discretion, Rauh never obtained written discretionary authority. Moreover, Linsco prohibited discretionary accounts. Rauh admitted that he traded equities and options on a discretionary basis in both JC and CS's accounts, and that he did so without obtaining written discretionary authority. Rauh therefore violated NASD Rules 2510(b) and 2860(b)(18)(A).[165]

[165] *Paul F. Wickswat*, 50 S.E.C. 785, 1991 SEC LEXIS 2482 (1991) (finding a violation when there was oral authorization to make discretionary trades without also obtaining written authority);

D. Rauh Violated NASD Conduct Rule 2310 by Making Unsuitable Recommendations in JC's Accounts (Fifth and Sixth Causes)

For most of the relevant period, JC was completely unaware of Rauh's trading activity and Rauh had complete control over the trading in JC's accounts. Rauh conceded that he used discretion in trading the accounts and because Rauh exercised discretionary authority, he had *de facto* control over JC's accounts and is deemed to have recommended the transactions he executed.[166]

NASD Conduct Rule 2310(a) provides that, in recommending a purchase of a security to a customer, a broker "shall have reasonable grounds for believing that the recommendation is suitable for such customer upon the basis of the facts, if any, disclosed by such customer as to his other security holdings and financial situation and needs." A broker's recommendations "must be consistent with his customer's best interests and he or she must abstain from making recommendations that are inconsistent with the customer's financial situation."[167] Rauh's recommendations were clearly not in JC's best interests or in accordance with JC's stated conservative financial profile. Rauh's trading was even more unsuitable once JC became ill.

Rauh's purchases of 724 Solutions were clearly speculative. A recommendation that results in concentration in an investment that is more aggressive than a customer's circumstances dictate is unsuitable.[168] A concentration of investments in a limited number of securities is unsuitable for investors who are not in a financial position to

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[166] *Clyde J. Bruff*, S.E.C. 880, 1998 SEC LEXIS 2266, at **6-7 (1998).
[167] *Dane S. Farber*, Exchange Act Release No. 49,216, 2004 SEC LEXIS 277, at *23-24 (2004); *Wendell D. Beldon*, Exchange Act Release No. 47,859, 2003 SEC LEXIS 1154, at *11 (May 14, 2003).
[168] *See Clinton Hugh Holland, Jr.*, 52 S.E.C. 562, 566 (1995), *aff'd sub nom, Holland v. SEC*, 105 F.3d 665 (9th Cir. 1997) (table format); *see also Jack H. Stein*, Exchange Act Release No. 47476, 2003 SEC LEXIS 566 (2003).

assume the risks associated with speculative investing.[169] Rauh gambled half the equity of JC's so-called growth account on this one highly speculative stock *after* JC told him of his terminal illness and need to conserve assets. The loss from that one stock exceeded $370,000.

Rauh's use of margin in JC's accounts was also unsuitable. As the Commission has explained,

> Trading on margin increases the risk of loss to a customer for two reasons. First, the customer is at risk to lose more than the amount invested if the value of the security depreciates sufficiently…Second, the client is required to pay interest on the margin loan, adding to the investor's cost of maintaining the account and increasing the amount by which his investment must appreciate before the customer realizes a net gain.[170]

In January 2000, after JC became seriously ill, Rauh heavily margined his accounts, which allowed him to trade options and to trade excessively in speculative stocks. The margin interest added to the losses from the stocks' depreciation. Rauh had an obligation to ensure that JC understood the risks of investing on margin and that the trades made using margin were suitable for him.[171] Rauh completely disregarded this obligation; not only did he neglect to explain margin to JC, he had him sign a blank margin agreement.

In addition to Rule 2310's suitability requirements, Conduct Rule 2860(b)(19) mandates a heightened suitability standard for options trading.[172] The representative must have a reasonable basis for believing that "the customer has such knowledge and

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[169] *See, e.g., Dane S. Farber,* Exchange Act Release No. 49216, 2004 SEC LEXIS 277 (2004) ("we have repeatedly found that high concentration of investments in one or a limited number of speculative securities is not suitable for investors seeking limited risk"); *Stephen Rangen,* 52 S.E.C. 1304, 1997 SEC LEXIS 762 (1997) ("by concentrating so much of their equity in particular securities, Rangen increased the risk of loss for these individuals beyond what is consistent with the objective of safe, non-speculative investing").
[170] *Stephen T. Rangen, supra; Department of Enforcement v. Jack H. Stein,* No C07000003, 2001 NASD Discip. LEXIS 38, *15 (N.A.C. Dec. 3, 2001).
[171] *Patrick G. Keel,* 51 S.E.C. 282, at 286, 1993 SEC LEXIS 41 (1993).
[172] *Dale E. Frey,* Initial Decisions Rel. No. 221, 2003 SEC LEXIS 306, at *41-42 (Feb. 5, 2003).

experience in financial matters that he may reasonably be expected to be capable of evaluating the risks of the recommended transaction, and is financially able to bear the risks of the recommended position in the option contract."[173]

Here, JC did not provide any information upon which Rauh could have believed the options transactions were suitable. Rauh falsified the information on the options agreement and then aggressively traded options after JC had told him he was terminally ill and needed to conserve his assets. JC had no understanding of options and was unaware of the trading. Indeed, the bulk of the options transactions occurred while JC was undergoing and recovering from his bone marrow transplant. Rauh's options transactions, done primarily in JC's "aggressive growth account," appear to have been a reckless and misguided effort to make up the losses he had sustained in JC's "growth account".

E. Unfair Delay—"Hayden Defense"

In his pre-hearing brief, Rauh argued that the Complaint's first and second causes, which allege that Rauh failed to disclose the EH lawsuit on his Forms U-4s, should be dismissed because of the length of time between the misconduct and the initiation of this disciplinary hearing. He argued that he had lost the ability to defend the "willful" misconduct allegation because his attorneys can no longer recall the advice they provided to him with respect to his Form U-4 allegations. Rauh points to the six years and eight months between the earliest alleged misconduct (the filing of the March 1998 Form U-4) and the initiation of the proceedings. He relies on *Jeffrey A. Hayden*[174] and argues that "fundamental notions of equity and fairness call for the dismissal of the U-4 charges."

[173] *DOE v. Bendetsen*, Complaint No. C01010025, 2004 NASD Discip. LEXIS 13 (N.A.C. Aug. 9, 2004).
[174] Exchange Act Release No. 42772, 2000 SEC LEXIS 946 (2000).

Recently, the SEC addressed the effect of delay on the fairness of a disciplinary proceeding and reiterated that there is no statute of limitations applicable to disciplinary actions and explicitly stated that *Hayden* did not endorse any de facto statute of limitations based on the time frames presented in that case. Rather, it is necessary to examine the entire record in analyzing the fairness of a proceeding.[175]

The Hearing Panel finds that Rauh was not prejudiced by his attorneys' inability to recollect their advice to him because Rauh did not provide evidence that his purported reliance on their advice was reasonable. Rauh admitted that he never showed his attorneys his Form U-4 and did not discuss his U-4 obligations with them. He conceded that neither attorney told him he did not have to report the EH lawsuit and stated that he didn't know if his attorneys "know what a U-4 is".

In addition, the Hearing Panel will not reward Rauh for his own misconduct. The NASD did not learn of the EH lawsuit until October 2001 because Rauh willfully failed to disclose it on his Form U-4s. He concealed the lawsuit for years and now claims disciplinary charges against him must be dismissed because the case is too old. The Hearing Panel, having examined the entirety of the record, finds that the disciplinary process in this matter was fair.

IV. Sanctions

A. Willfully Failing to Disclose Material Information on Linsco Form U-4

The NASD Sanction Guidelines ("Guidelines") for filing a false or inaccurate Form U-4 provide for fines ranging from $2500 to $50,000 and in egregious cases, a bar.[176] The Guidelines also identify a number of factors to be considered in determining

[175] *Mark H. Love*, Exchange Act Release No. 2004 SEC LEXIS 318 (2004).
[176] NASD Sanction Guidelines at 73-74 (2005).

sanctions including: "whether the respondent attempted to conceal his or her misconduct or to lull into inactivity…the member firm with which he or she is/was associated" (No. 10); "whether the respondent's misconduct resulted directly or indirectly in injury to…other parties; and…the nature and extent of the injury" (No. 11); and "whether the respondent's misconduct was the result of an intentional act, recklessness, or negligence." (No. 13).[177]

Rauh's deceptions set off a chain of events that resulted in harm and losses to customers. His failure to disclose the EH lawsuit resulted in his Linsco employment and his ability to function semi-autonomously as his own OSJ. That autonomy created an environment in which his sales practice abuses went undetected while he generated commissions and caused margin expenses in clients' accounts. The Hearing Panel finds that Rauh's conduct was egregious and therefore imposes a bar.

B. Exercise of Discretion Without Written Authorization

For use of discretion without written authorization, the Guidelines recommend a fine of $2,500 to $10,000, and in egregious cases, a suspension of 10 to 30 business days.[178] The Hearing Panel finds that Rauh's conduct would merit a fine and suspension in the upper end of the recommended range; however, because it is imposing a bar for his other misconduct, an additional sanction would not serve any purpose.[179]

C. Unsuitable Recommendations

The Guidelines for unsuitable recommendations call for a fine of $2,500 to $75,000, plus the amount of a respondent's retained financial benefit, and in egregious

[177] *Id.* at 6-7.
[178] *Id* at 90.
[179] *See DOE v. Hodde*, Complaint No. C10010005, 2002 NASD Discip. LEXIS 4, at *17 (N.A.C. Mar. 27, 2002).

cases, a bar.[180] In addition, General Principal 6, which is specifically referenced in the Guideline for unsuitable recommendations, recommends that adjudicators "fine away" a respondent's ill-gotten gain. This case involved several hundred transactions that generated customer losses and large gains for Rauh. Rauh used deception to gain the confidence of his customers, and then placed his own interests above theirs. Rauh's disregard for JC's financial needs, particularly when he was ill and completely dependent on Rauh for financial guidance, was especially reprehensible. The Hearing Panel finds that Rauh's conduct was egregious and that a bar is an appropriate sanction.

Rauh earned $118,495 in commissions from trading in JC's account. Because JC was made whole in an arbitration settlement, the Hearing Panel will not require restitution of this amount to him. Because Rauh did not pay any part of that settlement, however, the Hearing Panel fines him $118,495.

V. Order

Douglas A. Rauh is barred from association with any member firm in any capacity for violation of NASD Conduct Rules 2110, 2310, 2860(b)(19) and IM-1000.[181] He is also fined in the amount of $118,495. The bar shall become effective once this decision becomes the final disciplinary action of NASD. The fine shall be due and payable when and if Rauh seeks to return to the securities industry.

[180] NASD Sanction Guidelines at 99 (2005).

[181] The Hearing Panel has considered all of the arguments of the Parties. They are rejected or sustained to the extent they are inconsistent or in accord with the findings and conclusions expressed herein.

In addition, Rauh is ordered to pay the cost of this proceeding in the total amount of $5,134.16, which includes an administrative fee of $750.00 and hearing transcript costs of $4,384.16.

HEARING PANEL

_____

By: Rochelle S. Hall
Hearing Officer

Copies to:

Douglas A. Rauh *(via overnight and first class mail)*
Sylvia M. Scott, Esq. *(via electronic and first class mail)*
Joel T. Kornfeld, Esq. *(via electronic and first class mail)*
Rory C. Flynn, Esq. *(via first class mail)*