

**FINRA
OFFICE OF HEARING OFFICERS**

Department of Enforcement,

Complainant,

v.

Brookstone Securities, Inc.

[CRD No. 13366],

and



Respondents.

Disciplinary Proceeding

No. 2009019070902

COMPLAINT

The Department of Enforcement alleges:

SUMMARY

1. Brookstone Securities, Inc. recommended and sold oil and gas private placements offered by Provident Royalties, LLC that were ultimately exposed as part of a Ponzi scheme. Because of its failure to conduct adequate due diligence, Brookstone had no reasonable basis to conclude that the private placements were suitable for any customer.
2. Brookstone Securities, Inc., acting through its president [REDACTED] and its chief compliance officer¹ failed to conduct adequate due diligence of the private placements offered by Provident Royalties, LLC, pursuant to Regulation D. Accordingly,

¹ Without admitting or denying the charges, the compliance officer, Mark M. Mercier settled with FINRA by signing a Letter of Acceptance, Waiver, and Consent (AWC) in this matter. The AWC was issued on September 29, 2011.

Brookstone Securities, Inc. and [REDACTED] violated NASD Conduct Rules 2310, 3010, and 2110 and FINRA Rule 2010.

RESPONDENTS AND JURISDICTION

3. Respondent Brookstone Securities, Inc. ("Brookstone") has been a member of FINRA since April 8, 1983. During all periods mentioned herein, Brookstone was a registered broker-dealer with the United States Securities and Exchange Commission and a member of FINRA.
4. [REDACTED] entered the securities industry on August 5, 2003, as a General Securities Representative of a FINRA member firm. [REDACTED] during all periods mentioned herein, was associated with member firm Brookstone Securities, Inc. and was registered with FINRA under Article V of the By-Laws as a Financial and Operations Principal, Registered Options Principal, Municipal Securities Principal, General Securities Principal, and General Securities Representative, and subsequently, on December 15, 2009, as an Investment Banking Representative, which registrations remain currently in effect.

BACKGROUND

[REDACTED] Supervisory Responsibilities and Brookstone's Supervisory Procedures

4. [REDACTED] was the president of Brookstone from June 2005 through June 2011. From June 2005 through May 14, 2008, he was also the Firm's chief compliance officer. In these roles, he drafted the Firm's written supervisory procedures, including the procedures regarding due diligence. On May 15, 2008, Mark M. Mercier was hired as the chief compliance officer, and was employed in this capacity until November 14,

2008. During the six months that Mercier was chief compliance officer, █████ remained responsible for the Firm's written supervisory procedures.

5. █████ had included in Brookstone's written supervisory procedures extensive procedures addressing due diligence of private placements offered pursuant to Regulation D ("private placements") where the Firm acted as an underwriter. █████ did not, however, include written supervisory procedures addressing due diligence that should be conducted when the Firm acted as a selling agent for a private placement.²
6. Prior to the hiring of Mercier, █████ was responsible for due diligence regarding the Firm's sale of private placements. After his hire, Mercier assumed some responsibility for conducting due diligence on private placements where the Firm acted as a selling agent only. █████ however, never formally delegated full responsibility for due diligence to Mercier. Absent such a delegation, █████ as president, retained responsibility for conducting due diligence where the Firm acted as a selling agent only.
7. The unwritten due diligence procedures employed by the Firm, where it acted as a selling agent, required review of any due diligence package provided by the issuer, review of marketing materials, review of third-party due diligence reports that were available, and review of information about the issuer available on the internet.

Private Placement Offerings by Provident Royalties

8. From at least September 2006 through January 2009, broker-dealer Provident Asset Management, LLC (PAM) marketed and sold preferred stock and limited partnership

² In AWC 2009019837303 (May 23, 2011), without admitting or denying the charges, Brookstone and █████ settled with FINRA for failure to have reasonable written supervisory procedures regarding the due diligence of private placements where the Firm acted as a selling agent. The AWC included additional supervisory charges related to a Regulation D offering issued by Midwest Investment.

interests in a series of 23 private placements offered by an affiliated issuer, Provident Royalties, LLC.

9. PAM's only business line was acting as the wholesaling broker-dealer for the Provident offerings, which were sold to customers through more than 50 retail broker-dealers nationwide and which raised approximately \$485 million from over 7,700 investors.
10. Provident's business plan included the acquisition of a combination of producing and non-producing sub-surface mineral interests, working interests, and production payments in real property located within the United States.
11. The Provident offerings each claimed an exemption from the registration of the offerings pursuant to Rule 506 of Regulation D. The Provident offerings, designated as Shale Royalties, Inc., numbered II through 20 (Shale offerings), offered two series of non-convertible redeemable cumulative preferred stock. Each share of stock was offered for \$5,000 through a private placement memorandum.
12. The Shale offerings were virtually identical in their terms, had the same investment purpose, and were offered continuously for 30 consecutive months. The periods of many of the offerings overlapped and each offering was also limited to 500 investors and to varying dollar amounts. As an offering would approach a limit, Provident would create the next Shale offering. Audited financial statements were not prepared with respect to any of the Shale offerings.
13. Brookstone approved the sale of the Shale 17 and Shale 19 offerings, and rejected the sale of the Shale 22 offering.
14. At the outset of the Shale offerings by Provident, dividends on each share of Series A preferred stock were to accrue at the rate of 1.5% per month, and dividends on each

share of Series B preferred stock were to accrue at the rate of 1.25% per month. Series A preferred stock was redeemable at the end of either 24 or 36 months, and Series B preferred stock at the end of 24 months. These were the terms that applied to the Shale 17 offering.

15. At some point in time, Provident reduced the amount payable for dividends on Series A preferred stock to 1.375% and on Series B preferred stock to 1.167%. At the same time, the private placement memoranda for the Shale offerings changed the maturity to 48 months for Class A Preferred Shares and 36 months for Class B Preferred Shares. Dividend payments to the investors were to be paid four months in arrears, and thereafter monthly on the last day of each month. These were the terms that applied to the Shale 19 offering.
16. Although PAM made some direct retail sales of the Provident private placements, it primarily solicited retail broker-dealers such as Brookstone to enter into sales agreements for each Shale offering, and those retail broker-dealers sold the stock of the offerings to investors nationwide. The retail broker-dealers received fees and/or commissions for soliciting investors in the Shale offerings, including a specific fee related to due diligence that was purportedly performed in connection with each offering.
17. The owners and principals of Provident deposited investors' funds into the appropriate separate bank account designated for each Shale offering, knowing that the Shale offerings did not have sufficient revenues to pay investors' dividends as they became due.

18. Although a portion of the proceeds of the Shale offerings was used for the acquisition and development of oil and gas exploration and development activities, millions of dollars of investors' funds were transferred from the later Shale offerings' bank accounts to the Provident operating account in the form of undisclosed and undocumented loans, and were used to pay dividends and returns of capital to investors in the earlier Shale offerings.
19. The owners and principals of Provident and PAM did not tell investors, and the Shale private placement memoranda do not disclose, that the investors' funds would be used to pay earlier investors their dividends and return of principal, rather than to invest in oil and gas assets.
20. On July 2, 2009, the SEC filed a civil injunctive action in the United States District Court for the Northern District of Texas naming Provident, PAM and others, and the court granted its request for a temporary restraining order and an emergency asset freeze and appointment of a receiver to take control of the entities and marshal and preserve the assets for the benefit of the defrauded investors. The court set a hearing on the SEC's motion for a preliminary injunction. Subsequently, the order for the hearing was vacated when all the named defendants agreed to the entry of a preliminary injunction, which remains in effect.
21. Since July 1, 2009, Provident Royalties, LLC and its affiliates have been in receivership pursuant to the action initiated by the SEC.

22. On March 18, 2010, FINRA expelled Provident Asset Management from membership for marketing fraudulent private placements offered by its affiliate PAM as part of a large Ponzi scheme.³

Brookstone's Sales of the Shale 17 and Shale 19 Offerings

23. On July 18, 2008, Mercier signed the selling agreement for the Shale 17 offering, and on October 22, 2008, he signed the selling agreement for the Shale 19 offering.

24. Brookstone representatives recommended and sold the following investments in the Shale 17 and 19 offerings:

CUSTOMER	DATE	OFFERING	AMOUNT OF PURCHASE	COMMISSION AND DUE DILIGENCE FEE
DJJ AND PJ	8/21/2008	17	\$150,000	\$13,500
JSK REVOCABLE LIVING TRUST	8/26/2008	17	\$25,000	\$2,250
HKS	9/11/2008	17	\$25,000	\$2,250
GAR	9/12/2008	17	\$25,000	\$2,250
HF TRUST	9/12/2008	17	\$40,000	\$3,600
HF TRUST	10/29/2008	17	\$225,000	\$20,250
CG AND RMF LIVING TRUST	11/20/2008	17	\$200,000	\$18,000
LEP AND LP	1/5/2009	19	\$100,000	\$8,000
GAR	1/15/2009	17	\$25,000	\$2,250
TOTAL			\$815,000	\$72,350

25. Each of the customers that purchased the Shale 17 offering attended a seminar sponsored by Brookstone and Provident. At the seminar, the Brookstone registered

³ Without admitting or denying the charges, Provident Asset Management settled with FINRA by signing a Letter of Acceptance, Waiver, and Consent. *Provident Asset Management*, 2009017497201 (March 17, 2010).

representative made opening remarks and introduced the Provident speaker. At the close of the seminar, the customers were provided with the documentation to purchase the offering through Brookstone.

26. Customers LEP and LP purchased the Shale 19 offering after a Brookstone representative presented the investment to them.

27. Because the Shale 17 and Shale 19 offerings were forced into receivership on July 1, 2009, the seven customers listed above lost their entire principal investment.

Brookstone's Due Diligence Regarding the Shale 17 and Shale 19 Offerings

28. Consistent with the terms of the selling agreements for the Shale 17 and Shale 19, Brookstone received a commission of 8% for soliciting investors in the Shale offerings, and a 1% due diligence fee, specifically for due diligence purportedly performed by Brookstone in connection with each offering. However, the only due diligence conducted for either offering was review of the private placement memorandum associated with the offerings.

29. Both the private placement memorandum (PPM) for the Shale 17 and the Shale 19 offerings prominently stated on the last page that due diligence books were available upon request and provided contact information for making the request. No one at Brookstone requested the books.

30. Furthermore, Mick & Associates, PC, a third party due diligence provider, conducted due diligence reviews of both the Shale 17 and the Shale 19 offerings. Upon request, Mick & Associates provided the reports free of charge. No one at Brookstone requested the Mick report for Shale 17. Although [REDACTED] received the Mick report for

Shale 19 via email on November 17, 2008, he never reviewed it or provided it to anyone else to review.

31. The Mick reports for the Shale 17 and Shale 19 offerings identified a number of red flags with respect to the offerings.

32. For instance, both reports emphasized that the affiliated Shale offerings were collectively reporting a net operating loss for the first five months of 2008 of \$8 million. The reports further stated “**Provident has used the full amount of its credit line, which has a principal balance of about \$175 million**” and that “**[i]n the absence of additional credit line funds, Provident’s operating funds will need to come from (i) a higher level of production revenues going forward, or (ii) future divestures of lease/mineral assets**” in order to pay dividends and principle redemptions when they became due.⁴

33. The report for Shale 17 also stressed that the last six months of 2008 would be “**a critical time in Provident’s business cycle**” requiring additional cash flow resources. In an attempt to address the risk of Provident using current investments to pay the dividends for prior investors, the Mick report for Shale 17 cautioned “**In view of the significant capital raised in prior programs, [Mick and Associates] again would like to see some level of third-party validation with respect to Provident’s financials for the remaining fiscal quarters of 2008.**” The report for Shale 19 reiterated these warnings concerning the end of 2008 and the first five months of 2009.

34. The reports additionally underscored that the areas being relied upon by Provident to generate income (the Woodford Shale Play, the Fayetteville Shale Play, and the

⁴ All emphasis contained in the quotes from the Mick reports appeared in the original reports.

Marcello Shale Play) were in the early development stages and that their potential to generate profit was largely unknown.

35. In addition, the reports repeatedly alerted broker-dealers to the fact that certain Shale offerings were advancing funds to, or buying assets from, other Shale offerings. The reports observed that, because of the lack of transparency in Provident Royalties' financial statements, it was difficult to ascertain the asset and liability positions of the Shale offerings at any given moment in time.
36. Finally, the reports cautioned that the financial statements for the affiliated Shale offerings had not been formally audited or confirmed by an outside accounting firm necessary to validate the financial information reported by Provident Royalties.
37. The final summary of both reports ended with a great amount of hedging regarding the advisability of investing in either the Shale 17 or Shale 19 offerings. Specifically, the report for Shale 17 concluded, "Although [Mick and Associates] would not object to your offering of this program to investors, this conclusion is conditioned upon our recommendations above regarding guidelines and heightened financial disclosure of affiliated party advances."
38. Significantly, Brookstone recommended and sold three of the Provident investments after [REDACTED] receipt of and failure to review the Mick report for Shale 19.
39. Shale 17 stated a 1.5% monthly rate of return (or 18% annual rate of return, un compounded). Shale 19 stated a 1.35% monthly rate of return (or 16.5% annual rate of return, un compounded). These high rates of return suggested that the risk associated with these offerings was elevated, and should have alerted Brookstone to the need for close scrutiny of the offerings.

40. Even though Mercier assumed some responsibility for conducting due diligence, [REDACTED] as president, had a supervisory responsibility to ensure that Mercier was actually conducting adequate due diligence. Furthermore, [REDACTED] never formally delegated responsibility for conducting due diligence to Mercier. Thus, [REDACTED] retained ultimate responsibility for conducting due diligence on private placements where the Firm acted as a selling agent only.
41. Prior to Mercier's employment, [REDACTED] had conducted all due diligence reviews himself. Despite the fact that Mercier was new to Brookstone and that [REDACTED] had prior experience, [REDACTED] provided Mercier with no guidance on conducting due diligence for private placements. [REDACTED] had developed and used a due diligence checklist when he served as Brookstone's chief compliance officer, but never shared the checklist with Mercier. [REDACTED] also assigned due diligence responsibility to Mercier without discussing with him or learning that he had no prior experience with oil and gas private placements.
42. [REDACTED] did not ask Mercier whether he had looked for or analyzed any third party reviews such as the Mick reports. [REDACTED] did not discuss with Mercier whether the projected annual returns of 16.5% to 18% were reasonable, considering the economic conditions in the fall of 2008. Furthermore, [REDACTED] did not ask Mercier whether he had reviewed audited financial statements.
43. Finally, [REDACTED] never reviewed any of the due diligence files maintained by Mercier or took any other action to determine whether Mercier was conducting adequate due diligence.

Brookstone's Due Diligence Regarding the Shale 22 Offering

44. Mercier terminated his employment with Brookstone on November 15, 2008. Following his departure, Brookstone promoted DZ to chief compliance officer.
45. DZ conducted due diligence on Shale 22 in January 2009. As part of her due diligence, DZ requested and reviewed the Mick report for the offering.
46. The Mick report for the Shale 22 offering contained red flags similar to the red flags in the Mick reports for the Shale 17 and Shale 19 offerings. Like those reports, the report for Shale 22 stressed the lack of transparent accounting, the inability to accurately assess assets and liabilities, the depletion of the credit line, the developmental stage of the shale properties, and the need for independent accounting.
47. Based upon the red flags contained in the Mick report, DZ recommended that Brookstone decline to participate in the sale of the Shale 22 offering, and Brookstone did not participate.

FIRST CAUSE OF ACTION

NASD Conduct Rules 2310 and 2110, and FINRA Rule 2010 – Unsuitable Sales due to Lack of Reasonable Basis – Against Respondent Brookstone

48. The Department realleges and incorporates by reference paragraphs 1- 47 above.
49. NASD Conduct Rule 2310 requires that a FINRA firm, when making a recommendation to a customer to purchase or sell a security, have reasonable grounds to believe that the recommendation is suitable for its customers. To comply with Rule 2310, a FINRA firm must have an understanding of the potential risks and rewards of the security.

50. Brookstone, acting through its registered representatives, recommended and sold the Shale 17 and Shale 19 offerings to its customers as set forth in paragraph 24 above.
51. Brookstone, through [REDACTED] and Mercier, failed to conduct adequate due diligence of the Shale 17 and Shale 19 offerings before allowing its representatives to recommend and sell the securities. Without adequate due diligence, Brookstone could not identify and understand the inherent risks of the offerings.
52. As set forth above, the Firm did not obtain and review basic information about the Shale 17 and Shale 19 offerings.
53. Because Brookstone, acting through [REDACTED] and Mercier, failed to conduct adequate due diligence, the Firm had no reasonable basis for recommending the purchases by Customers DJJ and PJ, JSK Revocable Living Trust, HKS, GAR, HF Trust, and CG and RMF Living Trust of the Shale 17 offering. Likewise, the Firm had no reasonable basis for recommending the purchases by Customers LEP and LP of the Shale 19 offering.
54. Brookstone's sales to the customers of the Shale 17 and Shale 19 offerings totaled \$815,000. Brookstone earned \$72,350 in commissions and due diligence fees on the sales.
55. The conduct described in paragraphs 48 through 54 constitutes violations by Brookstone of NASD Conduct Rules 2310 and 2110, and FINRA Rule 2010.

SECOND CAUSE OF ACTION

NASD Conduct Rules 3010 (a) and 2110, and FINRA Rule 2010 – Failure to Supervise the Due Diligence Regarding the Shale 17 and Shale 19 Offerings -- Against Respondents [REDACTED] and Brookstone Securities, Inc.

56. The Department realleges and incorporates by reference paragraphs 1- 55 above.

57. From June 2005 through June 2011, [REDACTED] was the president of Brookstone. As president, [REDACTED] was responsible for the firm's compliance with all regulatory requirements imposed upon the firm.

58. NASD Rule 2310 required Brookstone to conduct reasonable due diligence of private placements such as the Shale 17 and Shale 19 offerings prior to recommending those private placements to investors.

59. As set forth in paragraphs 1 -55 above, Brookstone failed to conduct reasonable due diligence regarding the Shale 17 and Shale 19 offerings.

60. [REDACTED] did not formally delegate the responsibility for conducting due diligence for private placements in which the firm acted as a selling agent.

61. Despite the lack of a formal delegation, [REDACTED] failed to conduct any due diligence of the Shale 17 and Shale 19 offerings. [REDACTED] did not review the due diligence package provided by the issuer, the marketing materials, the third party due diligence reports that were available, or the information regarding the issuer that was available on the internet.

62. [REDACTED] also took no steps to ensure that anyone else within Brookstone conducted due diligence of the Shale 17 and Shale 19 offerings.

63. Thus, [REDACTED] and Brookstone failed to discharge their supervisory responsibilities.

64. No one at Brookstone requested the due diligence packages offered in the Shale 17 and Shale 19 offering PPMs, and no one reviewed the third party due diligence reports. Consequently, Brookstone conducted no due diligence, beyond review of the PPMs, to determine whether it would be reasonable for the firm to recommend the securities to its customers.

65. The conduct described in paragraphs 57 through 64 constitutes violations of NASD Conduct Rules 3010(a) and 2110, and FINRA Rule 2010 by Brookstone and [REDACTED]

RELIEF REQUESTED

WHEREFORE, the Department respectfully requests that the Panel:

- A. order that one or more of the sanctions provided under FINRA Rule 8310(a) be imposed, including that the Respondents be required to disgorge fully any and all ill-gotten gains and/or make full and complete restitution, together with interest.
- B. order that the Respondents bear such costs of proceeding as are deemed fair and appropriate under the circumstances in accordance with FINRA Rule 8330.

FINRA DEPARTMENT OF ENFORCEMENT

Date: November 16, 2011

A handwritten signature in black ink, appearing to read "Laura Leigh Blackston", written over a horizontal line.

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