

**FINANCIAL INDUSTRY REGULATORY AUTHORITY
OFFICE OF HEARING OFFICERS**

DEPARTMENT OF ENFORCEMENT,

Complainant,

v.

SOURCE CAPITAL GROUP, INC.
(BD No. 36719)

Respondent.

DISCIPLINARY PROCEEDING
No. 2014038889501

COMPLAINT

The Department of Enforcement alleges:

SUMMARY

1. During the period from September 2009 through September 2014 (the “Relevant Period”), Source Capital Group, Inc. maintained an Office of Supervisory Jurisdiction (“OSJ”) in Bowling Green, Kentucky. The Bowling Green OSJ, in turn, supervised the Source branch offices in Allen, Texas and Coconut Creek, Florida. The Bowling Green OSJ, along with the Texas and Florida branch offices (collectively, the “Bowling Green Complex”), principally sold the securities of two issuers: Blue Ridge Group, Inc. and Bayou City Exploration, Inc. During the Relevant Period, Source abdicated its responsibility to supervise the Bowling Green Complex and, instead, permitted the principals of Blue Ridge and Bayou City to supervise the Firm’s registered personnel and to assert control over the Firm’s systems, operations and activities. By failing to establish and maintain a reasonable supervisory system to supervise the Bowling Green OSJ and to address the risks and potential conflicts of interest posed by Blue Ridge’s and Bayou

City's exercise of supervisory control over the Bowling Green Complex, Source violated NASD Rule 3010 and FINRA Rule 2010.

2. During the period from May 2012 through October 2013, Source permitted two principals of Blue Ridge and Bayou City, neither of whom was registered with FINRA in any capacity, to supervise personnel and activities in the Bowling Green Complex in violation of NASD Rule 1021 and FINRA Rule 2010.

3. During the period from March 2013 through January 8, 2014, Source failed to disclose material facts to prospective investors in connection with the Firm's sale of two Blue Ridge offerings and four Bayou City offerings, including that Blue Ridge and Bayou City (1) paid the expenses of the Source offices in the Bowling Green Complex, (2) paid non-cash compensation to Source registered representatives, and (3) exercised significant control over the personnel and operations of the Bowling Green Complex. As a result, Source acted in contravention of Section 17(a)(2) and 17(a)(3) of the Securities Act of 1933 ("Securities Act") and, thereby, violated FINRA Rule 2010.

4. Finally, from October 2013 through September 2014, Source failed to retain certain business-related instant messages, which were sent and received by Source personnel on a communications system maintained exclusively by Bayou City. As a result, Source violated Section 17(a) of the Securities Exchange Act of 1934 ("Exchange Act"), Exchange Act Rule 17a-4, and FINRA Rules 4511 and 2010.

RESPONDENT AND JURISDICTION

5. Source has been registered with FINRA as a member firm since October 1994. The Firm is headquartered in Westport, Connecticut. During the Relevant Period, Source had approximately 130 registered representatives and 15 branch offices.

6. Under Article IV of FINRA's By-Laws, FINRA possesses jurisdiction over Source because (a) Source currently is a FINRA member, and (b) the Complaint charges the Firm with securities-related misconduct committed while it was a FINRA member.

OTHER ENTITIES

7. Blue Ridge Group, Inc. is a Nevada corporation organized in August 1993. During the Relevant Period, Blue Ridge was engaged primarily in the business of sponsoring and managing oil and gas drilling limited partnerships.

8. Bayou City Exploration, Inc. is a Nevada corporation which was organized in November 1994 as Gem Source Incorporated. The company changed its name to Blue Ridge Energy, Inc. in May 1996 and then to Bayou City Exploration, Inc. in September 2005. During the Relevant Period, Bayou City was engaged primarily in the business of sponsoring and managing oil and gas drilling limited partnerships.

9. During the Relevant Period, Bayou City and Blue Ridge were affiliates due to common management and ownership of the companies.

10. During most of the Relevant Period, the headquarters of both Blue Ridge and Bayou City were located in the same building in Bowling Green, Kentucky. This building, known as the "Blue Ridge Building," was owned by an entity controlled by RB, who was the majority owner of Blue Ridge and the largest shareholder in Bayou City.

FACTS

A. The Bowling Green Complex

11. During the Relevant Period, Source Chief Financial Officer RN was responsible for supervising the manager of the Bowling Green OSJ who, in turn, was responsible for supervising representatives within the Bowling Green Complex.

12. From at least September 2009 through October 2013, the manager of the Bowling Green OSJ was KC. In September 2013, KC entered into a Letter of Acceptance, Waiver and Consent, in which he was suspended from association with any FINRA member in any capacity for three months and fined \$10,000. Without admitting or denying the allegations, KC consented to the described sanctions and to the entry of findings that, among other things, he sold or caused the sale of securities issued by Blue Ridge without adequately disclosing that Blue Ridge provided funds to KC that he then used to pay brokers who sold Blue Ridge investments. Following the three-month suspension described above, KC did not return to Source, but instead, began working for Bayou City.

13. In November 2013, Source hired ML to replace KC as the manager of the Bowling Green OSJ. KC was the spouse of SL, who, during the Relevant Period, was the President and CEO of both Blue Ridge and Bayou City.

14. During the Relevant Period, Source was the sole-broker dealer used by Blue Ridge and Bayou City to sell their offerings. Virtually all of the revenue generated by the Bowling Green Complex during the Relevant Period was from the sale of the offerings of Blue Ridge, Bayou City and another affiliated issuer.

B. Blue Ridge and Bayou City Provided Office Space for the Bowling Green Complex and Paid the Bowling Green Complex's Operating Expenses

15. From 2003 until approximately the end of 2013, Source's Bowling Green OSJ was located in the same building as the joint headquarters of Blue Ridge and Bayou City. The rent for this office space was paid for by Blue Ridge.

16. On March 1, 2011 and again on March 1, 2013, Source entered into agreements with Blue Ridge and Bayou City in which the issuers agreed to provide the Source offices within the Bowling Green Complex with a range of services, including accounting, human resources, and other administrative and professional services. In addition, Blue Ridge and Bayou City agreed to pay certain of the Bowling Green Complex's administrative expenses. For example, during the period from August 2012 through February 2014, Bayou City paid \$157,741.92 in expenses for the Bowling Green Complex.

C. The Bowling Green Complex Used Blue Ridge's and Bayou City's Computer Systems and Programs

17. To sell Blue Ridge and Bayou City securities, Source brokers in the Bowling Green Complex used the Central Lead System ("CLS"), a computer program designed and implemented by a Blue Ridge employee, to track sales leads.

18. Blue Ridge and Bayou City also required Source brokers to use a program provided by Blue Ridge and Bayou City called DataTrak, which Blue Ridge and Bayou City then used to monitor Source brokers' activities, including the number of sales calls brokers made and the number of sales successfully closed.

19. In addition, during the Relevant Period, Source representatives within the Bowling Green Complex communicated using an instant-messaging system maintained by Bayou City, not Source. Although Source representatives used this instant-messaging system to

send and receive business-related communications, Source did not take any steps to preserve and retain these communications. In fact, when FINRA Staff asked Source personnel for a copy of certain instant-messages, the Firm replied that it could not access those messages because (1) the system was controlled by Bayou City, not Source, and (2) the system only retained the five most-recent messages and continually deleted all previous messages.

D. Blue Ridge and Bayou City Executives Supervised Source Representatives

20. During the Relevant Period, SL was the President and CEO of Blue Ridge and Bayou City and HP was a Senior Vice President with Bayou City. Neither SL nor HP has ever been registered with FINRA in any capacity.

21. During the period of at least May 2012 through at least October 2013, SL exercised significant control over the operations of the Bowling Green Complex.

22. During this period, SL communicated regularly with Source's managers within the Bowling Green Complex. SL provided direction to those managers on various areas of management, including the hiring, registration, performance and supervision of Source brokers.

23. For example, in an email dated March 30, 2012, a Source manager requested SL's permission to register two Source brokers in certain states. SL responded, "No. Call to discuss."

24. SL also used Blue Ridge's and Bayou City's control of the CLS and DataTrak systems to track and manage the sales efforts of Source brokers.

25. Similarly, during the period of at least May 2012 through at least October 2013, HP exercised significant control over the operations of the Bowling Green Complex. During this period, HP participated in interviewing, hiring, and firing Source brokers. HP also determined which Source brokers would receive sales leads to sell Blue Ridge and Bayou City offerings.

E. Blue Ridge and Bayou City Paid Source Representatives Non-Cash Compensation

26. Between in or about August 2011 and June 2013, Blue Ridge and Bayou City paid Source representatives non-cash compensation on numerous occasions. This non-cash compensation included airfare, hotel accommodations, and other travel expenses for Source representatives and their families, and totaled several thousand dollars. Blue Ridge and Bayou City paid this non-cash compensation to select Source representatives in consideration for their sales of Blue Ridge and Bayou City offerings.

F. Source Failed to Disclose Material Facts in connection with Blue Ridge and Bayou City Offerings

27. Prior to March 2013, the private placement memoranda used by Source to solicit investors in Blue Ridge and Bayou City offerings disclosed that Blue Ridge or Bayou City paid certain expenses for the Bowling Green Complex. For example, a private placement memorandum for a Blue Ridge offering sold by Source, dated May 15, 2012, provided: “In addition, certain overhead expenses of the Source Capital branch office located in Bowling Green, Kentucky are paid by Blue Ridge.”

28. In March 2013, at RN’s direction, this disclosure language was removed from the private placement memoranda used to solicit investors for Blue Ridge and Bayou City offerings, even though Blue Ridge and Bayou City continued to pay expenses for the Bowling Green Complex as detailed in paragraphs 15 – 16 above.

29. From March 8, 2013 through at least January 8, 2014, the private placement memoranda for the following two Blue Ridge offerings and four Bayou City offerings failed to contain any disclosure language addressing the payment of Source expenses by the issuers as detailed in paragraphs 15 – 16 above:

- Blue Ridge Group, Inc. 2013 Seabreeze Offset Drilling Program, LP dated March 8, 2013;
- Blue Ridge Group, Inc. 2013 Seabreeze Field Development, LP dated July 1, 2013;
- Bayou City Exploration, Inc. 2013 Seabreeze Offset Drilling Program LP dated March 8, 2013;
- Bayou City Exploration, Inc. 2013 Seabreeze Field Development, LP dated July 1, 2013;
- Bayou City Exploration, Inc. 2013 Mississippian Development Program, LP dated September 19, 2013; and
- Bayou City Exploration, Inc. 2014 Illinois Basin Drilling Program, LP dated January 8, 2014.

30. The private placement memoranda also failed to disclose that Blue Ridge and Bayou City had paid Source representatives non-cash compensation as detailed in paragraph 26 above and that SL and HP exercised significant control over the operations of the Bowling Green Complex as detailed in paragraphs 20 – 25 above.

**FIRST CAUSE OF ACTION
FAILURE TO ESTABLISH, MAINTAIN AND ENFORCE
AN ADEQUATE SUPERVISORY SYSTEM
(Violations of NASD Rule 3010 and FINRA Rule 2010)**

31. The Department realleges and incorporates by reference paragraphs 1 through 30 above.

32. NASD Rule 3010(a) required a member “to establish and maintain a system to supervise the activities of each registered representative, registered principal, and other associated person that is reasonably designed to achieve compliance with applicable securities laws and regulations, and with applicable NASD [and FINRA] Rules.”

33. NASD Rule 3010(b) required a member to “establish, maintain, and enforce written procedures . . . to supervise the activities of registered representatives . . . that are reasonably designed to achieve compliance with applicable securities laws and regulations, and with the applicable Rules of NASD [and FINRA].”

34. FINRA Rule 2010 requires members and associated persons, in the conduct of their business, to “observe high standards of commercial honor and just and equitable principles of trade.”

35. During the Relevant Period, Source failed to establish, maintain and enforce a supervisory system, including written procedures, reasonably designed to address the risks and potential conflicts of interest posed by Blue Ridge’s and Bayou City’s exercise of supervisory control over the Bowling Green Complex.

36. Throughout this period, Source was aware of certain risks and red flags that required further scrutiny to ensure that the representatives within the Bowling Green Complex remained independent from Blue Ridge and Bayou City. Among other things, Source was aware of the close relationship between, on the one hand, Blue Ridge and Bayou City; and on the other hand, certain Source personnel within the Bowling Green Complex, including KC and ML. Source also was aware that Blue Ridge and Bayou City provided office space and paid expenses for the Source offices, and that Source personnel used computer systems owned and controlled by Blue Ridge and Bayou City, not Source.

37. Despite this knowledge, Source failed to take any reasonable steps to ensure that Source personnel remained independent from Blue Ridge and Bayou City. Instead, Source abdicated its supervisory responsibilities by permitting the principals of Blue Ridge and Bayou City to control the Firm’s representatives, systems, and operations.

38. As a result of the foregoing, Source violated NASD Rule 3010 and FINRA Rule 2010.

**SECOND CAUSE OF ACTION
UNREGISTERED PRINCIPALS
(Violations of NASD Rule 1021 and FINRA Rule 2010)**

39. The Department realleges and incorporates by reference paragraphs 1 through 38 above.

40. NASD Rule 1021(a) provides, in pertinent part, that: "All persons engaged or to be engaged in the investment banking or securities business of a member who are to function as principals shall be registered as such with NASD in the category of registration appropriate to the function to be performed as specified in Rule 1022."

41. During the period of at least May 2012 through at least October 2013, Source permitted SL to engage in activities requiring principal registration. SL was not registered with FINRA in any capacity during any time relevant to this Complaint.

42. During the period of at least May 2012 through at least October 2013, Source permitted HP to engage in activities requiring principal registration. HP was not registered with FINRA in any capacity during any time relevant to this Complaint.

43. As a result of the foregoing, Source violated NASD Rule 1021 and FINRA Rule 2010.

**THIRD CAUSE OF ACTION
FAILURE TO DISCLOSE MATERIAL FACTS IN SALE OF LIMITED PARTNERSHIP INTERESTS
(Violations of FINRA Rule 2010)**

44. The Department realleges and incorporates by reference paragraphs 1 through 43 above.

45. Section 17(a)(2) of the Securities Act of 1933 prohibits, in the offer or sale of any securities using interstate commerce, obtaining "money or property by means of any untrue

statement of a material fact or any omission to state a material fact necessary in order to make the statements made, in light of the circumstances under which they were made, not misleading.”

46. Section 17(a)(3) of the Securities Act prohibits, in the offer or sale of any securities using interstate commerce, engaging “in any transaction, practice, or course of business which operates or would operate as a fraud or deceit upon the purchaser.”

47. The Blue Ridge and Bayou City partnership interests sold by the representatives in the Bowling Green Complex listed in paragraph 29 above were securities. Accordingly, Source was required to disclose all material facts and was prohibited from making any material misrepresentations to its customers in connection with the sale of these Blue Ridge and Bayou City partnership interests.

48. During the period from March 8, 2013 through January 8, 2014, in connection with the sale of the Blue Ridge and Bayou City limited partnerships listed in paragraph 29 above, by the means and instrumentalities of interstate commerce, Source failed to disclose material facts to prospective investors. Specifically, Source failed to disclose that: the issuers paid expenses of the Source offices in the Bowling Green Complex; the issuers paid non-cash compensation to Source registered representatives; and SL and HP exercised significant control over the personnel and operations of the Bowling Green Complex.

49. As a result of the foregoing, Source acted in contravention of Sections 17(a)(2) and 17(a)(3) of the Securities Act, and thereby violated FINRA Rule 2010, and independently violated FINRA Rule 2010.

**FOURTH CAUSE OF ACTION
FAILURE TO PRESERVE ELECTRONIC COMMUNICATIONS
(Violations of Section 17(a) of the Securities Exchange Act of 1934,
Exchange Act Rule 17a-4, and FINRA Rules 4511 and 2010)**

50. The Department realleges and incorporates by reference paragraphs 1 through 49 above.

51. Section 17(a) of the Exchange Act and Rule 17a-4(b)(4) promulgated thereunder requires members to preserve, for a period of not less than three years, electronic and other communications relating to their business as broker-dealers.

52. FINRA Rule 4511 requires members to make and preserve books, accounts, records, memoranda, and correspondence in conformity with all applicable laws.

53. During the period from October 2013 through September 2014, Source failed to retain and preserve business-related instant messages sent and received by Source representatives within the Bowling Green Complex.

54. As a result of the foregoing, Source violated Section 17(a) of the Exchange Act and Rule 17a-4(b)(4) promulgated thereunder, and FINRA Rules 4511 and 2010.

RELIEF REQUESTED

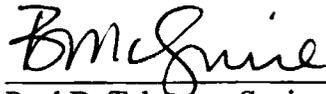
WHEREFORE, the Department respectfully requests that the Panel:

- A. make findings of fact and conclusions of law that the Respondent committed the violations charged and alleged herein;
- B. order that one or more of the sanctions provided under FINRA Rule 8310(a), including that Respondent be required to disgorge fully any and all ill-gotten gains, together with interest; and

- C. order that the Respondent 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: 12/23/16



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