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

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| DEPARTMENT OF ENFORCEMENT,<br><br>Complainant,<br><br>v.<br><br>SHOPOFF SECURITIES, INC.<br>(CRD No. 142866),<br><br>WILLIAM A. SHOPOFF<br>(CRD No. 1273471),<br><br>and<br><br>STEPHEN R. SHOPOFF<br>(CRD No. 5276325),<br><br>Respondents. | Disciplinary Proceeding<br>No. 2016048393501<br><br>Hearing Officer–MC<br><br>**EXTENDED HEARING PANEL DECISION**<br><br>May 21, 2020 |

**The Department of Enforcement did not prove by a preponderance of the evidence that Respondents engaged in fraudulent sales of securities or made unsuitable recommendations to investors. The Complaint is dismissed.**[1]

*Appearances*

For the Complainant: Carolyn O'Leary, Esq., Gina Petrocelli, Esq., and Payne L. Templeton, Esq., Department of Enforcement, Financial Industry Regulatory Authority

For the Respondent: Michael J. Watling, Esq. and Russell G. Ryan, Esq., King & Spalding LLP, and Bruce B. Kelson, Esq., Laurel Gift, Esq., Courtney Devon Taylor, Esq., and Randall P. Hsia, Esq., Schnader Harrison Segal & Lewis LLP

[1] By consent, Enforcement filed its "First Amended Complaint" on April 1, 2019, correcting several typographical errors that did not affect the substance of the charges. This Decision refers to the First Amended Complaint as the "Complaint" or "Compl."

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# DECISION

## I. Introduction

The underlying premise of the Complaint in this disciplinary proceeding is that from December 2010 through March 2017, Respondent Shopoff Securities, Inc., through Respondents William and Stephen Shopoff, defrauded investors to obtain desperately needed cash to prop up a failing enterprise. They allegedly did so by selling $12.47 million in promissory notes to fund the real estate investment business belonging to William Shopoff and his wife. Three of the Complaint's four causes of action allege violations of Section 10(b) of the Securities Exchange Act of 1934 ("Exchange Act"), Rule 10b-5 thereunder, and FINRA Rules 2020 and 2010. The remaining cause of action alleges that Respondents' recommendations were unsuitable in violation of NASD Rule 2310(b) and FINRA Rules 2111(a) and 2010. Based on the egregiousness of their alleged wrongdoing, Enforcement seeks to permanently bar William and Stephen Shopoff from associating with any FINRA member firm in any capacity, expel Shopoff Securities, Inc. from the securities industry, and compel Respondents to disgorge $134,070 in commissions gained from sales of securities they offered to investors through other broker-dealers.

It is undisputed that Respondents limited their solicitations to 29 family members and friends, all affluent customers who knew Respondents and had previously invested with them. None of the customers lost money or complained that Respondents misled them. The non-family members have been repaid in full with interest as promised. At the time of the hearing, of the $12.47 million in notes issued over roughly six years, about $1.1 million in principal and interest remained to be repaid to several family members.

After carefully reviewing the evidence presented and the testimony given during the hearing, assessing the credibility of the witnesses, and considering the parties' extensive pre-hearing and post-hearing briefing and the applicable rules and law, the Panel concludes that the evidence is insufficient to establish the elements essential to prove fraud. Critically, there is insufficient evidence to support the allegations that Respondents made material misrepresentations and omissions, acted intentionally or recklessly to defraud the note purchasers, and recommended the notes without a reasonable basis to believe the notes were suitable investments for the purchasers.

The Complaint is therefore dismissed.

## II. Background

### A. Respondents

William Shopoff founded Shopoff Securities, Inc. in 2006. He and his wife, Cindy Shopoff, own the firm through their family trust, the Shopoff Revocable Trust ("Shopoff Trust"),

of which they are the only trustees and primary beneficiaries.[2] The Respondent firm, Shopoff Securities, registered with FINRA in May 2007. Its main office is in Irvine, California. At the hearing, William Shopoff stated that Shopoff Securities has six or seven employees.[3]

William Shopoff is the President and Chief Executive Officer of Shopoff Securities. He is registered with FINRA through Shopoff Securities as a General Securities Principal, a Direct Participation Programs Principal, and a Corporate Securities Representative.[4]

Stephen Shopoff, William Shopoff's older brother,[5] has been associated with Shopoff Securities since its founding.[6] He is registered through Shopoff Securities as a General Securities Principal, a Direct Participation Programs Representative, and a Corporate Securities Representative. His title at the firm is Senior Vice President, Investor Relations.[7] Stephen Shopoff worked full time at Shopoff Securities until 2015, when he scaled back to work half time. While working full time, he had a broad range of responsibilities, including raising capital, working with limited partners, preparing quarterly reports, and generally assisting his brother.[8]

### B. The Shopoff Real Estate Business

In the late 1980s, William and Cindy Shopoff became partners in a residential and commercial real estate business in Austin, Texas, during the savings and loan crisis and real estate market downturn.[9] According to William Shopoff, for a time they were "dead broke." Over the years, their business weathered economic swings in the real estate market.[10] The business grew and acquired assets in Southern California, leading them to relocate there in January 2001.[11]

After moving to California, their business grew until it peaked with about 50 employees in 2007. Then, starting in 2008, with the onset of the real estate crash and recession, the staff shrank to 15. The Shopoffs invested almost $11 million of their own cash to keep the business

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[2] Hearing Transcript ("Tr.") 63–64; Answer ("Ans.") ¶ 11; Complainant's Exhibit ("CX-") 95, at 5.

[3] Tr. 1493–94.

[4] Tr. 62–63; CX-95, at 5, 7; CX-99, at 5.

[5] Tr. 830.

[6] Tr. 749; CX-96, at 6.

[7] Tr. 749.

[8] Tr. 750–53. FINRA has jurisdiction over Shopoff Securities pursuant to Article IV of FINRA's By-Laws because it is a current FINRA member and the Complaint charges the firm with securities-related misconduct committed during its period of membership. William and Stephen Shopoff are currently registered with FINRA and therefore subject to FINRA's jurisdiction under Article V, Section 4, of the By-Laws.

[9] Tr. 1318–20.

[10] Tr. 1487.

[11] Tr. 1324.

alive.[12] William Shopoff attributes the survival of the Shopoff business partly to their good fortune in having profitably sold two assets in early 2008, just before the economy severely deteriorated.[13]

In 2010, after more than 30 years in the real estate business, William Shopoff considered retiring. However, he and his wife decided instead to make one more sustained effort to rebuild the business. In the years since, the Shopoff business has recovered and expanded into almost 200 entities.[14]

### C. Shopoff Realty

One of the Shopoff's real estate investment business entities is Shopoff Realty Investments, L.P. William and Cindy Shopoff formed Shopoff Realty in 2004.[15] Shopoff Realty is a limited partnership that, like Shopoff Securities, is wholly owned by William and Cindy Shopoff through the Shopoff Trust. Shopoff Realty is the primary operating entity of the Shopoff group of companies, and the Shopoffs have conducted their real estate business chiefly through it and its affiliates.[16] William Shopoff is President of Shopoff Realty.[17] Cindy Shopoff is Executive Vice President and runs the company's day-to-day operations.[18] Stephen Shopoff is Senior Vice President for Investor Relations.[19] At the hearing, William Shopoff testified that Shopoff Realty has nearly 60 employees.[20] He estimated that over the years he has personally invested more than $20 million in Shopoff Realty.[21]

Shopoff Realty purchases undeveloped and commercial income-producing real estate that can be improved or repositioned.[22] Shopoff Realty does some conventional real estate development: purchasing, improving, and selling office and apartment buildings.[23] But it also

[12] Tr. 1331–33.

[13] Tr. 1487.

[14] Respondent's Post-Hr'g Br. 14.

[15] Tr. 70–71, 1327. The business was originally named the Shopoff Group L.P., and became Shopoff Realty in 2014. There was no change in the ownership. Tr. 65, 237. For simplicity we refer to both the Shopoff Group, L.P. and Shopoff Realty Investments, L.P. as Shopoff Realty.

[16] Tr. 66; CX-10, at 9. The Shopoff Trust is the sole limited partner of Shopoff Realty, with a 99% interest; the general partner, with a 1% interest, is TSG GP, LLC, which is also owned by the Shopoff Trust. Tr. 71.

[17] CX-95, at 5.

[18] Tr. 1317.

[19] Tr. 748–49.

[20] Tr. 1492–94.

[21] Tr. 1831.

[22] Tr. 58.

[23] Tr. 732.

engages in what Cindy Shopoff describes as "land entitlement."[24] The Shopoffs' specialty, according to William Shopoff, is to identify property with "untapped value," obtain the permits required to change the property's land use, rezone it, and sell it at a substantial profit.[25] For example, they purchased 20 acres in Anaheim, California with a large warehouse and provided the seller with a short-term lease that generated income while they obtained land use change permits and rezoned the property from industrial to residential—partly for apartments, and partly for single-family home sites. They purchased the property for $38 million and within three years sold it to builders for $68 million.[26]

### D. Funding Shopoff Realty

In 2006, William and Cindy Shopoff formed TSG Fund IV, L.P.[27] to raise cash for Shopoff Realty by selling shares in the limited partnership.[28] Investors received an annual ten percent interest rate on an 18-month unsecured note.[29] Investors' funds went to TSG Fund IV to lend to Shopoff Realty to use for "any working capital needs" of its own or its affiliates.[30] Along with other information, the TSG Fund IV offering provided investors with a private placement memorandum ("2006 PPM") that disclosed risk factors and described prospective revenues from real estate projects that Shopoff Realty was engaged in and expected to close in late 2007.[31] William Shopoff, as manager of TSG Fund IV, offered $5 million in limited partnership interests in 2006.[32]

In 2010, the annual combined revenue of Shopoff Realty and Shopoff Securities was slightly less than $1 million. As the economy began to recover, revenues increased and William Shopoff decided to sell the notes at issue in this proceeding and, he testified, use the funds raised as working capital and for general corporate purposes of Shopoff Realty.[33] TSG Fund IV and another entity, Shopoff Enterprises, Inc., issued the notes. Later, Shopoff Realty sponsored two private placements, Shopoff Land Fund III and Shopoff Land Fund IV, also subject to these proceedings.

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[24] Tr. 1327.

[25] Tr. 734–35.

[26] Tr. 734–36.

[27] CX-1, at 47. TSG GP, LLC is the general partner of TSG Fund IV, L.P.

[28] CX-1, at 4.

[29] CX-1, at 4; Tr. 80–82.

[30] CX-1, at 4.

[31] CX-1, at 2–26.

[32] Tr. 82. The Complaint alleges no misconduct related to the 2006 offering.

[33] Tr. 827–28, 1486.

### 1. The Class C Note Offering

According to William Shopoff, borrowing money is part of his normal course of business, but in 2010, in the aftermath of the economic downturn, he was unable to borrow from the banks he had previously dealt with.[34] It was a "very difficult time" for Southern California's real estate industry.[35] The Shopoffs' real estate business needed cash but bank lending had become "very, very dry."[36] They decided to take a different approach.[37] The Shopoffs describe it as creating mutually beneficial relationships with friends and family, enabling those with available cash to lend operating capital for the Shopoffs' business and in return earn interest while waiting for the recovering economy to provide other investment opportunities.[38] William Shopoff testified it made him "happier" to pay interest to friends and family than to an institutional lender. Even though he paid them higher interest than he would have paid a bank, it was "not that much money" because the interest was tax deductible. William Shopoff estimates the allowable tax deductions "paid" about half the cost of the interest.[39]

In July 2010, William Shopoff amended the TSG Fund IV Limited Partnership Agreement.[40] The amendment altered the structure of TSG Fund IV by creating three classes of limited partners. First, limited partners holding interests in the original 2006 offering were designated collectively as "Class A" limited partners. Second, other original limited partners converted their partnership interests into shares of a different Shopoff entity, Shopoff Properties Trust, and became "Class B" limited partners. Third, purchasers of a new issue of notes would constitute "Class C" noteholders.[41]

From December 2011 to January 2017, Respondents recommended and sold Class C notes to 13 individuals for $1.57 million.[42] Unlike the 2006 Class A limited partnership interests,

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[34] Tr. 1495–96, 1498.

[35] Tr. 868–69.

[36] Tr. 872.

[37] Tr. 1500.

[38] Tr. 872–73.

[39] Tr. 1498–1500.

[40] CX-1, at 31.

[41] CX-1, at 31–32.

[42] Appendix A of the Complaint ("Compl. Appendix A") incorrectly identifies the date of the first Class C note purchase as November 9, 2011, by customer JMS. The correct purchase date of that note is November 9, 2015. CX-162, at 1. The first Class C note purchase was actually on December 1, 2011, by customer TS. CX-187, at 1.

The Complaint's first cause of action charges 19 fraudulent transactions totaling $1.67 million. Compl. ¶¶ 21–22; Compl. Appendix A. The charges were based on erroneous information provided by Respondents. At the hearing, William Shopoff testified that Stephen Shopoff's January 27, 2016 note purchase for $105,000 was erroneously attributed to Customer JMS. Based on this testimony, Enforcement withdrew its allegations related to that note purchase, thus reducing the total amount of allegedly fraudulent Class C note purchases from $1.67 million to $1.57 million. Enforcement's Post-Hr'g Br. 3 n.8.

each Class C note's terms were individually negotiated—including amount, interest rate, timing of interest payments, maturity date—and varied from note to note.[43]

#### 2. The Shopoff Enterprises, Inc. Note Offering

William Shopoff formed Shopoff Enterprises, Inc., a Texas real estate brokerage company, in 1981. He is its President. He and Cindy Shopoff own Shopoff Enterprises through the Shopoff Trust.[44] From December 2010 through February 2017 ("Notes Period"), Respondents sold 42 Shopoff Enterprises notes to 23 customers for approximately $10.9 million.[45] Some of these customers also purchased Class C notes.[46]

#### 3. The Shopoff Land Fund III and Shopoff Land Fund IV Offerings

Shopoff Realty sponsored two private placement limited partnership offerings, Land Fund III, marketed from May 2014 through September 2015, and Land Fund IV, marketed from September 2015 through October 2016.[47] Shopoff Securities sold them directly to its customers and reached selling agreements with several other broker-dealers it authorized to sell to their customers.[48] Shopoff Securities received commissions from sales by the other broker-dealers of less than two percent.[49] The other broker-dealers sold about $3.4 million in Land Fund III and about $3.2 million in Land Fund IV, generating $134,070 in commissions to Shopoff Securities.[50]

## III. The Disciplinary Proceeding

### A. The 2014 Cycle Examination: Origins of This Proceeding

The events leading to the filing of the Complaint in this disciplinary proceeding began when FINRA's Member Regulation Department initiated a routine FINRA cycle examination of Shopoff Securities in the fourth quarter of 2014.[51] By the end of 2015, the cycle examiners concluded that Shopoff Securities had failed to make several timely amendments to its Uniform

[43] Tr. 118, 717–18, 783–84.

[44] Compl. ¶¶ 37–39; Ans. ¶¶ 37–39.

[45] Compl. ¶ 39; Ans. ¶ 39. Enforcement refers to the notes as investments, Respondents call them loans.

[46] Compl. Appendix A; Appendix B of the Complaint ("Compl. Appendix B").

[47] Tr. 537; CX-224; CX-13a; CX-73a.

[48] Tr. 537–38; CX-74–CX-76; CX-78.

[49] Tr. 631–34.

[50] Tr. 1108-09; CX-224.

[51] Tr. 701-02, 1966-67; Respondents' Exhibit ("RX")-18, at 1.

Application for Securities Industry Registration or Transfer ("Form U4") and needed to improve its written supervisory procedures pertaining to disclosures on Form U4.[52]

In a letter dated December 14, 2015, Member Regulation informed William Shopoff that it was referring findings "related to private placement offerings . . . and disclosure of adverse financial events on Form U4" to Enforcement "for its review and disposition." The letter did not explain why Member Regulation included the private placement offerings in its referral.[53]

On January 22, 2016, Enforcement issued its initial investigatory requests to Shopoff Securities for production of documents pursuant to FINRA Rule 8210. Enforcement sought bank and financial statements for a number of Shopoff Securities affiliates.[54] There were numerous follow-up document requests. Ultimately, Shopoff Securities produced over 1.1 million documents that constituted much of the discovery Enforcement produced to Respondents after filing the Complaint.[55]

Enforcement also conducted on-the-record interviews ("OTRs") of William and Stephen Shopoff, as well as Sandra Sciutto, Shopoff Realty's Chief Financial Officer ("CFO") from November 2012 through April 2016.[56] Enforcement filed the Complaint in January of 2019. The eight-day hearing occurred in November 2019. Enforcement presented its case through the testimony of William and Stephen Shopoff; a FINRA examiner who participated in the 2014 Shopoff Securities cycle examination; and the OTR transcripts. Respondents presented their case through William, Cindy, and Stephen Shopoff; five Shopoff Securities customers; the former chief executive officer of a company that issued due diligence reports on Shopoff Realty; and the FINRA investigator who participated in Enforcement's investigation, attended the OTRs, and prepared memoranda of Enforcement's interviews of noteholders.

### B. Complaint and Answer

The first three causes of action are directed at all three Respondents. The first relates to the Class C note offering and the second to the Shopoff Enterprises offering. Both allege that Respondents sold the promissory notes fraudulently. The third cause of action alleges that Respondents' recommendations of the notes were unsuitable.

The fourth cause of action charges only Shopoff Securities and William Shopoff with fraudulent sales of securities by providing false information about William and Cindy Shopoff's cash assets for inclusion in third-party due diligence reports. The company producing the reports

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[52] RX-18, at 3–5. Member Regulation conducted a telephonic exit review of its findings with Shopoff Securities in March 2015. RX-18, at 4.

[53] RX-18, at 5.

[54] CX-211.

[55] Declaration of Carolyn O'Leary in Support of Enforcement's Opposition to Respondents' Motion to Compel ("O'Leary Decl.") 5–6.

[56] CX-65, at 6.

sent them to broker-dealers who recommended investments in the Land Fund III and Land Fund IV private placement offerings Shopoff Realty sponsored from May 2014 through October 2016.

Respondents challenge Enforcement's characterization of the notes in the first two causes of action. Respondents contend they are not securities but "working capital loans" that family and friends made to two Shopoff Realty affiliates for the benefit of Shopoff Realty. Because they are not securities, Respondents contend, they are not subject to securities laws and regulations, and not within FINRA's jurisdiction.[57] As for the fourth cause of action, Respondents claim the third-party due-diligence reports' representation of William and Cindy Shopoff's liquidity was accurate, and not misleading.[58]

### 1. First Cause: The Class C Notes

As described above, TSG Fund IV is a limited partnership William Shopoff formed in 2006 to raise capital for Shopoff Realty. In 2006, it issued an offering for investors to purchase limited partnership interests under terms described in the 2006 PPM provided with the other offering materials.[59]

The first cause of action focuses on the Class C notes Respondents began offering years later, in December 2011. Thirteen customers purchased a total of approximately $1.57 million in Class C notes during the Notes Period.[60]

A key allegation in the Complaint is that Respondents sold the Class C notes using the 2006 PPM purportedly given to all purchasers.[61] By December 2011, the 2006 PPM was outdated. Enforcement asserts that the PPM underestimated Shopoff Realty's debts; inaccurately projected income Shopoff Realty could receive from pending real estate deals; and named two executives who no longer worked for Shopoff Realty in its list of managers.[62] In addition, the PPM allegedly omitted material facts concerning how proceeds of note sales would be used and Shopoff Realty's limited liquidity and reliance on cash "infusions" from William Shopoff and the Shopoff Trust.[63]

Respondents provided Class C note purchasers with a subscription agreement and a Loan Agreement Guaranty ("Guaranty").[64] The Complaint alleges that the subscription agreement

[57] Ans. 2, ¶ 1.

[58] *Id*. 3.

[59] Compl. ¶ 20.

[60] *Id*. ¶¶ 19, 21.

[61] *Id*. ¶ 111.

[62] *Id*. ¶ 112.

[63] *Id*. ¶ 113.

[64] *Id*. ¶¶ 31, 33.

falsely represented that TSG Fund IV had no current financial or operating history.[65] The Guaranty, signed by William and Cindy Shopoff, committed the Shopoff Trust to repay customers their principal and interest if TSG Fund IV defaulted. The Complaint alleges that the Guaranty failed to disclose material facts about the Shopoffs' net worth, liquidity, available cash balance, and the actual value of their assets.[66]

The Complaint also charges William and Stephen Shopoff with orally misrepresenting material facts when they told investors their funds would be used as working capital for general corporate purposes of Shopoff Realty and its affiliates.[67]

The first cause of action further alleges that when they asked noteholders to extend the maturity dates on their notes, Respondents failed to inform them that TSG Fund IV and Shopoff Realty were experiencing serious financial difficulties requiring them to extend maturity dates and repayment deadlines.[68]

The Complaint states that this conduct violated Section 10(b) of the Exchange Act ("Section 10(b)"), Rule 10b-5 thereunder, and FINRA Rules 2020 and 2010.

Specifically addressing the first cause of action, Respondents deny using or distributing the 2006 PPM when they sold Class C notes.[69] They deny that the subscription agreement contained any material false representations, and that they omitted material disclosures from the Guaranty.[70]

Respondents admit that some Class C noteholders voluntarily extended or amended the terms of their notes, either on their own initiative or in response to a request from William or Stephen Shopoff, but deny failing to disclose material adverse facts about Shopoff Realty or TSG Fund IV's ability to pay noteholders when the notes matured.[71]

**a. The 2006 PPM**

Enforcement emphasizes the 2006 PPM's role in Respondents' allegedly fraudulent sales of the Class C notes. A key allegation is that William and Stephen Shopoff gave the PPM to each

[65] *Id*. ¶ 114.

[66] *Id*. ¶¶ 33–35, 115.

[67] *Id*. ¶ 118.

[68] *Id*. ¶¶ 36, 121–22.

[69] Ans. ¶ 111.

[70] *Id*. ¶¶ 114–15.

[71] *Id*. ¶ 36.

purchaser in connection with the sales of the Class C notes. Enforcement argues the PPM was "materially false and misleading" in six significant ways.[72]

First, Enforcement asserts, the 2006 PPM "falsely described" Shopoff Realty's debt as $2.8 million when, according to Shopoff Realty's balance sheets, at the outset of the Class C note offering it was much higher—an estimated $21 million—and by December 31, 2012, it exceeded $25 million, compared to less than $2 million in assets.[73]

Second, Enforcement points to projections contained in the 2006 PPM stating that Shopoff Realty expected to earn $40 million in profits from selling five real estate projects by the end of 2007. Enforcement states that none were sold in 2007; some were sold at a loss in 2009, 2011, and 2014; and one was still unsold as late as November 2019.[74]

Third, Enforcement claims the 2006 PPM "falsely identified" Shopoff Realty's Chief Financial Officer and a Senior Vice President for Land Acquisitions, both of whom had resigned by December 2012.[75]

Fourth, Enforcement asserts the 2006 PPM stated that TSG Fund IV's repayment of its debt obligations would derive from Shopoff Realty's income and cash flow, failing to disclose that Shopoff Realty was experiencing "substantial cash flow and liquidity issues starting in 2011 and had net losses in 2013."[76]

Fifth, Enforcement asserts that the 2006 PPM represented that Shopoff Realty would use investor proceeds for its and its affiliates' working capital needs without disclosing that some investor proceeds would be used to repay previous Class C note buyers.[77]

Sixth, Enforcement points out that the 2006 PPM described the maximum size of the offering as $5 million, when Respondents actually raised more than $6 million.[78]

Enforcement claims these facts and omissions are material because Shopoff Realty's debt burdens, asset structure, liquidity issues, as well as the identities of two senior officers, the uses of the investors' proceeds, and the size of the offering would be "important to any reasonable investor."[79] Enforcement charges that Respondents knew the PPM made these

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[72] Enforcement's Post-Hr'g Br. 6.

[73] *Id*.; CX-11; CX-12.

[74] Enforcement's Post-Hr'g Br. 6.

[75] *Id*. at 6–7.

[76] *Id*. at 7.

[77] *Id*. at 7–8.

[78] *Id*. at 8.

[79] *Id*. at 29.

misrepresentations and omissions, or else were reckless in ignoring information available to them.[80]

### b. Enforcement's Evidence That Respondents Gave the 2006 PPM to All Purchasers of Class C Notes

Enforcement relies heavily on its conclusion that Respondents used the outdated and misleading 2006 PPM in selling Class C notes. We now review the evidence that led Enforcement to its conclusion.

On December 29, 2014, a FINRA examiner participating in the cycle examination asked Shopoff Securities to provide PPMs for a number of offerings, including TSG Fund IV. The next day Shopoff Securities provided a file containing eight PPMs, including the 2006 PPM.[81]

On June 24, 2016, Enforcement sent an "Investor Spreadsheet" to Respondents asking them to fill in information about all three classes of TSG Fund IV offerings. The spreadsheet required Respondents to identify the documents given to each investor.[82] The information Respondents provided in the spreadsheet for purchasers of Class A and B limited partnership interests from the 2006 offering, and the later-issued Class C notes, is identical. The spreadsheet states that each Class A, B, and C investor received the PPM, subscription documents, and quarterly reports.[83]

Furthermore, some of the transaction documents signed by Class C note purchasers appear to refer to a PPM. William and Stephen Shopoff signed one of those forms, "Broker-Dealer and Registered Representative Information" in December 2011, which they sent with some of the subscription agreements. It contains what appears to be a boilerplate representation that the Shopoffs had "delivered a current Prospectus and related supplements . . . to the Investor."[84] In addition, all Class C subscription agreements contain language referring to "the terms and conditions set forth in the Confidential Private Placement Memorandum ('***Memorandum***')" and an acknowledgement that the note purchaser "received and reviewed" the PPM.[85] Enforcement insists these multiple references in transaction documents provide "overwhelming evidence . . . that the 2006 PPM . . . was delivered to the Class C investors."[86]

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[80] *Id*. at 32–33.

[81] Tr. 1151–54; CX-228; CX-229.

[82] CX-211b, at 5–8; CX-19.

[83] CX-19.

[84] CX-5, at 1; CX-160a, at 1; CX-166a, at 1.

[85] *See, e.g.*, CX-162, at 1, 8.

[86] Enforcement's Post-Hr'g Br. 11–12.

Enforcement questioned William and Stephen Shopoff about the 2006 PPM during their OTRs in December 2016 and January 2017.[87] The questions and answers reflected a shared assumption that the Shopoffs had provided the Class C note purchasers with a PPM that "was virtually identical" to the 2006 PPM they gave to the Class A investors in the 2006 offering.[88]

When asked during his OTR what documents he provided to Class C noteholders DC and RC, Stephen Shopoff replied, "They would have received a PPM, subscription agreement, and then . . . a loan agreement, and the Guaranty."[89] But when Enforcement asked if he gave the documents to the customers personally, he stated that, because of the passage of time, he "wouldn't be able to say" if the documents were mailed or hand-delivered, and he had no recollection of handing the documents to the customers.[90] Under further questioning, he agreed that typically the Class C customers first received the PPM and the limited partnership and subscription agreements; then, after confirming they would make the loan, the customers would receive the loan agreement, or note, and the Guaranty.[91] He testified that this was the normal sequence of providing information to customers investing in other Shopoff limited partnership offerings.[92] However, he pointed out that the PPM "had little or no relevance" to Class C note purchasers.[93]

Similarly, when Enforcement asked William Shopoff during his January 30, 2017 OTR if it was his understanding that the Class C noteholders received the 2006 PPM, he answered, "I believe so." Asked if Shopoff Securities usually tracks the delivery of PPMs, William Shopoff again answered, "I believe so."[94]

In March 2017, Enforcement made a request pursuant to FINRA Rule 8210 for Shopoff Securities to provide documentation reflecting the delivery of the "TSG Fund IV PPM to each of the TSG Fund IV investors, including the date it was sent to each investor."[95] By letter dated April 7, 2017, Respondents' counsel replied that in "the TSG Fund IV Subscription Agreements, each TSG Fund IV lender specifically acknowledged having received (and reviewed) the PPM. The PPMs were either hand-delivered, mailed, or emailed." The letter went on to state Stephen Shopoff's recollection "that he would have hand-delivered the PPMs" to three specific lenders

[87] William Shopoff testified at OTRs on December 29, 2016, and January 30, 2017. Tr. 420. Stephen Shopoff testified at an OTR on December 19, 2016. Tr. 775.

[88] Enforcement's Post-Hr'g Br. 5.

[89] Tr. 776–77.

[90] Tr. 778–79.

[91] Tr. 779–80.

[92] Tr. 781.

[93] Tr. 785.

[94] Tr. 269.

[95] CX-211a, at 3.

"and possibly to others." The letter also noted that it "was not part of Shopoff Securities' procedures to specifically document the delivery of the PPM."[96]

Enforcement argues that these facts substantially prove that Respondents gave all 13 purchasers of Class C notes a 2006 PPM "rife with . . . material misrepresentations and omissions,"[97] along with a subscription agreement and Guaranty also containing "material misrepresentations and omissions, as described in the First and Third Causes of Action."[98]

### c. Respondents' Denial That They Provided the 2006 PPM to Class C Noteholders

As explained above, in their OTRs William and Stephen Shopoff testified that they had provided the 2006 PPM to Class C note purchasers. At the hearing, their testimony changed. William Shopoff testified that in preparing for the hearing he searched the Shopoff investor database and his email records, but found no evidence that he delivered the PPM before a customer purchased a Class C note.[99] William and Stephen Shopoff both testified they examined records of transmittal emails and letters that kept details of documents sent to customers purchasing Class C notes, but found no references to the 2006 PPM.[100] William Shopoff testified that these were different from transmittals they sent to customers who participated in other offerings, which specifically stated they were sending a PPM.[101]

On the first day of the hearing, William Shopoff testified that after this search, he concluded that five Class C noteholders had requested and received the 2006 PPM, but only *after* they negotiated and executed the notes and Guaranties. The PPM thus would not have been a factor in those note purchases.[102] He then directed his staff to conduct a further review of Shopoff Securities' web-based document delivery system. This search yielded a document indicating a Fund IV "prospectus" was delivered to five of the 13 Class C noteholders. The document showed that the five requested written materials on particular dates, after they purchased their notes. The document identified a unique "prospectus number" to record what was sent to them.[103]

Two days later William Shopoff again changed his testimony. In the interim, he had instructed a member of the Shopoffs' technology team and an outside consultant to conduct a more extensive search to identify precisely what documents were requested by, and delivered to,

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[96] CX-212a, at 1, 4.

[97] Enforcement's Post-Hr'g Br. 8–11.

[98] *Id*. at 4–5.

[99] Tr. 97–98.

[100] Tr. 146–48, 773, 794–95.

[101] Tr. 149.

[102] Tr. 95–96, 148–52.

[103] Tr. 660–61; RX-11.

the five customers. Because the documents were assigned "prospectus numbers," William Shopoff had assumed they were PPMs. He explained that is why he testified on the first day of the hearing that he provided PPMs to the five customers. It turned out, however, the "Fund IV prospectus" sent to the five customers was *not* the 2006 PPM: it was a TSG Fund IV quarterly report.[104]

Enforcement asked William Shopoff about Shopoff Securities' April 2017 response to Enforcement's Rule 8210 request to document sending the 2006 PPM to purchasers of Class C notes. In the response letter, his lawyer wrote that each note purchaser acknowledged receiving one; the PPMs were mailed, emailed, or hand-delivered; and at that time Shopoff Securities did not maintain a record of PPM deliveries. Enforcement asked how this "very careful lawyer" could have been mistaken in making these representations.[105]

William Shopoff answered that he and his team had made mistaken assumptions. He noted there was "a lot of document production in this case" and somebody on the team assisting with the responses to Enforcement's multiple requests for documents must have given the attorney inaccurate information.[106] Shopoff Securities produced over 1.1 million documents to Enforcement in the course of the FINRA investigation.[107] William Shopoff testified that his "team made their best response that they could at the time," surmising they "probably looked at the client files and saw subscription agreements and made an assumption that a PPM had [been] delivered . . . [and] erroneously answered the question."[108]

Looking back, William Shopoff believes that before and during their OTRs, he and his staff incorrectly assumed they had sent Class C customers a PPM.[109] With other offerings, they would send PPMs, consistent with standard practice.[110] In subsequent searches of the databases that track delivery of documents, they found records showing they sent PPMs with their other note offerings, but not the Class C offering.[111] He testified he does not know why Shopoff Securities incorrectly stated they did not document deliveries of PPMs to customers during the Notes Period, but insisted they had a database that "categorized and logged things that went out" to investors at the time. That database has no record of the 2006 PPM being sent to Class C note purchasers.[112]

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[104] Tr. 665–69.

[105] Tr. 100–04.

[106] Tr. 106.

[107] Tr. 151–52; O'Leary Decl. 5–6.

[108] Tr. 114–15.

[109] Tr. 101, 263.

[110] Tr. 108-10.

[111] Tr. 147-51.

[112] Tr. 104–06.

The hearing produced one piece of direct evidence of delivery of a 2006 PPM to a customer before he purchased a Class C note. Enforcement confronted William Shopoff with a new exhibit it had not included in its pre-hearing submissions: a FedEx transmittal form confirming delivery of a "TSG Fund IV PPM" to customer RC on February 9, 2011.[113] This was approximately ten months before RC purchased a $100,000 Class C note on December 20, 2011.[114]

The introduction of the FedEx delivery confirmation at the hearing enabled Respondents to undertake a more focused search of Enforcement's voluminous discovery production. This search revealed a chain of emails exchanged between Stephen Shopoff and customer RC, beginning on January 27, 2011. Following up on a conversation from that morning, Stephen Shopoff sent RC an email attaching "a series of Fund IV documents" that included the first 28 pages of the 2006 PPM given to Class A investors. The body of the email directed RC's attention to the attachments, with a caveat.

In the email, Stephen Shopoff informed RC that "a good bit of this information [in the PPM] is geared towards the original loan [2006 Class A] . . . and is not particularly relevant now." He wrote that the Class C note contained the current relevant terms. He also offered to send hard copies of the documents to RC. RC acknowledged receipt of the email on February 4, 2011.[115] Stephen Shopoff does not know what the FedEx package delivered to RC on February 9 contained,[116] but, based on the email and Stephen Shopoff's offer to send hard copies of the email attachments, it is reasonable to infer that the FedEx package contained the same documents that were in the email attachments, including the 2006 PPM. William and Stephen Shopoff now believe this is the only 2006 PPM that went to a Class C note purchaser before a purchase.[117]

There are other indicators that Respondents did not provide the 2006 PPM to Class C note purchasers. Respondents sent transmittal emails to Class C note purchasers identifying various documents sent in connection with the transactions. They listed limited partnership agreements, investment questionnaires, notes, Guaranty agreements, subscription agreements, authorization forms, and "direction of investment" forms. William Shopoff testified that none of the emails listed the 2006 PPM.[118] William Shopoff testified that when Shopoff Securities issued other limited partnership offerings in the Notes Period using PPMs, "[i]f we sent a physical PPM, we kept a record."[119]

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[113] Tr. 313–318; CX-226.

[114] CX-164.

[115] RX-25.

[116] Tr. 921.

[117] Tr. 771–72, 669-70.

[118] Tr. 148–52.

[119] Tr. 106–07, 109–10.

Two Class C noteholders testified at the hearing. One, RC, to whom Stephen Shopoff sent the email with the PPM discussed above, testified that he received the PPM, as Stephen Shopoff testified, but he could not recall what it looked like. He said it was not a document important to his decision to purchase Class C notes—he relied on the promissory note, the Guaranty, and a profit-sharing offer.[120] The other witness, WM, said the only documents he received in connection with his Class C note purchase were a subscription agreement, a limited partnership agreement, a pledge of future profits, and a Guaranty.[121]

### d. The Class C Subscription Agreement

Along with a note and Guaranty, the Shopoffs sent the Class C note purchasers a document titled "Subscription Agreement-Class C."[122] The subscription agreement was a modified—or repurposed—Shopoff Securities form with language taken directly from a template for the 2006 Class A limited partnership offering.[123] The first page of the subscription agreement mentions a PPM, stating that the "undersigned, the investor, hereby subscribes for . . . units of limited partnership interest . . . in Class C of TSG Fund IV, L.P., a California limited partnership . . . on the terms and conditions set forth in the confidential private placement memorandum."[124] The form has a space to fill in the number of units being purchased. On some subscription agreements the blank was filled in, but on others it was not.[125]

The Complaint charges that the subscription agreement makes a material misrepresentation concerning TSG Fund IV's "financial and operating history."[126] The alleged misrepresentation is the statement that the "Partnership has no current financial or operating history."[127] Enforcement claims this was false because by the beginning of the Notes Period, Respondents knew that TSG Fund IV "had four years of operational and financial history."[128]

When questioned about this, William Shopoff conceded that TSG Fund IV's history extends back to 2006.[129] But because it was not a business entity such as a brokerage or a real estate company, it did not have an "operating history" such as an active company would have.

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[120] Tr. 1770–71, 1787–88.

[121] Tr. 1743–46. Enforcement apparently did not ask Class C noteholders it interviewed during its investigation about the 2006 PPM. During closing arguments, when asked what Class C noteholders said about receiving the 2006 PPM during investigative interviews, Enforcement represented that its customer interview notes do not "reflect any questions directly on that subject." Tr. 2002.

[122] Tr. 83–84; *see, e.g.*, CX-2, at 2.

[123] Tr. 138, 145, 1963.

[124] Tr. 145; CX-2, at 2.

[125] Tr. 1798.

[126] Compl. ¶ 32; Enforcement's Post-Hr'g Br. 12.

[127] CX-2, at 4.

[128] Enforcement's Post-Hr'g Br. 12.

[129] Tr. 168.

For Class C noteholders, the prior "history" of the Class A investments in TSG Fund IV was, William Shopoff testified, "largely irrelevant."[130] Respondents argue that the history of the TSG Fund IV Class A offering has no bearing on the Class C notes. Terms of the Class C notes were different from the terms offered to Class A and Class B investors, as discussed above. For these reasons, Respondents argue that the subscription agreement's statement about financial and operating history is "completely immaterial." They also point out that because the subscription agreement was required by the IRA custodian to allow noteholders to purchase notes with IRA funds, the reference to operating history was "inconsequential."[131]

#### e. Other Alleged Fraudulent Misrepresentations and Omissions

The first cause of action also alleges that the Guaranty given by Respondents to each Class C noteholder fraudulently failed to disclose material negative information about the Shopoffs' illiquidity, and that Respondents orally misrepresented how they were using proceeds of note sales. In addition, as mentioned above, it charges that Respondents omitted material information when they asked a number of noteholders to extend the maturity dates of their notes. The details of these assertions are discussed below as they apply to both the Class C and Shopoff Enterprises transactions.

### 2. Second Cause: The Shopoff Enterprises Notes

The second cause of action relates to sales of $10.9 million in Shopoff Enterprises notes that Respondents sold to 23 customers,[132] some of whom also purchased Class C notes.[133] Shopoff Enterprises provided note purchasers with (i) a promissory note that identified Shopoff Enterprises as the "Borrower" and the purchaser as "Lender" and spelled out the note's terms, including amount, interest rate, payment schedule, and maturity date; and (ii) a Guaranty identical to the one provided to Class C note purchasers.[134]

The second cause of action alleges that Respondents made material false oral representations that the proceeds of the noteholders' purchases would be used for working capital and general corporate needs.[135] It alleges that Respondents also failed to disclose a number of material facts: (i) that some proceeds would be used to pay William and Cindy Shopoff's personal expenses; (ii) that some proceeds would be used to repay principal and interest owed on matured Class C and Shopoff Enterprises notes; and (iii) that Shopoff Realty relied on cash transfers from William Shopoff and other Shopoff entities to operate.[136] Other

[130] Tr. 165–66.

[131] Tr. 96–97, 1962–63; Respondents' Post-Hr'g Br. 31.

[132] Compl. ¶ 39.

[133] RX-13, at 4–6.

[134] *See, e.g.*, CX-117.

[135] Compl. ¶¶ 132–33.

[136] *Id*. ¶ 134.

alleged omissions relate to the Guaranty given to each Shopoff Enterprises note purchaser. The Guaranty allegedly failed to disclose that the Shopoffs lacked liquidity; their claimed net worth was based on "self-valuations of their closely-held private corporations"; their assets consisted primarily of real estate holdings; and the Shopoff Trust had little cash.[137] In addition, when Respondents negotiated extensions of maturity dates with Shopoff Enterprises noteholders, they allegedly failed to disclose that the extensions were required because of the financial problems of Shopoff Enterprises and its affiliates.[138] Enforcement contends these were material facts for a reasonable investor to assess the reliability of the Guaranty and the risks of investing in the Shopoff Enterprises notes.[139] According to Enforcement, the Shopoffs' claimed ability to liquidate assets to cover the notes is irrelevant. Enforcement accuses Respondents of substituting "their own (self-interested) judgment of the risk for the judgment of the customers."[140] The Complaint states this conduct violated Section 10(b), Rule 10b-5, and FINRA Rules 2020 and 2010.

Respondents deny that the Shopoffs' assets were illiquid, and that the Shopoffs' liquidity, net worth, cash balance, and assets were material facts that they failed to disclose.[141] They contend that the Shopoffs had sufficient liquidity available if needed.[142] Respondents deny that William and Cindy Shopoff used note proceeds to pay personal expenses.[143] They admit telling Shopoff Enterprises noteholders the note proceeds would be used for working capital and general corporate needs. They admit some Shopoff Enterprises note proceeds were used to pay interest or principal on some prior Class C notes, but deny failing to disclose this to Shopoff Enterprises note purchasers.[144] Respondents also insist they used the noteholders' monies appropriately. Paying principal owed to noteholders whose notes had matured, and interest due to previous note purchasers, are "debt retirement" and "debt service" within the generally accepted understanding of what constitutes working capital and general corporate needs.[145] They further deny failing to disclose to individuals renegotiating payment terms that Shopoff Enterprises and its affiliates were experiencing financial difficulties. They acknowledge that William Shopoff and the Shopoff Trust contributed capital and cash to Shopoff Realty.[146]

[137] *Id*. ¶¶ 49, 135–38; Enforcement's Post-Hr'g Br. 18.

[138] Compl. ¶¶ 53, 139.

[139] Enforcement's Post-Hr'g Br. 16–18.

[140] *Id*. at 19.

[141] Ans. ¶¶ 48–49.

[142] Respondents' Post-Hr'g Br. 49–50.

[143] Ans. ¶¶ 56–61.

[144] Ans. ¶ 62.

[145] Respondents' Post-Hr'g Br. 37–38.

[146] Ans. ¶¶ 50–54.

Respondents also point out that the note purchasers were satisfied with the uses to which Respondents put the proceeds. All 29 purchasers, some of whom purchased both Class C and Shopoff Enterprises notes, signed and submitted declarations attesting to their satisfaction.[147]

### a. The Guaranty and the Shopoffs' Liquidity

As discussed above, each Class C and Shopoff Enterprises noteholder received a Guaranty, titled "Loan Guaranty Agreement." William and Cindy Shopoff signed it as co-trustees of the Shopoff Trust. It "irrevocably, absolutely and unconditionally" guaranteed, "on demand after the occurrence or existence of any default," repayment of principal, interest, and any expenses incurred by a noteholder's efforts to obtain payment. The Guaranty makes explicit its materiality to the transaction by stating expressly that the "Guarantor desires to enter into this Agreement to induce Lender to make the Loan" to TSG Fund IV or Shopoff Enterprises.[148]

### b. Enforcement's Evidence of the Shopoffs' Illiquidity

Enforcement contends the Guaranty is fraudulent because it "omitted material information regarding William and Cindy Shopoffs' lack of liquidity." In support of its claims, Enforcement refers to William and Cindy Shopoff's joint checking account statements from February 2014 through November 2015, financial statements for 2012 to 2015, and two emails.[149]

The first email was from Shopoff Realty's then-CFO in July 2011. The CFO was negotiating terms of payment for a bank judgment against William Shopoff. The CFO wrote that William Shopoff did not have sufficient liquidity to pay $35,000 that he owed to the bank at that time, and offered to pay $15,000 followed by monthly payments of $10,000 until he fully repaid the bank. The bank agreed.[150] The second email was from a senior Shopoff Realty accountant in March 2012 asking William Shopoff for permission to move funds from a Shopoff Enterprises account to William Shopoff's personal bank account to prevent it from "going negative."[151]

The bank account statements for William and Cindy Shopoff's joint checking account from February 1, 2014, through November 30, 2015,[152] include the March 31, 2014 statement showing a $1.5 million balance[153] and fluctuations in the account over the 22 months covered by the statements. Aside from the March 31, 2014 balance, the highest ending balance was

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[147] RX-1. Their sworn statements also describe the terms of their loans, their earnings from them, and that the note and Guaranty were the key documents on which they relied when they purchased their Class C and Shopoff Enterprises notes.

[148] *See, e.g.*, CX-8 and CX-35.

[149] Enforcement's Post-Hr'g Br. 12–13 & n.57.

[150] *Id.*; CX-22, at 6–7.

[151] CX-23.

[152] CX-64.

[153] CX-64, at 10.

$301,231 on July 31, 2014,[154] and the lowest was $8,836 on December 31, 2014.[155] The Shopoff's financial statements show their net worth growing from an estimated $41.65 million in December 2011 to more than $131 million in December 2015.[156]

Notably, Enforcement does not contend directly and did not prove that Class C and Shopoff Enterprises note purchasers were *actually* exposed to significant risk of loss because of the Shopoffs' alleged illiquidity. Rather, Enforcement argues that the alleged omissions left note purchasers without the information "necessary . . . to assess the risk involved," which, Enforcement argues, was "the Shopoffs' ability to satisfy the Guaranty."[157]

Enforcement points to other emails as additional evidence of the "lack of liquidity and low cash levels" of William and Cindy Shopoff and the Shopoff entities that, Enforcement argues, motivated Respondents to defraud customers by telling them their funds would be used for Shopoff Realty's working capital, when instead they used the funds to pay personal expenses and to repay earlier investors.[158] There are nine email exchanges spanning almost four years:

- On December 23, 2011, a Shopoff Realty accountant emailed William Shopoff that an account balance was $6,000, and they needed $62,000 to cover payroll at the end of the month.[159]

- A March 15, 2012 email chain concerned a bank draft for $39,895 for payroll returned for insufficient funds.[160]

- In April 2013, Shopoff Realty's then-CFO Sciutto wrote William Shopoff about "cash needs that can't wait," asking for guidance on how to pay notes coming due and other expenses, "presuming" he will lend funds.[161]

- A May 2013 email exchange between Sciutto and William Shopoff discussing cash flow mentioned William Shopoff's personal account is "$0," so Sciutto was transferring funds to it.[162]

- In a June 2013 email chain, Sciutto and William Shopoff discussed pending bills, including an overdue American Express bill for $100,000. William Shopoff wrote

[154] CX-64, at 46.

[155] CX-64, at 86.

[156] CX-110; CX-114, at 4.

[157] Enforcement's Post-Hr'g Br. 12–13, 18.

[158] *Id*. 16–17 & n.77.

[159] CX-59.

[160] CX-61.

[161] CX-41.

[162] CX-202.

he was "still trying to source a little float" and directed Sciutto to let American Express know the bill would be paid by the weekend.[163]

- In a November 2014 email exchange, Sciutto informed William Shopoff of her concerns about being "stretched to the limit" and that they "could run out of cash by mid-Dec." William Shopoff replied, "We will work through it . . . . Maybe bring cash account current and accrued interest in iras [sic]."[164]

- A December 17, 2014 email exchange between Sciutto and William Shopoff discussed pending bills and Sciutto's work on a cash flow projection. William Shopoff wrote he would "arrange additional capital to fill gaps," and asked, "Can you tell me how much we need?"[165]

- On December 19, 2014, Sciutto informed William Shopoff "$500k squeaks us by" although "Jan. will be tight too as expected." Sciutto also listed cash available and cash needed.[166]

- In a July 2015 email, Sciutto asked William Shopoff for permission to make overdue payments to vendors owed $200,000, noting she did not want to have to "scramble" to obtain $200,000 for an upcoming payroll.[167]

### c. Respondents' Evidence of Liquidity

Respondents discount the emails as merely evidence of "various periodic cash flow challenges" for "a small handful of affiliated entities." They argue the emails "simply reflected ordinary day-to-day operational and 'cash management' challenges."[168] William Shopoff testified that he has been in business for 40 years and "this is just business management for us. And we have money, you know, sometimes the money's in my personal account." He testified that, when necessary, he "took cash out of [his] pocket, [and] contributed to the company to make sure the company survived."[169] The email exchanges with Sciutto and Shopoff Realty's accountants reflect notifications of bills due, fees to be collected, the need to move funds from one account to another, between entities, and "a lot of things going on across the portfolio."[170]

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[163] CX-62.

[164] CX-51.

[165] CX-63.

[166] CX-193.

[167] CX-47.

[168] Respondents' Post-Hr'g Br. 40–41.

[169] Tr. 366–67.

[170] Tr. 380.

As CFO, Sciutto sent emails to apprise William Shopoff of the Shopoffs' financial "state of the union," cash needs, and "cash management."[171]

Respondents contend that Enforcement's assertions about the Shopoffs' low liquidity are mistaken. In their view, Enforcement's assessment of the Shopoffs' liquidity is predicated on "an artificially narrow" consideration of the Shopoffs' actual assets, focused on only a few entities and "an incomplete" consideration of William Shopoff's available assets.[172] For example, the investigation leading to the Complaint did not include a review of "dozens of [Shopoff Realty's affiliated] entities that were generating income" in the relevant period.[173] Respondents point out that the 2014 cycle examiner, who testified as Enforcement's key witness for its liquidity analysis, acknowledged the examination was limited to a small sample of eight to twelve Shopoff business entities. Her team referred only "around six" offerings or entities to Enforcement that she "reviewed and had concerns about."[174] The examiner knew there were many other entities she and her team did not include in the cycle examination. She did not know if they were revenue-generating entities.[175]

At the hearing, William Shopoff presented a picture—in sharp contrast to Enforcement's depiction—of his net worth and access to liquidity throughout the Notes Period. He testified that an examination of his business entities and his personal financial statements, not considered by Enforcement, shows that, if necessary, he could "create liquidity . . . in relatively short order."[176] He pointed to "internally drafted" compilations of assets and liabilities illustrating the assets available to him.[177]

William Shopoff did not suggest he could make all of his assets liquid quickly. For example, he could not liquidate the operating companies, valued at $5.85 million, unless he were to go out of business.[178] He would not want to liquidate the approximately 40 percent of his total net worth in holdings with general partners in the near term because doing so would harm his partners.[179] But he owns two parcels of real estate worth about $33 million that, he testified, he could profitably sell relatively quickly.[180] In addition, he owns a half-acre oceanfront residential

[171] Tr. 381–83.

[172] Respondents' Post-Hr'g Br. 41.

[173] *Id*. at 12.

[174] Tr. 1180–84. The examiner also testified that, considering the recent recession, she considered it "odd," and "a red flag" when the examination revealed no Shopoff entity had failed, and that there were no customer complaints. Tr. 1178–79.

[175] Tr. 1183–84.

[176] Tr. 1836–37.

[177] Tr. 1841–42; RX-17.

[178] Tr. 1843–44.

[179] Tr. 1844–45.

[180] Tr. 1845, 1856.

lot in Laguna Beach, California valued at $6 million, with a $2.4 million mortgage, that he testified he could easily sell to raise about $3 million.[181] Even more easily liquidated are retirement accounts worth more than $7 million.[182]

William Shopoff testified that to prepare for the hearing, he conducted an analysis to ascertain his available liquid assets in the Notes Period. He first calculated his available cash, stocks, bonds, retirement accounts, and the cash value of his life insurance policies—assets that he believed he could make liquid within a week. He then took into account other assets he could have liquidated within 90 days.[183] He tied his analysis to six dates between August 2014 and December 31, 2015.[184] He reviewed seven bank accounts—more than the cycle examiners did—and entities holding cash.[185] He calculated that he could have accessed $1.3 million to $1.75 million within five days,[186] and he could have obtained $6 million to $6.5 million in cash from other assets within 90 days.[187]

William Shopoff testified that he also conducted a quarterly analysis of his liquid or near-liquid assets extending back to 2011 to determine whether he could have made good on the Guaranties to Class C and Shopoff Enterprises noteholders throughout the Notes Period.[188] Without dipping into his real estate assets, he estimated that liquid assets available to him within 5 to 90 days ranged from approximately $4.5 million in the early years of the Notes Period, when the outstanding note balances were lower, to $7 million in the later years.[189]

William Shopoff estimated that the total amount owed to Class C and Shopoff Enterprises noteholders peaked briefly in 2015 at $6.8 million.[190] At that time, in addition to his liquid assets, he also had available the two real estate properties valued at approximately $33 million.[191] William Shopoff is confident he could have sold them, albeit perhaps for less than

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[181] Tr. 1847.

[182] Tr. 1846–47.

[183] Tr. 1925–29.

[184] Tr. 1929–32. He selected the dates because of their relation to the issuance of the third-party due diligence reports that are the subject of the fourth cause of action, and the dates of internally prepared statements of his and his wife's financial condition.

[185] Tr. 1932–34, 1940–42. He noted that Enforcement had taken into consideration and reviewed only four bank accounts.

[186] Tr. 1935.

[187] Tr. 1936–37.

[188] Tr. 1940–41.

[189] Tr. 1940–42.

[190] Tr. 1855–56. RX-13, at 3, charting the total owed to noteholders annually from 2010 through September 2019 shows the peak at $6.4 million in 2015.

[191] Tr. 1845.

$33 million.[192] Thus, he testified, aside from other near-liquid assets, in these two marketable properties he estimated he had four to five times more than needed to cover the total amount of outstanding notes.[193]

### 3. Third Cause: Suitability

The third cause of action alleges that Respondents recommended Class C and Shopoff Enterprises notes without a reasonable basis to believe they were suitable for at least some investors.[194] The Complaint alleges that the notes were unsuitable for any investor because some investment proceeds were used to pay William and Cindy Shopoff's personal expenses and to repay previously purchased mature notes, and because of the allegedly precarious financial condition of Shopoff Realty, its affiliates, and the guarantors, William and Cindy Shopoff.[195]

By making these allegedly unsuitable recommendations, the Complaint states that Respondents violated NASD Rule 2310(b) during the first part of the Notes Period, and its successor, FINRA Rule 2111(a), during the remainder of the Notes Period, as well as FINRA Rule 2010.[196]

Respondents categorically deny that they failed to satisfy their reasonable-basis suitability obligation, and deny that the Class C and Shopoff Enterprises notes were unsuitable for any investor. They further deny the notes were unsuitable because of the allegedly poor financial condition of Shopoff Realty, Shopoff Enterprises, and TSG Fund IV, and the alleged illiquidity of the Shopoff Trust.[197]

### 4. Fourth Cause: Fraudulent Third-Party Due Diligence Reports

The fourth cause of action alleges that Shopoff Securities, through William Shopoff, engaged in fraudulent sales of securities in the two private placement offerings, Land Fund III and Land Fund IV, sponsored by Shopoff Realty. They allegedly did so by providing false information about William and Cindy Shopoff's available cash to a company they engaged to prepare and disseminate third-party due diligence reports.[198] The Complaint charges Respondents with causing misleading overstatements of William and Cindy Shopoff's liquidity to be made to the broker-dealers that were sent the due diligence reports and sold the Land Fund

[192] Tr. 1852–53.

[193] Tr. 1855–56.

[194] Compl. ¶¶ 150–51.

[195] *Id*. ¶¶ 152–53.

[196] *Id*. ¶¶ 148–50, 154.

[197] Ans. ¶¶ 151–54.

[198] Compl. ¶ 5.

III and Land Fund IV offerings.[199] The Complaint states that this conduct violated Section 10(b), Rule 10b-5, and FINRA Rules 2020 and 2010.[200]

Respondents Shopoff Securities and William Shopoff deny causing material overstatements of William and Cindy Shopoff's cash position or liquidity to be made to retail broker-dealers soliciting investments in Shopoff private placement offerings.[201]

### a. The Third-Party Operational Due Diligence Reports and Certifications

The centerpiece of the Complaint's fourth cause of action is a financial statement William Shopoff sent to FactRight, LLC, a company that prepares and disseminates due diligence reports on issuers and their investment offerings.[202] FactRight prepared due diligence reports assessing Shopoff Realty in connection with the Land Fund III and Land Fund IV private placements. Shopoff Realty sponsored, and Shopoff Securities marketed, the offerings directly and through other "downstream" broker-dealers.[203] Sales of Land Fund III occurred from May 2014 through May 2015, and sales of Land Fund IV from September 2015 through October 2016.[204]

There is no allegation that Respondents gave the allegedly misleading information to any customer, or to any broker who relied on it to solicit sales of the offerings. Instead, Enforcement cites emails that an employee registered with Shopoff Securities sent to representatives at seven FINRA broker-dealers providing them with a link to the reports on FactRight's website.[205] Enforcement asserts that three downstream broker-dealers solicited investments in the offerings based on the reports' allegedly misleading information, for which William Shopoff and Shopoff Securities were responsible.[206]

### b. The 2013 FactRight Report

William Shopoff had previously engaged FactRight in 2013 to prepare an "operations due diligence report" on Shopoff Realty in connection with earlier offerings.[207] The 2013 report included descriptions of Shopoff Realty's organizational structure, its risks and strengths,

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[199] *Id*. ¶¶ 156, 158.

[200] *Id*. ¶ 163.

[201] Ans. ¶¶ 156–59, 161–63.

[202] CX-130.

[203] Tr. 537–38.

[204] Tr. 537; CX-13a; CX-73a; CX-224.

[205] Tr. 1138–47; CX-70; CX-79; CX-83; CX-84; CX-149; CX-150; CX-151.

[206] Compl. ¶¶ 156, 158; Enforcement's Post-Hr'g Br. 20–21.

[207] Tr. 538.

ownership, financial position, and past business performance.[208] It observed that Shopoff Realty appeared to possess "adequate resources . . . to fund the operations of sponsored and managed investment programs," but it nevertheless recommended "on-going monitoring of [Shopoff Realty's] financial position."[209]

In a section titled "Risks," the 2013 report pointed out that Shopoff Realty relied on William and Cindy Shopoff's financial support, and that "the financial position of William and Cindy Shopoff did not demonstrate they had sufficient resources to provide support, if needed." It also stated that "Cash flow and liquidity for [Shopoff Realty], absent further support of William and Cindy Shopoff, [was] uncertain at [that] time"[210] and, although the Shopoffs' net worth exceeded $60 million, they had "minimal liquid net assets."[211]

In his testimony, William Shopoff disagreed with those statements, insisting that he knew he had sufficient liquid resources and had always provided financial support when needed.[212]

### c. The 2014 and 2015 FactRight Reports

When William Shopoff and Shopoff Realty engaged FactRight to prepare due diligence reports on Shopoff Realty in connection with the Land Fund III and Land Fund IV offerings,[213] Enforcement argues that William Shopoff "had a strong interest in making sure" the reports "supported" the sales, and that he "sought to alleviate the concerns raised in the 2013 report." To that end, Enforcement contends, William Shopoff "massively inflated his and his wife's cash assets" in a financial statement he submitted to FactRight.[214]

William Shopoff describes that financial statement as a "compilation" of his and his wife's financial statements. He hired an accounting firm to prepare it at the end of the first quarter of 2014.[215] At the time, he was completing a major business transaction involving the purchase and sale of real estate. He and a partner closed the transaction, buying out other partners. The transaction generated approximately $1.5 million for Shopoff Realty.[216] The money was distributed on March 28, 2014, to the Shopoff Corporation, which acted as general partner in the transaction.[217] The transaction's "significant monetization" created, in William

[208] CX-130.

[209] CX-130, at 9.

[210] CX-130, at 10.

[211] CX-130, at 8, 10.

[212] Tr. 545.

[213] Tr. 537–38.

[214] Enforcement's Post-Hr'g Br. 20–21.

[215] Tr. 567–74.

[216] Tr. 551–53.

[217] William and Cindy Shopoff own the Shopoff Corporation. RX-19, at 37–38.

Shopoff's view, a good opportunity to measure his and his wife's financial situation at the end of the first quarter of 2014 and in advance of the Land Fund III offering.[218]

At William Shopoff's direction, Shopoff Realty's CFO Sciutto transferred the $1.5 million distribution from the Shopoff Corporation to his and his wife's checking account on March 31, 2014. Sciutto sent him an email confirming the transfer, noting, "We will need some back at some point." According to William Shopoff, this meant that some of the funds would be returned to Shopoff Realty.[219]

In an OTR,[220] Sciutto testified that transferring the cash to the Shopoffs' personal checking account meant that it would be reflected as a personal asset in the compilation. Had it been kept in the Shopoff Corporation, the cash would have been less identifiable as a liquid asset, because it would be recorded as part of the value of the company,[221] or, as she put it, "buried in an entity that wouldn't be reflected on his personal balance sheet."[222] In addition, March 31 was an appropriate time to put the cash into the checking account, she testified, because that was the date on which his accountant's compilation would be based.[223] In Sciutto's view, there was "nothing unusual . . . about what happened there."[224]

On August 1, 2014, the accounting firm issued the 12-page report, "William A. & Cindy Shopoff Statement of Financial Condition with Independent Accountants' Compilation Report March 31, 2014" ("Compilation").[225] It details the Shopoffs' assets and liabilities, including an entry under "Assets" of nearly $1.5 million in cash.[226] The Compilation was sent to FactRight.[227]

FactRight issued an operational due diligence report dated August 29, 2014 ("2014 FactRight Report"). Sixty-four pages in length, it includes a notation that because Shopoff Realty relies on William and Cindy Shopoff for financial support, FactRight had requested their personal financial statements and received the Compilation. The 2014 FactRight Report states that, in addition to their net worth of more than $60 million, the Shopoffs included the "[c]ash balance of 1.5 million . . . as of March 31, 2014."[228]

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[218] Tr. 552–53.

[219] Tr. 557–58.

[220] Sciutto's OTR took place on February 7, 2018. CX-65; RX-19. She did not testify at the hearing.

[221] RX-19, at 17.

[222] RX-19, at 18.

[223] RX-19, at 25.

[224] Tr. 1305–08.

[225] Tr. 579; CX-101.

[226] CX-101, at 4.

[227] Tr. 589–90.

[228] CX-102, at 26.

Within a short time after the Compilation was completed, the cash balance in the checking account was significantly reduced. Sciutto observed that the Shopoffs, like many real estate businesspeople, use most of their cash to invest in real estate or to operate their business. The checking account was for William and Cindy Shopoff's personal expenses, and they did not need such a large cash balance.[229] William Shopoff transferred $500,000 from the checking account to Shopoff Realty on April 2, 2014, followed by $100,000 on April 16, and $550,000 on April 28.[230] William Shopoff testified that these transfers were investments of capital in or loans to Shopoff Realty.[231] Enforcement contends the movement of the funds to and from the Shopoffs' checking account is evidence of fraud because the $1.5 million deposit presented a misleadingly "favorable accounting record" for the due diligence report.[232]

The 2014 FactRight Report contained William Shopoff's certification that the report was "complete, true, and accurate."[233] Enforcement charges that the certification, dated September 16, 2014, is false because on that date the Shopoffs' joint checking account had a balance of less than $80,000.[234] According to Enforcement, Shopoff Securities and William Shopoff thus "intentionally and materially" misrepresented his liquidity in the 2014 FactRight Report.[235]

In 2015, William Shopoff engaged FactRight to produce another operational due diligence report in connection with Shopoff Realty's offering of Land Fund IV ("2015 FactRight Report"). The 2015 FactRight Report repeated a reference to the Compilation and stated that as of March 31, 2014, the Shopoffs had a cash balance of $1.5 million. In addition, it reported that Shopoff Realty's management represented that William and Cindy Shopoff's financial position had "not changed significantly" since the Compilation was issued.[236] As he had done the year before, William Shopoff certified the accuracy of the 2015 FactRight Report.[237]

According to Enforcement, his certification made the 2015 FactRight Report materially misleading because the Shopoffs' joint checking account balance was only about $10,000 in November 2015. Enforcement also accuses William Shopoff of "deliberately" deciding not to send FactRight an internal Shopoff financial statement showing that on December 31, 2014, the Shopoffs' checking account balance was just $5,000.[238]

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[229] Tr. 1292.

[230] CX-67, at 1.

[231] Tr. 561–65.

[232] Enforcement's Post-Hr'g Br. 21.

[233] CX-102, at 49.

[234] Enforcement's Post-Hr'g Br. 24 n.120.

[235] *Id*. at 24–25.

[236] CX-103, at 24.

[237] Tr. 619–21; CX-103, at 44.

[238] Enforcement's Post-Hr'g Br. 26.

Enforcement argues that Section 10(b) and Rule 10b-5 impose a duty on one making a statement in connection with a securities transaction to ensure that it is not misleading. Because William Shopoff knew his checking account was substantially depleted when the 2014 and 2015 FactRight Reports were issued, Enforcement contends, he had a duty to disclose the balance was not $1.5 million as reflected in each report. Moreover, his certification in the 2015 FactRight Report was false, Enforcement argues, because the depletion of the balance was a substantial change in his financial position.[239]

Enforcement asserts that William Shopoff acted fraudulently because the 2014 and 2015 FactRight Reports were provided to broker-dealers who "used the fraudulent and misleading due diligence reports in connection with the sales" of Land Fund III and Land Fund IV offerings. Enforcement claims the broker-dealers that received and reviewed the 2014 FactRight report stated they had reviewed them and "solicited 70 investors to invest more than $3.4 million" in Land Fund III and Land Fund IV; the broker-dealers that received and reviewed the 2015 FactRight report "solicited 46 investors to invest more than $3.2 million in the Land Fund IV Offering."[240]

Respondents argue, first, that there is no authority for Enforcement's contention that William Shopoff was obligated to update the financial information represented in a report that FactRight, not he, controlled. Second, they insist that the reports accurately represented the Shopoffs' cash balance as of March 31, 2014.[241]

Finally, Respondents challenge the materiality of the representations in the FactRight reports about the Shopoffs' liquidity. By the terms of FactRight's agreement with broker-dealers receiving the report, broker-dealers could only show the reports to their due diligence officers and no one else, including registered representatives. Thus the contents of the reports, Respondents argue, could not have been part of the mix of information available to an investor making an investment decision. Respondents point out that there is no evidence that any registered representative in the downstream broker-dealers received the reports or used them to solicit a transaction.[242]

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[239] *Id*. at 43–44.

[240] *Id*. at 20–21. Enforcement cites exhibits CX-80, CX-81, CX-82, CX-88, CX-88a, CX-90, CX-155, and CX-224 to support its contentions. These exhibits confirm that four broker-dealers for the offerings and sales received and reviewed the third-party due diligence reports. They do not, however, provide any indication, as Enforcement asserts, that the salespersons "solicited" any sales.

[241] Respondents' Post-Hr'g Br. 45–46.

[242] *Id*. at 48–49.

## IV. Discussion

### A. Burden of Proof

We begin with the well-established principle that, to prevail in this disciplinary proceeding, Enforcement must prove the elements of each allegation by a preponderance of the evidence.[243] Enforcement does not meet its required burden of proof if "the totality of the evidence suggests an equally or more compelling inference than [Enforcement's] allegation."[244]

### B. Securities Fraud: The First, Second, and Fourth Causes

From the outset, Respondents have insisted that the Class C and Shopoff Enterprises notes are not securities, and not subject to the securities laws and regulations that the Complaint alleges they have violated. Therefore, our initial task is to resolve the question of whether the notes are securities as defined by the Exchange Act. That definition begins, "The term security means *any note*." Thus, a note is presumed to be a security.[245] It then provides a lengthy list of instruments included in the definition of securities. It ends with a shorter list of instruments that mature in nine months or less and are not securities.[246]

The Supreme Court has observed that the "'fundamental purpose undergirding the Securities Acts" was to regulate the previously largely unregulated securities market to protect investors against serious abuses.[247] The Exchange Act defines "security" broadly enough "to encompass virtually any instrument that might be sold as an investment."[248] The Court cautioned, however, that the use of "the phrase 'any note' should not be interpreted to mean literally 'any note."'[249] Congress left the responsibility of deciding what instruments are covered by the securities statutes ultimately to the courts.[250] The courts, taking into consideration the economic realities of a transaction, not merely the label affixed to an instrument, have recognized certain types of notes as non-securities.[251]

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[243] *John D. Audifferen*, Exchange Act Release No. 58230, 2008 SEC LEXIS 1740, at *12 n.9 (July 5, 2008) (citing *David M. Levine*, 57 S.E.C. 50, 73 n.42 (2003) (preponderance of the evidence is the standard of proof in self-regulatory disciplinary proceedings)).

[244] *Dep't of Enforcement v. Reynolds*, No. CAF990018, 2001 NASD Discip. LEXIS 17, at *55 (NAC Jun. 25, 2001) (quoting *SEC v. Moran*, 922 F. Supp. 867, 892 (S.D.N.Y. 1996)).

[245] 15 U.S.C. § 78c(a)(10); *Reves v. Ernst & Young*, 494 U.S. 56, 65 (1990).

[246] 15 U.S.C. § 78c(a)(10) (emphasis added).

[247] 494 U.S. 56, at 60 (citing *United Housing Foundation, Inc. v. Foman*, 421 U.S. 837, 849 (1975)).

[248] *Id*. at 61.

[249] *Id.* at 63.

[250] *Id.* at 61.

[251] *Id*. at 62.

In *Reves v. Ernst & Young*, the Court prescribed the standards for determining whether the presumption that a note is a security may be rebutted.[252] The Court identified four factors to employ in the analysis. The presumption may be rebutted if, analyzed in terms of the factors, a note "bears a strong resemblance" to one of the types of notes recognized as non-securities. If the note is not sufficiently similar to an instrument on the list of recognized non-securities, then the same four factors should be used to determine whether the note should be added to the list.[253]

### 1. An Assessment of the Class C and Shopoff Enterprises Notes Under *Reves*

Our starting point is the Supreme Court's statement in *Reves* that "the fundamental essence of a 'security' [is] its character as an 'investment.'"[254] We must review the pertinent facts through the lens of the *Reves* factors to make that determination.

#### a. The First *Reves* Factor: Motivations of the Parties to the Transactions

Applying *Reves*, our first task is to determine "the motivations that would prompt a reasonable seller and buyer to enter into" a transaction.[255] The determination is objective and not dependent on what the parties to a transaction say motivated them.[256] Still, what they say about their intentions and expectations can provide context for determining what would be reasonable under the circumstances.[257]

##### i. The Buyers and Sellers Viewed the Transactions as Loans

Certainly, the Shopoffs viewed the notes as loans, not as securities.[258] As Stephen Shopoff testified, William Shopoff offered the notes to select friends and family members for what he believed was a mutually beneficial opportunity. Shopoff Realty could borrow cash to operate its business at a time when, traditionally sustained by borrowed cash, it had difficulty obtaining bank loans.[259] The evidence is that both William and Stephen Shopoff presented the transactions as loans to the note purchasers, and the purchasers, not unreasonably, accepted the Shopoffs' characterization.

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[252] *Reves*, 494 U.S. at 60.

[253] *Id*. at 66–67.

[254] *Id*. at 68–69.

[255] *Id*. at 66.

[256] *McNabb v. SEC*, 298 F.3d 1126, 1131 (9th Cir. 2002).

[257] *See, e.g.*, *Stoiber v. SEC*, 161 F.3d 745, 750 (D.C. Cir. 1998) (court reviews what note purchasers said motivated them when interviewed by investigator).

[258] Tr. 118–19.

[259] Tr. 872–73.

Respondents contend that the Class C and Shopoff Enterprises notes fall under the Supreme Court's list of notes not considered securities because they "bear a strong family resemblance to at least three of the instruments" that are not securities as defined by the Exchange Act: short-term notes secured by a lien on a small business or its assets; short-term notes secured by an assignment of accounts receivable; or bank loans to fund current operations.[260] Respondents conclude that the note buyers were lenders providing "working capital" for Shopoff Realty and its affiliates "to meet short-term business needs," not for the general growth of the Shopoff business.[261] Enforcement points out in response that the Class C and Shopoff Enterprises notes were not secured by a lien or accounts receivable, and the purchasers cannot be equated to commercial bank lenders funding current operations of Shopoff Realty.[262]

Some of the documentation accompanying the notes supports characterizing them as loans. Shopoff Enterprises notes all refer to the purchaser as "Lender" and Shopoff Enterprises as "Borrower."[263] The Guaranty provided to Class C and Shopoff Enterprises notes is titled "Loan Guaranty Agreement," the Fund is described as "Borrower," the purchaser as "Lender," and the transaction as "Loan."[264]

On the other hand, the Class C subscription agreement describes the purchaser as an "Investor" and the transaction as a purchase of units in a limited partnership.[265] Moreover, some note purchasers received letters confirming their "recent investment" involving the purchase of units.[266] As Enforcement correctly points out, interests in limited partnerships are securities under the Exchange Act.[267]

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[260] Respondents' Post-Hr'g Br. 34.

[261] *Id*. at 33–34. Respondents argue that notes are not securities when their purpose is to "provide working capital," citing one case, *Sunset Mgmt. v. Am. Realty Inv'rs*, No. 4:06cv18, 2007 U.S. Dist. LEXIS 16654 (E.D. Tex. Mar. 8, 2007). However, that decision, a U.S. Magistrate's Report and Recommendation, recites facts that distinguish its circumstances from those present here: short term (one year), no direct chance of profit, and a finding that no reasonable investor would consider it a security. *Sunset*, 2007 U.S. Dist. LEXIS 16654, at 12–13.

[262] Enforcement's Post-Hr'g Br. 39.

[263] *E.g.*, CX-117. Class C notes, however, refer to a purchaser as "Payee." *E.g.*, CX-7.

[264] *E.g.*, CX-8; CX-36.

[265] *See, e.g.*, CX-158, at 8. However, as discussed above, on some of the Class C subscription agreements, the space for recording the number of units purchased is blank. *See, e.g.*, CX-159, at 7.

[266] *E.g.*, CX-158, at 7.

[267] Enforcement's Post-Hr'g Br. 30–31 (citing *Dep't of Enforcement v. Seol*, No. 2014039839101, 2019 FINRA Discip. LEXIS 9, at *28 (NAC Mar. 5, 2019) (finding that purchasers' funds were pooled into a common enterprise to fund a loan to develop a business project, and the purchasers, with no role in management of the enterprise, and with expectations of profiting through others' efforts, were limited partners)). The purchasers of the Class C and Shopoff Enterprises notes similarly played no role in Shopoff Realty or its affiliates' management, and held expectations of profit through the efforts of the Shopoffs.

Under the circumstances of this case, the buyers and the sellers of the notes reasonably believed they were engaging in loan transactions to provide working capital for Shopoff Realty. However, their belief does not determine whether the notes are investments.

### ii. The Buyers Were Motivated by an Expectation of Profit

The evidence is persuasive that profit was the prevailing motivation of purchasers of both the Class C and Shopoff Enterprises notes. Stephen Shopoff acknowledged this when he testified about the attractive interest rates he offered.[268]

For example, Customer KO, an experienced investor and money manager,[269] testified that the primary motive for her two Shopoff Enterprises note purchases was the interest rate.[270] She initially purchased a Shopoff Enterprises note for $250,000. It was to mature in three months, with an annual interest rate of 20 percent plus a 5 percent loan fee. She considered it a personal loan to William Shopoff. William Shopoff asked her to extend the maturity date twice, and she did so willingly. When the note matured, they decided to negotiate a new one, with a new loan fee of 3 percent and an interest rate of 16 percent, adjusted to reflect then-current market conditions, to mature in four months. William Shopoff asked for additional extensions to which she agreed after negotiating and receiving an increase in the loan fee. They agreed he would pay interest and return the principal when she wished; she received interest payments when she requested them and the note was paid in full.[271] KO received $87,358 in interest.[272]

Customer RM and his wife invest in art and real estate, and they participate in some limited partnerships.[273] They invested in several Shopoff offerings.[274] RM and his wife purchased a $100,000 30-day Shopoff Enterprises note, which they considered a loan to William Shopoff, at 10 percent annual interest.[275] Subsequently, they renegotiated and the loan "became a $400,000 loan" for four years with an additional 2 percent annual interest paid quarterly starting in 2015. In addition to the Guaranty, RM received a profit-sharing agreement entitling him to a share of profits of certain real estate deals that closed during the life of the note.[276] RM testified that on the occasions William Shopoff raised the possibility of extending the maturity date, he

[268] Tr. 872–73.

[269] Tr. 1382–85.

[270] Tr. 1402.

[271] Tr. 1386–96; CX-174.

[272] RX–1, at 21.

[273] Tr. 1348-49.

[274] Tr. 1350.

[275] Tr. 1351–53; CX-178. The promissory note describes the loan inconsistently as being "Two Hundred Thousand dollars ($100,000)." The Guaranty states the amount as $100,000, which is consistent with RM's testimony.

[276] Tr. 1354–59; CX-178.

and his wife agreed because they wanted to "continue the generation of revenue that we were receiving."[277] As of January 2018, their note had earned $259,631 in interest.[278]

Customer LP has made a number of investments in various Shopoff entities, totaling more than $2.5 million.[279] She was motivated to purchase Shopoff Enterprises notes by the quarterly interest payments and the rate of return.[280] Confident in the Shopoffs' integrity,[281] she considered the notes to be loans to William and Cindy Shopoff and a "smart deal." She testified, "[W]here else was I going to get eight percent, and be liquid enough to pay my monthly bills"?[282] She purchased a three-year note for $625,000 in July 2015, with an annual interest of 8 percent paid quarterly. Soon thereafter, she made another $100,000 loan.[283] They have been paid in full, with no extensions. As of December 31, 2017, LP had received $103,660 in interest.[284]

Customer RC, an accredited investor actively involved in managing his portfolio,[285] testified about purchasing five notes, four at 15 percent interest, and one at 12 percent.[286] He considered them loans.[287] RC and his wife, DC, each purchased a $100,000 Class C note in December 2011. Hers was to mature in three years with 15 percent interest, his in two years with an interest rate that varied over time, ranging from 5 to 15 percent. His note was extended twice.[288] When Stephen Shopoff offered to extend the maturities, RC was grateful for the opportunity and elected to do so; his wife did not, and her note was repaid. There was no requirement to extend the maturities.[289] RC also purchased three Shopoff Enterprises notes. He made the first purchase in May 2013, before the Class C notes matured.[290] The note was for $250,000 for two years with a 15 percent annual interest rate, terms he negotiated with Stephen Shopoff. RC purchased the second note for $100,000, to mature in one year, also with a 15 percent annual interest rate.[291] The third was a four-year note for $50,000 at 12 percent annual

[277] Tr. 1370.

[278] Tr. 1367; RX-1, at 17.

[279] Tr. 1437.

[280] Tr. 1446.

[281] Tr. 1447.

[282] Tr. 1442.

[283] Tr. 1432–34, 1440–42; CX-188.

[284] RX-1, at 22.

[285] Tr. 1619; CX-19.

[286] Tr. 1638–41; CX-164; CX-171.

[287] Tr. 1622.

[288] Compl. Appendix. A; CX-7; CX-164, at 6, 12, 13.

[289] Tr. 1634–35; CX-191.

[290] Tr. 1636; Compl. Appendix B.

[291] CX-171, at 22.

interest.[292] Some notes contained "profit kickers," promising a share of any profits earned on pending deals of a Shopoff Enterprises affiliate during the term of the notes.[293] For the $600,000 RC and his wife invested, as of December 31, 2018, they had received $226,603 in interest.[294]

Customer WM, an accredited investor with experience in real estate investments,[295] is a long-time friend of William and Cindy Shopoff. He invested $300,000 at the peak of the real estate market, just before the crash. He lost the entire investment. There was no Guaranty: it was a speculative investment. He knew the loss was not William Shopoff's fault, and he continued to invest or loan him funds.[296] In 2013, William Shopoff asked if WM could lend him $100,000, and WM agreed. He understands from his own experience that real estate developers at times run low on cash. He purchased a 60-day Shopoff Enterprises note for $100,000 with a 3.25 percent annual interest rate.[297] WM also purchased a Class C note, which he considered a loan. WM had inherited $4,000 from his father's IRA and asked William Shopoff as a favor to "put it in something."[298] The Class C note had a two-year maturity and paid 25 percent interest annually, with a profit "kicker" entitling him to a share of profits, if any, from investments while the loan was outstanding.[299] Neither note was extended and both have been paid in full.[300] On the two notes, WM received $15,480 in interest.[301]

The sworn declarations of the noteholders also reflect generally their expectation of profit. All include a summary of their earnings as of the date they signed the declarations. Customers JH and SH earned more than $700,000 in interest on approximately $1.9 million spent on seven notes, with maturities ranging from 2 to 68 months.[302] Customer RL purchased six notes for $300,000, with maturities from 22 months to 54 months and received $148,459 in interest.[303] Customers AL and DL purchased three notes for about $277,000, with maturities ranging from four to five years. As of December 31, 2017, they had received approximately

[292] CX-171, at 34.

[293] *See, e.g.,* CX-171, at 41.

[294] RX-1, at 3.

[295] Tr. 1727; CX-19.

[296] Tr. 1728–31.

[297] Tr. 1732–40; CX-179.

[298] Tr. 1741.

[299] Tr. 1742–46; CX-168.

[300] Tr. 1747.

[301] RX-1, at 7.

[302] RX-1, at 4.

[303] RX-1, at 5.

$51,586 and earned an additional $66,285.[304] Customer KS, a Shopoff family member, purchased a $40,000 four-year Class C note and received $20,908 in interest.[305]

Based on the evidence presented in this case, it is clear that the overarching motivation of the note purchasers was to profit from the favorable interest rates the Shopoffs offered. A favorable interest rate can be, and we find it is here, evidence that profit is a primary objective of a lender.[306]

The Shopoffs' use of the funds they borrowed also supports the argument that the notes are securities. William Shopoff described what he used proceeds for: "In some cases it was operating expenses of the firm. In some cases it was investments that we were making on behalf of myself and the firm . . . managing and growing the business" for the benefit of all concerned, including the interest the note purchasers would receive.[307] Thus, these were not notes sold to "facilitate the purchase and sale of a minor asset or consumer good," or to solve a short-term cash flow problem. They did not resemble instruments designed to "advance some other commercial or consumer purpose," making them unlike securities.[308] The funds were used for general operations and investments to grow the business and to profit noteholders.

As described above, the returns on the notes were attractive. We find that a reasonable investor would think so and would be motivated to invest in them for profit. The weight of the evidence supports our finding that, applying the first element of the *Reves* analysis, the Class C and Shopoff Enterprises notes are securities.

#### b. The Second *Reves* Factor: Distribution of the Notes to a "Broad Segment of the Public"

The second *Reves* factor requires an assessment of whether Respondents distributed the notes to a sufficiently "broad segment of the public" to establish "common trading" in the notes.[309]

As detailed above, from late 2010 to early 2017, 29 individuals purchased the Class C and Shopoff Enterprises notes, some buying both, for approximately $12.47 million. Thirteen

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[304] RX-1, at 6.

[305] RX-1, at 8.

[306] *Stoiber*, 161 F3d. at 750 (citing *Reves*, 494 U.S. at 67–68). In *Stoiber*, the lenders submitted affidavits stating, "I believe Mr. Stoiber is an honest and successful business person, and I believe him to be a good risk to repay me the loan; that is the reason why I loaned him this money." The *Stoiber* court found that their "display" of trust was not evidence of "the note holders' original motivations in making the loans" but, rather, their reasons for concluding the loans had a tolerable level of risk. *Id*. The Class C and Shopoff Enterprises note purchasers expressed similar sentiments toward the Shopoffs.

[307] Tr. 127.

[308] *Reves*, 494 U.S. at 66.

[309] *Id*. at 68.

customers purchased 19 Class C notes for approximately $1.57 million and 23 customers paid approximately $10.9 million for 42 Shopoff Enterprises notes. The customers knew the Shopoffs and their business well, as they had previously invested in Shopoff entities, and Respondents knew their customers.[310]

Respondents point to several characteristics of the notes that they argue distinguish them from securities under the second *Reves* factor: each note was individually negotiated, with unique terms; there was no secondary trading market; and the notes were not generally available to the investing public, but offered only to persons close to the Shopoffs. Respondents argue that these features of the notes "conclusively" indicate that, under the second *Reves* factor, the notes are not securities.[311] Enforcement counters by citing to court cases holding that notes offered to significantly fewer purchasers have been deemed securities; therefore, because Respondents sold notes to 29 customers, Enforcement argues the distribution was sufficiently broad to establish the notes were securities.[312]

It is true Respondents and the noteholders negotiated the terms of each note individually, and they were "not part of a general offering of uniform products."[313] Nevertheless, Respondents' characterization of each note as unique is not dispositive. The individually negotiated variables were the interest rates, payment terms, and maturity dates of each. Otherwise, the notes had features in common. All of the Class C and a number of the Shopoff Enterprises notes were funded from the purchasers' retirement accounts. The Guaranty accompanied both Class C and Shopoff Enterprises notes. Both offered attractive interest rates. Proceeds from both were to be used for working capital for Shopoff Realty and its affiliates. True, there is no evidence of common trading for speculation or a secondary market for the notes. The absence of such features has been held to weigh against finding notes to be securities, but is not determinative.[314] It is more important that Respondents offered the Class C and Shopoff Enterprises notes to 29 customers. Except for a few family members,[315] all that most purchasers had in common was that they knew the Shopoffs and had previously invested in Shopoff entities.[316]

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[310] Respondents' Post-Hr'g Br. 1.

[311] *Id.* at 35–36.

[312] Enforcement's Post-Hr'g Br. 37.

[313] Respondents' Post-Hr'g Br. 35.

[314] *LeBrun v. Kuswa*, 24 F. Supp. 2d 641, 647–48 (E.D. La. 1998); *SEC v. Global Telecom Servs.*, 325 F. Supp. 2d 94, 114–15 (D. Conn. 2004).

[315] Three Shopoff relatives purchased notes. KS purchased one Class C note (CX-163), TS purchased three Class C notes and one Shopoff Enterprises note (RX-13), and JS purchased three Shopoff Enterprises notes (CX-186).

[316] *Deal v. Asset Mgmt. Grp.*, No. 92 C 187 & No. 92 C 3023, 1992 U.S. Dist. LEXIS 13011, at *12–13 (N.D. ILL 1992) (distribution of note to six people with no ties other than being customers of the offering firm supported inference they came from a broad segment of the public); *Stoiber*, 161 F.3d at 751 (Although 13 customers with whom seller had a personal relationship did not qualify as a broad segment of the public, the solicitation of individuals rather than institutions by the seller, offering few details, was held to "suggest common trading").

Therefore, we find the evidence relevant to the second factor supports finding the notes to be securities.

### c. The Third *Reves* Factor: Reasonable Investors' Expectations

The third *Reves* factor requires us to consider whether the investing public would have a reasonably held expectation that a note is a security. For example, the investing public's expectation that common stock is always a security has led courts to consider common stock to be a security even when the economic realities of a transaction might lead to the conclusion that it is not.[317]

Respondents' argument that the notes are not securities relies on the evidence, discussed earlier, that they and the noteholders believed they were engaging in loans, not investments.[318] The factor is objective, however, and the Panel must assess public expectation from the perspective of a reasonable investor, not just the views of the specific note sellers and buyers involved in these transactions.[319] As discussed above, there were other indicia supporting characterization of the notes as investments: the use of the word "investor" and the references to units of limited partnership interests in the Class C subscription agreements, and the motivation of note purchasers to profit from the attractive earnings offered by Class C and Shopoff Enterprises notes.

Taking the circumstances as a whole into consideration, we find in applying the third *Reves* factor that a reasonable investor would consider Class C and Shopoff Enterprises notes to be investments.

### d. The Fourth *Reves* Factor: Regulatory Scheme to Protect Investors

The fourth *Reves* factor requires us to ask whether another regulatory structure provides protection reducing the risk of loss to investors, making the application of the securities laws unnecessary.[320] Respondents assert that the Guaranty given to each noteholder mitigated the purchasers' risk because it was "fully enforceable under contract and commercial law," therefore rendering the protection of the securities laws unnecessary and weighing in favor of finding that the notes are not securities.[321]

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[317] *Reves*, 494 U.S. at 66–68.

[318] Respondents' Post-Hr'g Br. 36.

[319] *McNabb*, 298 F.3d at 1132.

[320] *Reves*, 494 U.S. at 67, 69.

[321] Respondents' Post-Hr'g Br. 36–37 (citing *Bass v. Janney Montgomery Scott, Inc.*, 210 F.3d 577, 580, 585 (6th Cir. 2000) (finding that loan notes were not securities in part because they were "heavily secured" by collateral that served to reduce the purchasers' risk, which included a lien on "virtually all of the assets" of the borrowers)). However, as Enforcement points out, the noteholders did not have liens or other security interests provided to them. Enforcement's Post-Hr'g Br. 38.

We find the argument unpersuasive. True, the evidence establishes that the Shopoff Trust had sufficient assets to repay the noteholders if needed, and we find that the Shopoffs sincerely represented they would do so. But the Shopoff Trust is a revocable trust. By definition, then, the Shopoffs have the right to terminate the trust and take possession of trust property and any undistributed income.[322] Even if noteholders could sue the Shopoffs personally, the Guaranty did not provide the functional equivalent of a protective regulatory scheme to which the note purchasers could turn. For these reasons, we find that the fourth *Reves* factor weighs in favor of deeming the notes securities.

#### 2. The Class C and Shopoff Enterprises Notes Are Securities

Taking all of the circumstances into consideration, and applying the analysis prescribed by *Reves*, the preponderance of the evidence leads us to conclude that the Class C and Shopoff Enterprises notes are securities. We find that the notes do not fit or strongly resemble any of the categories of notes recognized as non-securities.[323] Therefore, the laws and rules applicable to securities transactions apply to them.[324]

### C. First Cause: Respondents Did Not Engage in Securities Fraud in Connection with the Sale of the Class C Notes

#### 1. Respondents Did Not Distribute the 2006 PPM in Connection with the Sale of the Class C Notes

As discussed earlier, at the hearing the parties strongly disagreed on a major premise of the first cause of action: that Respondents gave the 2006 PPM to all Class C note purchasers. The evidence Enforcement relies on includes the following:[325]

- A February 2011 FedEx delivery confirmation of a package containing the PPM to customer RC, who purchased a note in December 2011.
- Broker-Dealer and Registered Representative forms William and Stephen Shopoff signed attesting, among other things, to the delivery of a prospectus to note purchasers.
- Subscription Agreements the note purchasers signed acknowledging receipt and review of the PPM.

[322] *See Black's Law Dictionary* 1746 (10th ed. 2014).

[323] We find no reason to designate the notes as a new category of non-security instruments under *Reves*.

[324] *Reves*, 494 U.S. at 67.

[325] *See supra* Section III.B.1.

- Forms submitted to custodians of purchasers' IRA funds, stating that investors would be provided with offering documentation, including a PPM.

- William and Stephen Shopoff's OTRs in which they indicated they sent the PPM to note purchasers.

Enforcement rejects Respondents' denial that they gave Class C note purchasers the 2006 PPM. Enforcement characterizes it as a desperate "eleventh hour" ploy to avoid responsibility. Enforcement accuses Respondents of trying to "disassociate themselves from the operative (and fraudulent) PPM,"[326] by claiming "*for the first time* in their prehearing brief and then again at hearing that they did *not* deliver the TSG Fund IV PPM to the Class C investors."[327] Enforcement contends that the hearing testimony of William and Stephen Shopoff that "none of the Class C limited partners received the 2006 PPM was completely unfounded, uncorroborated, and not credible."[328]

Addressing Enforcement's "eleventh hour" argument, the Panel notes that Respondents' Answer to the Complaint denies each of the allegations in the Complaint related to use of the 2006 PPM in sales of the Class C notes. The Answer, filed February 13, 2019, put Enforcement on notice of the denials nine months before the hearing began.

Next, we examine Enforcement's attack on the Shopoffs' credibility. We have carefully reviewed Respondents' testimony, with close attention to its substance as well as Respondents' demeanor, in the context of the entire record of the Extended Hearing.

We found the Shopoffs to be candid in their hearing testimony. They admitted mistakes. They acknowledged that they, their attorney, and their staff, contributed to errors in some written responses to FINRA Rule 8210 requests, attributable to assumptions they all made about their standard practices without first confirming whether they had actually adhered to those practices. Considering the massive document requests and productions in this case, it is believable that the Respondents and their staff could have mistakenly provided some inaccurate information that was relied upon by counsel when preparing their responses. The uncontradicted testimony they gave about digging deeper into their databases as the hearing date approached, and finding no evidence of inclusion of PPMs in transmittal communications with the 13 Class C note purchasers, rang true. And the testifying customers, who were themselves credible, provided evidence of good character when they attested to the integrity of the Shopoffs.[329]

William and Stephen Shopoff's hearing testimony about the 2006 PPM differed from their OTRs, and changed during the course of the hearing. Enforcement argues that their

[326] Enforcement's Post-Hr'g Br. 10.

[327] *Id*. at 8–9.

[328] *Id*. at 12.

[329] Tr. 1364, 1447, 1464, 1731, 1736; RX-1, at 3, 7, 17, 21; RX-5, at 6.

testimony therefore is fabricated and untruthful, and that their sworn testimony is not to be believed.[330] We disagree.

We find their explanations for the inaccuracy of some portions of their OTRs to be credible. We accept William Shopoff's hearing testimony that he did not review "source data" before his OTR, and that he gave answers he believed to be true at the time, that in the end were unintentionally inaccurate.[331] Similarly, we accept Stephen Shopoff's admission that in his OTR he assumed that because the Shopoffs' normal procedure was to send PPMs with all limited partnership offerings, they must have done so with the Class C offering. Stephen Shopoff explained that when he saw a record stating a "prospectus" was sent, he inferred that the prospectus was the 2006 PPM.[332] After considering the circumstances, listening to their testimony, and observing their demeanor over the course of the hearing, we find the Shopoffs' explanations reasonable and credible.

It bears consideration that William Shopoff testified, without challenge or contradiction, that during the Notes Period, he managed 8 to 12 other limited partnership offerings, with approximately 5,000 investors.[333] Only 29 investors purchased the notes at issue. It is understandable that during his OTRs, William Shopoff's recollection of the details of the Class C offering might not have been crystal clear. It appears that he made assumptions based on his usual practice in other offerings. When asked if note purchasers received the 2006 PPM, he testified, "I believe so."[334] Similarly, when Stephen Shopoff was asked at his OTR what documents he provided to customers, he said, "[t]hey would have received a PPM . . ." with other transaction documents.[335] However, at the hearing he explained that at his OTR he "made a bad assumption" that they followed their "normal process" in delivering the usual documents.[336]

We find credible, too, the Shopoffs' description of why documents associated with the sales of Class C notes refer to a PPM that Respondents did not use to sell the notes. They utilized an old firm template for subscription agreements from previous offerings made with PPMs, and did not remove the language referring to a PPM from the agreements signed by the Class C note purchasers. This was unfortunate, and not good practice. William Shopoff conceded that in the future he will not "repurpose" loan documents from a previous offering.[337] In the end, Enforcement proved that Stephen Shopoff provided the 2006 PPM to just one person, RC, almost a year before he purchased a Class C note. That RC did not rely on it in deciding to invest would

[330] Enforcement's Post-Hr'g Br. 11-12.

[331] Tr. 270.

[332] Tr. 773–74.

[333] Tr. 736-37.

[334] Tr. 269–70.

[335] Tr. 777.

[336] Tr. 773.

[337] Tr. 1963.

be irrelevant if Respondents gave it to him with scienter.[338] But that is not what happened here. Stephen Shopoff's accompanying email accurately informed RC that "a good bit" of the information in the PPM was "not particularly relevant," and is evidence that he did not intend to mislead RC.[339] The evidence does not establish that Respondents gave the 2006 PPM to any other Class C note purchaser.[340]

Enforcement did not prove by a preponderance of the evidence that Respondents distributed the 2006 PPM to customers as they sold the Class C notes, and through it made fraudulent misrepresentations and omissions of material fact. Those allegations therefore fail.

### 2. Respondents Did Not Misrepresent or Fail to Disclose Material Facts in the Class C Subscription Agreement and Guaranty

Section 10(b) makes it unlawful, in connection with the purchase or sale of a security, to use manipulation or deception in violation of Exchange Act rules. Rule 10b-5 makes it unlawful, using the means or instrumentalities of interstate commerce, to falsely represent or fail to disclose a material fact.[341] FINRA Rule 2020 is violated when FINRA members engage in a purchase or sale of a security "by means of any manipulative, deceptive or other fraudulent device or contrivance," and a violation of Rule 2020 contravenes the high ethical standards imposed on FINRA members by FINRA Rule 2010.[342]

Thus, to prevail, Enforcement must prove four essential elements by a preponderance of the evidence. First, as discussed above, the transactions must involve the purchase or sale of securities. Second, the misrepresented or undisclosed facts must be material. Third, Respondents must have made the alleged material misrepresentations and omissions with scienter. Fourth, Respondents must have made their fraudulent recommendations by means of instrumentalities of interstate commerce. The first and fourth elements have been established. As shown in the discussion above, the Class C and Shopoff Enterprises notes are securities. And it is undisputed that Respondents sold them utilizing email, the U.S. Postal Service, and FedEx. [343] We turn now to the elements of materiality and scienter.

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[338] *Geman v. SEC*, 334 F.3d 1183, 1192 (10th Cir. 2003) (reliance need not be proven in securities enforcement actions).

[339] RX-25.

[340] As discussed earlier, Enforcement conceded that when it interviewed the Class C noteholders, it did not ask them if they received or relied upon the 2006 PPM.

[341] 17 C.F.R. § 240.10b-5(b).

[342] *Louis Ottimo*, Exchange Act Release No. 83555, 2018 SEC LEXIS 1588, at *28 (June 28, 2018), *aff'd on remand*, No. 2009017440201r, 2020 FINRA Discip. LEXIS 5 (NAC Mar. 27, 2020), *appeal docketed*, No. 3-17930r (SEC Apr. 27, 2020).

[343] Tr. 470–72.

The test for determining materiality is an objective one. It requires assessment of the likely significance of a fact to a reasonable investor.[344] For example, it is well established that a misrepresented fact relating to the financial condition, solvency, or profitability of a company is material to a reasonable investor.[345] Similarly, an omitted, or undisclosed, fact is material if there is a "substantial likelihood" that a reasonable investor would consider it important in deciding whether to invest. In other words, an undisclosed fact is material if there is a "substantial likelihood that the disclosure of the omitted fact would have been viewed by a reasonable investor as having significantly altered the 'total mix' of information made available."[346]

Scienter is a "mental state embracing intent to deceive, manipulate, or defraud." [347] Proof of scienter requires evidence that the misrepresentation or failure to disclose a material fact was willful, knowing, or reckless. Conduct is reckless if it is "highly unreasonable" and constitutes "an extreme departure from the standards of ordinary care . . . which presents a danger of misleading buyers or sellers that is either known to the defendant or is so obvious that the actor must have been aware of it."[348]

Respondents allegedly misrepresented a material fact in the Class C note subscription agreement; omitted material facts in the Guaranty; and made oral misrepresentations about the use of the proceeds of sales of notes. In addition, when asking noteholders to extend the maturity dates of their notes, Respondents allegedly failed to disclose that TSG Fund IV and Shopoff Realty's financial difficulties required them to ask for extensions, and that those difficulties required Respondents to ask earlier purchasers to extend maturity dates as well.

### a. The Class C Note Subscription Agreement

The first cause alleges that the Class C subscription agreement misrepresents a material fact when it states that TSG Fund IV "has no current financial or operating history."[349] Enforcement asserts that the statement is material and is false because TSG Fund IV had been in existence since 2006.[350] Respondents counter that the statement is immaterial.[351]

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[344] *TSC Indus. Inc. v. Northway, Inc.*, 426 U.S. 438, 445 (1976). *See also Basic Inc. v. Levinson*, 485 U.S. 224, 232 (1988) (adopting objective materiality standard for Rule 10b-5 cases); *Amgen Inc. v. Conn. Ret. Plans & Trust Funds*, 568 U.S. 455, 459 (2013) ("[M]ateriality is judged according to an objective standard.").

[345] *SEC v. Murphy*, 626 F.2d 633, 653 (9th Cir. 1980) ("Surely the materiality of information relating to financial condition, solvency and profitability is not subject to serious challenge") (citations omitted).

[346] *Basic Inc.*, 485 U.S. at 231–32 (quoting *TSC Indus.*, 426 U.S. at 449).

[347] *Ernst & Ernst v. Hochfelder*, 425 U.S. 185, 193 n.12 (1976).

[348] *Sunstrand Corp. v. Sun Chem. Corp.*, 553 F.2d 1033, 1045 (7th Cir. 1977).

[349] Compl. ¶¶ 32, 114.

[350] Enforcement's Post-Hr'g Br. 12.

[351] Respondents' Post-Hr'g Br. 31.

As William Shopoff testified without challenge, TSG Fund IV was not an "operating entity" in the sense that it engaged, for example, in real estate or other business activities. True, the entity was created in 2006 with an offering of limited partnerships, but the Class C notes, five years later, with their individually negotiated maturity dates and interest rates, were distinct from the original TSG Fund IV Class A limited partnerships. The documentation of TSG Fund IV's "operations" consists of a financial and income statement, and a balance sheet tracking the assets held on behalf of limited partners. Thus, William Shopoff's testimony that for Class C note purchasers, the "prior history was largely irrelevant" makes sense.[352] The differences between the terms of the two offerings and the length of time between them undercut the potential materiality of the statement that TSG Fund IV "has no current financial or operating history."

As we have seen, William and Stephen Shopoff explained that the purpose of the subscription agreement was to enable customers to use IRA funds to purchase Class C notes. The subscription agreement was not, as the Guaranty was, a material inducement to buy. Given the experience of the note purchasers with investments in general and their specific familiarity and prior dealings with the Shopoffs, it is reasonable that they would focus on the Guaranty and individually negotiated terms of their notes, and not on the boilerplate subscription agreement.

Under the totality of the circumstances, we conclude that Enforcement did not meet its burden to prove that a reasonable investor considering Class C notes would believe this statement in the subscription agreement to be material.

**b. The Guaranty**

The first cause charges Respondents with failing to disclose material information "about the Shopoffs' liquidity, net worth, cash balance and assets that was necessary for an investor to assess the risk" of investing in Class C notes.[353] In Enforcement's view, the Shopoffs' claimed net worth was questionable because it was "largely derived from self-valuations" and "their assets lacked liquidity."[354] Enforcement argues the Guaranty did not disclose that William and Cindy Shopoff's bank account held little cash, or that Shopoff Realty and the Shopoffs were illiquid.[355] Enforcement alleges this information was "necessary for an investor to assess the risk" of a default and weigh the ability of the Shopoffs to honor the Guaranty.[356]

William Shopoff's unrebutted testimony was that he told people of his substantial liabilities.[357] Enforcement presented no evidence demonstrating anything questionable about the Shopoffs' valuations of their assets. Enforcement did not establish that Shopoff Realty's

[352] Tr. 165–68.

[353] Compl. ¶ 115.

[354] Compl. ¶ 35; Enforcement's Post-Hr'g Br. 18.

[355] Enforcement's Post-Hr'g Br. 13.

[356] Compl. ¶¶ 35, 115.

[357] Tr. 226.

profitability or the Shopoffs' checking account balance were material to the viability of the Guaranty. Moreover, the Shopoffs, through the Shopoff Trust, were the guarantors, not Shopoff Realty. It was their overall financial picture that mattered.

William Shopoff's testimony, along with financial statements, the FactRight reports, and other evidence, establish that the Shopoffs and their overall business were solvent. William Shopoff had substantial net worth and ample liquidity available to make good on the Guaranty if necessary. As shown above, the evidence Enforcement offered to prove the Shopoffs' illiquidity consisted of financial statements estimating debt levels of several Shopoff entities and 11 email exchanges spanning four years discussing cash flow. William Shopoff convincingly explained the emails were related to cash management challenges typical in real estate-related businesses with limited access to sources of commercial lending. He presented persuasive evidence that during the Notes Period he had assets valued between $4.5 million and $7 million that could readily be converted to cash. His retirement accounts alone provided a more than sufficient cushion to honor the Guaranty.

Enforcement did not prove by a preponderance of the evidence that the overall financial condition of the Shopoffs and their entities was financially precarious during the Notes Period. Nor did Enforcement establish by a preponderance of the evidence that Respondents, as alleged, fraudulently failed to disclose facts relating to liquidity, net worth, cash balance and assets to purchasers of the notes that would have been material to a reasonable investor in assessing the worth of the Guaranty.

### 3. Respondents Did Not Misrepresent Their Use of Class C Loan Proceeds

The first cause charges that William and Stephen Shopoff misled Class C note purchasers by telling them that Shopoff Realty and its affiliates would use their funds for "working capital" or "general corporate purposes."[358] Enforcement claims this was misleading because Respondents did not disclose they would pay some of the funds to other investors.[359] Enforcement argues that a reasonable investor would consider the omitted information, if disclosed, to alter the total mix of information Respondents made available to prospective note purchasers.[360]

William Shopoff freely admits he used proceeds of new note purchases to pay principal and interest on notes that were due. He testified that most noteholders knew their funds could be used this way. He testified, without contradiction, that he discussed what he referred to as

[358] Compl. ¶ 118.

[359] Compl. ¶ 52; Enforcement's Post-Hr'g Br. 13.

[360] Enforcement's Post-Hr'g Br. 29.

"duration risk" with noteholders—the possibility that when a note matured, he might need to ask for an extension because of cash flow issues.[361]

William Shopoff testified that he discussed this with many noteholders. In their testimony and declarations, customers confirmed that William Shopoff could use their funds at his discretion for his business. He recalled specifically telling customer JM that he wanted to obtain operating capital pending the completion of closings on property sales in early 2014.[362] JM's declaration states that he "did not have an issue with how the proceeds of the loans would be used, whether for general business overhead expenses, refinancing of other debt, or payment of earnest money on new investment deals, etc."[363] Customer RC testified that he understood the proceeds of his note purchases would be used for working capital, without restriction. If used to make principal and interest payments to previous note purchasers, RC had no objection. He testified, "that's how business works."[364] Customer LP also testified there was no restriction on the use William Shopoff could make of her proceeds.[365] Customer RM testified that he expected the proceeds of his purchase to be used by the Shopoffs to operate their business, and using proceeds of note sales to pay down principal on previously purchased notes "would be fine. It's the operation of a business."[366] Customers JH and SH stated in their declaration that they were told the proceeds of their note purchases "would be used by affiliates of Shopoff Enterprises and TSG Fund IV at their discretion . . . [with] no restrictions by us."[367]

Respondents contend that the uses they made of note proceeds were legitimate and consistent with generally accepted definitions of working capital and general corporate purposes. They cite a Securities and Exchange Commission ("SEC") publication that defines working capital as the difference between a company's current assets and current liabilities, and states that the definition of current liabilities includes interest owed to lenders.[368] Respondents argue that current liabilities also include, among other things, short-term loans due on demand or within 12 months, and the portion of matured long-term debt payable within the next 12 months.[369]

The terms "general corporate purpose" and "working capital" are broad. *Black's Law Dictionary* defines general corporate purpose as "the general scope of the business objective for

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[361] Tr. 226–27.

[362] Tr. 418–19.

[363] RX–1, at 14.

[364] Tr. 1629, 1769.

[365] Tr. 1444.

[366] Tr. 1362.

[367] RX–1, at 4.

[368] Respondents' Post-Hr'g Br. 37–38 (citing *U.S. Securities and Exchange Commission Beginners' Guide to Financial Statements*, https://www.sec.gov/oiea/reportspubs/investor-publications/beginners-guide-to-financial-statements.html).

[369] *Id*. at 38 & n.213 (citing https://www.accountingtools.com/articles/2017/5/5/current-liability).

which a corporation was created,"[370] and working capital as "current assets . . . less current liability."[371] Moreover, it is well established that "a function of working capital is to fund operations."[372]

Based on this record, we conclude that Enforcement did not establish by a preponderance of the evidence that William and Stephen Shopoff failed to disclose they would devote some proceeds to pay interest and repay principal to previous note purchasers whose notes had matured.[373] The testifying noteholders stated this use of funds was within the scope of serving general corporate purposes, and all of the noteholders stated as much in their declarations. We agree.

Enforcement asserts that disclosure would have significantly altered the total mix of available information for a reasonable investor. We disagree. Even if there were evidence that Respondents failed to disclose their use of proceeds to a noteholder, we find that an experienced, reasonable investor, given the information the Shopoffs made available, including the terms of the note and the Guaranty, would deem immaterial the use of some proceeds to pay principal and interest on notes that were due.

#### 4. Respondents Did Not Fail to Disclose the Basis for Requesting Extensions of Loan Maturity Dates

The first cause also alleges that Respondents, when they asked Class C noteholders to extend maturity dates, failed to disclose the alleged material fact that TSG Fund IV and Shopoff Realty's financial difficulties necessitated the extensions. In a similar vein, the first cause alleges that when Respondents solicited purchases of Class C notes after extending notes held by earlier purchasers, they failed to disclose that it had been necessary to extend maturity dates for previously purchased notes because of funding shortfalls.[374] No noteholders testified in support of these allegations.

William Shopoff's uncontradicted testimony was that when he asked noteholders for extensions, he explained the reason was that an anticipated cash influx did not materialize as expected. Some noteholders were agreeable; if not, he paid the notes when due.[375] His testimony and supporting exhibits establish that he and the Shopoff Trust could have repaid all outstanding notes if necessary. His testimony that he asked for, but did not insist upon, extensions of note maturity dates as he addressed normal business cash-flow issues was corroborated by

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[370] *Black's Law Dictionary* 415.

[371] *Id*. at 251.

[372] *In re WorldCom, Inc. Sec. Litig.*, 346 F. Supp. 2d 628, 696–97 (S.D.N.Y. 2004) (quoting *Demaria v. Anderson*, 153 F. Supp. 2d 300, 313 (S.D.N.Y. 2001)).

[373] Enforcement did not present any noteholder testimony to support the allegation.

[374] Compl. ¶¶ 119–22, 139–42.

[375] Tr. 126.

noteholders who confirmed they felt free to decline to extend, and when they wanted to be paid, they were. The record shows that William Shopoff made interest and principal payments on time, and when asked, paid principal and interest before a note matured.

William Shopoff testified persuasively that financial difficulties did not compel him to seek extensions of maturity dates. He used the Class C and Shopoff Enterprises notes to raise capital as part of his cash management strategy during the Notes Period. William Shopoff testified that he elected to borrow from noteholders rather than sell assets he preferred to grow until it was time to "harvest" them for the benefit of the partnership.[376]Throughout the Notes Period, his personal net worth substantially exceeded the total owed to noteholders: the total of the notes was never more than seven percent of his net worth.[377] In the early years of the Notes Period, the total of the "loans" from note purchasers was roughly equivalent to the combined revenues of Shopoff Securities and Shopoff Realty, but from 2013 through 2017, their revenues substantially exceeded the total of the outstanding notes.[378]

We find the evidence insufficient to substantiate the allegations that Respondents asked noteholders to extend the notes' maturity dates because TSG Fund IV and Shopoff Realty's financial condition required them to do so, or that they failed to disclose that it was necessary to extend the maturity dates of previous Class C notes.

### D. Second Cause: Respondents Did Not Engage in Securities Fraud in Connection with the Sale of the Shopoff Enterprises Notes

Most of the fraud allegations in the Complaint's second cause of action, focused on the sales of Shopoff Enterprises notes, are indistinguishable from the fraud allegations in the first cause of action. To summarize, they allege that Respondents:

- misrepresented that they would use loan proceeds for working capital and general corporate purposes;
- failed to disclose that they would use proceeds to repay other investors;
- failed to include alleged negative information in the Guaranty;
- failed to disclose that Shopoff Enterprises and Shopoff Realty's funding problems required Respondents to ask for extensions of maturity dates and to ask previous lenders for extensions;

[376] Tr. 1514–15, 1808.

[377] Tr. 1518; RX-12, at 8.

[378] In 2010, the two entities' combined revenues were just under $1 million, and the total "loaned" by noteholders was $250,479. At the end of 2016, their combined revenues exceeded $18 million and the notes totaled $5.7 million. Tr. 1488; RX-12, at 7.

- failed to disclose that Shopoff Realty's limited liquidity required cash infusions from affiliates and William Shopoff.

Having addressed these allegations in the first cause as they pertain to the sales of Class C notes, we need not repeat the above discussion in connection with the sales of Shopoff Enterprises notes.[379] We reach the same conclusions for the same reasons.

The second cause of action adds the allegation that Respondents fraudulently failed to disclose they would transfer note proceeds to William Shopoff and the Shopoff Trust and use those proceeds to pay William and Cindy Shopoff's personal expenses.[380] It alleges that the Shopoffs used $165,000 of $10.9 million, approximately 1.5 percent, of the Shopoff Enterprises note proceeds for personal expenses.[381] The alleged personal expenditures include $105,000 for a mortgage payment on a real estate lot they planned to build a home on;[382] $50,000 for house rent;[383] and approximately $10,000 to pay personal expenses Cindy Shopoff incurred, including a vacation.[384]

Enforcement relies substantially on the testimony of its examiner and the demonstrative exhibits she prepared to support the Complaint's factual allegations.[385] Enforcement's examiner testified that she reviewed bank account statements and emails showing Respondents spent Shopoff Enterprises funds for the Shopoffs' personal purposes.[386] She did not inquire how Shopoff entities treated these payments in their books and records and did not know if they were recorded as business expenses, dividends, or returns of capital.[387]

As evidence that the Shopoffs used Shopoff Enterprises' funds to pay for Cindy Shopoff's personal expenses, the examiner relied on a company-issued American Express

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[379] The Complaint alleges misrepresentations related to the use of proceeds for working capital and general corporate purposes in sales of Class C notes (¶ 118) and sales of Shopoff Enterprises notes (¶ 132). The Complaint also alleges the failure to disclose payments to other investors as a use of proceeds to Class C purchasers (¶¶ 30(e), 113, 122) and to Shopoff Enterprises purchasers (¶¶ 62, 134(b)). It also alleges the failure to disclose negative information in the Guaranty to Class C purchasers (¶¶ 115–17, 123) and to Shopoff Enterprises purchasers (¶¶ 136–38); the failure to disclose Shopoff Realty and Land Fund IV's funding problems, the need for extensions of maturity dates, and that they had required extensions of previous lenders' maturity dates to Class C purchasers (¶¶ 119–22) and Shopoff Enterprises purchasers (¶¶ 139–42); and the failure to disclose that Shopoff Realty's liquidity limitations required cash infusions from affiliates and William Shopoff to Class C purchasers (¶ 113(b)) and Shopoff Enterprises purchasers (¶ 134(c)).

[380] Compl. ¶¶ 56, 134(a).

[381] *Id.* ¶ 56.

[382] *Id.* ¶ 57.

[383] *Id.* ¶¶ 58–59.

[384] *Id.* ¶ 60.

[385] Tr. 1195–96; *see, e.g.*, CX-222.

[386] Tr. 1211–12; CX-222.

[387] Tr. 1211–13.

account statement showing payments to hotel in the British Virgin Islands. She concluded, with no further explanation, that the charges were "for a vacation . . . which Mr. and Mrs. Shopoff and their two children and two of their friends attended."[388] When asked what accounting standard she used to conclude that an expense was personal, the examiner answered, "[N]o standard." During her investigation, she did not inquire whether the underlying expenses that Shopoff Enterprises' funds reimbursed were business-related. The examiner decided an expense was personal based upon the credit card used.[389] In the end, she conceded that she had no way of knowing whether the underlying expenses were legitimate business expenses.[390]

When questioned about her personal expenses, Cindy Shopoff testified that when she uses a personal credit card for business-related purposes, Shopoff Realty's accountants book the charge and allocate it appropriately. She testified that the hotel charge was for a business trip she and her family took with another couple, WM and his wife. The couple are investors and also trustees of the Shopoff Trust. The trip mixed business with pleasure. The Shopoffs and the couple discussed Shopoff Realty's business and its direction, something the Shopoffs "tend to do" with that couple. She testified that Shopoff Realty and the Shopoffs' tax filings have been regularly audited, with no questions raised about personal versus business expense claims. During its investigation, FINRA never questioned her about these charges on her credit card.[391]

Enforcement argues that when Respondents told Shopoff Enterprises note purchasers their funds would be used for working capital or general corporate purposes without disclosing that their money would also pay the Shopoffs' personal expenses, it created "a misleading impression," like a "half-truth," which is "always misleading."[392]

However, the evidence, discussed in detail above, supports the conclusion that Respondents did use Shopoff Enterprises proceeds for working capital and general corporate purposes. William Shopoff's unrebutted testimony is that the property for which he made the mortgage payment was an investment.[393] As co-owners of Shopoff Realty and other Shopoff entities who contributed millions of dollars to support Shopoff Realty, Respondents argue the Shopoffs are entitled to take distributions from the business and use them as they wish.[394]

We conclude that a reasonable investor would consider the Shopoffs' use of some Shopoff Enterprises' loan proceeds for a mortgage payment on an investment property to be immaterial. The record provides no persuasive evidence or authority that use of some proceeds to

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[388] Tr. 1041.

[389] Tr. 1034, 1211–13.

[390] Tr. 1160–62.

[391] Tr. 1337–40.

[392] Enforcement's Post-Hr'g Br. 34 (citing *Initial Public Offering Sec. Litig.*, 241 F. Supp. 2d 281, 380 (S.D.N.Y. 2003) (half-truth misleads by omitting material information and is always misleading)).

[393] Tr. 401–02.

[394] Respondents' Post-Hr'g Br. 39–40 & n.225.

make the mortgage payment was inconsistent with a general corporate purpose. Furthermore, Enforcement did not establish that the Shopoffs were not entitled to a distribution to use some proceeds to pay for two months' rent, and did not establish that a reasonable investor would consider an omission to disclose that fact to be material. Finally, the testimony and evidence did not establish that the Shopoffs spent Shopoff Enterprises' funds to reimburse Cindy Shopoff's personal expenditures. Enforcement's evidence depends on the cycle examiner's assumptions based on the credit card to which expenses were charged and the entries in an American Express bank statement. Enforcement's assumptions do not overcome the weight of Cindy Shopoff's unchallenged and credible testimony that there was a legitimate business purpose for the Virgin Islands hotel expenses.[395]

### E. Third Cause: Respondents Did Not Make Unsuitable Recommendations of Class C and Shopoff Enterprises Notes

At the beginning of the Notes Period, in December 2010, NASD Rule 2310 was the rule requiring members to ensure that the investments they recommended to customers were suitable. Effective July 9, 2012, FINRA Rule 2111 replaced NASD Rule 2310, but it did not change the substance of the suitability standard. There are three major aspects to the suitability standard imposed by Rule 2111. They are reasonable basis suitability, customer-specific suitability, and quantitative suitability.[396] The third cause of action focuses on reasonable basis suitability.

The SEC has long held that to fulfill their reasonable basis suitability obligation, firms and brokers must have a '"reasonable basis' to believe that a recommendation could be suitable for at least some customers." This requires them to make a reasonable investigation of the recommended note or other security and understand "the potential risks and rewards inherent in that recommendation." These are necessary prerequisites for making customer-specific suitability determinations.[397] Customer-specific suitability requires that any recommendation be consistent with the customer's best interests,[398] based on the customer's investment objectives, financial situation, and needs.[399]

The suitability requirement incorporates the concept of "fair dealing."[400] Inducing customers to purchase securities by making recommendations containing false representations

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[395] At the conclusion of Cindy Shopoff's testimony explaining the hotel charge and her practices concerning submission of credit card charges to company accountants, Enforcement asked only two questions on cross-examination and did not challenge her testimony about personal expenses. Tr. 1341–42.

[396] https://www.finra.org/rules-guidance/key-topics/suitability.

[397] *F. J. Kaufman & Co.*, 50 S.E.C. 164, 168 nn.16–18 (1989).

[398] *Scott Epstein*, Exchange Act Release No. 59328, 2009 SEC LEXIS 217, at *39 n.24 (Jan. 30, 2009) (quoting *Dane S. Faber*, 57 S.E.C. 297, 310–11 (2004)).

[399] *Rafael Pinchas*, 54 S.E.C. 331, 341 (1999).

[400] *Epstein*, 2009 SEC LEXIS 217, at *39.

violates a registered person's duty of fair dealing.[401] Thus, recommendations predicated upon fraudulent representations cannot have a reasonable basis and are therefore deemed unsuitable for any investor.[402]

The third cause of action alleges that Respondents did not have a reasonable basis for believing their recommendations of Class C and Shopoff Enterprises notes were "suitable for at least some investors."[403] Indeed, the Complaint charges that Class C and Shopoff Enterprises notes were "not suitable for any investor" because of Respondents' fraudulent sales practices of using new proceeds to pay previous note purchasers and using proceeds for personal expenses. In addition, their alleged unsuitability stemmed from the poor financial condition of TSG Fund IV, Shopoff Enterprises, Shopoff Realty, and the limited liquidity of the Shopoff Trust.[404] Enforcement states its case for the suitability charge succinctly: Respondents sold Class C and Shopoff Enterprises notes by fraudulent means, and "[s]ecurities sold through fraudulent means are not suitable for any investor."[405]

We have found that the evidence fails to establish that Respondents sold the notes fraudulently, and that therefore they were unsuitable for "any investor."

Moreover, the evidence does not suggest the notes were unsuitable for the individuals who purchased them. The purchasers of the notes of both offerings were experienced investors, affluent, knowledgeable about investing, and familiar with the Shopoffs and their businesses. The four testifying customers who were asked responded that they were willing and able to accept the risk of losing the entire amount of their notes.[406]

Furthermore, William Shopoff testified that he and Stephen Shopoff had "suitability conversations" with all 13 Class C note purchasers.[407] Despite believing the notes were not securities, he wanted to ensure that each note purchase fit the "particular financial position" of each purchaser. According to William Shopoff, although the objective was to "help us get capital that we were looking for . . . we also had to be looking out for the client, and we did."[408] He was

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[401] *Mac Robbins & Co.*, 41 S.E.C. 116, 119 (1962) ("Outright false statements are not only expressly proscribed by the securities laws but are patently inconsistent with the duty of fair dealing.").

[402] *Dep't of Enforcement v. John Carris Invs., LLC*, No. 2011028647101, 2015 FINRA Discip. LEXIS 34, at *125 (OHO Jan. 20, 2015).

[403] Compl. ¶ 150.

[404] *Id*. ¶¶ 152–53.

[405] Enforcement's Post-Hr'g Br. 41; *Dep't of Enforcement v. Reyes*, No. 2016051493704, 2019 FINRA Discip. LEXIS 57, at *52 (OHO Dec. 17, 2019) (citing *Carris*, 2015 FINRA Discip. LEXIS 34, at *125), *appeal docketed* (NAC Jan. 10, 2020).

[406] Customer RM testified that he could afford to lose his $400,000. Tr. 1376. Customer KO said the same about her $250,000. Tr. 1407. LP testified she could afford to lose her $625,000. Tr. 1473. Customer WM described the funds he used for his note purchases as money he "could lose." Tr. 1750.

[407] Tr. 209–10.

[408] Tr. 207–08.

familiar with the purchasers. The Class C note offering was structured for note purchases to be made with retirement funds. William Shopoff advised customers on their retirement accounts and the required minimum distributions from their funds.[409] He met with one couple three or four times to ensure that the plan satisfied their needs and desires.[410] He was similarly familiar with the Shopoff Enterprises notes purchasers. He testified that he talked with them about whether a note was "the appropriate place for [them] to put [their] money."[411]

Stephen Shopoff testified that he determined the notes were suitable for each individual purchaser with whom he dealt. When Enforcement asked why he did this if he did not think the notes were securities, he answered, "[I]t just makes sense that it would become standard practice . . . to make sure that this fits . . . their overall portfolio . . . what their goals are, their tax situation."[412]

For these reasons, the charge that the recommendations were unsuitable fails.

### F. Fourth Cause: Shopoff Securities, Through William Shopoff, Did Not Engage in Securities Fraud in Connection with the Land Fund III and Land Fund IV Offerings

The fourth cause of action charges Shopoff Securities and William Shopoff with engaging in securities fraud through the 2014 and 2015 FactRight reports disseminated to broker-dealers in connection with Shopoff Realty's Land Fund III and Land Fund IV offerings. The crux of the charge is that William Shopoff, with intent to deceive, temporarily deposited $1.5 million into his and Cindy Shopoff's joint checking account on March 31, 2014, so that the balance would be included in the Compilation sent to FactRight, causing the FactRight reports to contain materially inflated, misleading representations of William and Cindy Shopoff's finances.

The Complaint alleges that these representations were false because immediately after March 31, 2014, the Shopoffs' checking account balance plunged and remained far below $1.5 million. Therefore, William Shopoff's certification in the 2015 FactRight report that his financial position had not changed was false because his joint checking account had been substantially depleted. The fraud was allegedly completed when the 2014 and 2015 FactRight reports were sent to three downstream broker-dealers whose representatives solicited investors to invest in Land Fund III and Land Fund IV.[413]

[409] Tr. 350.

[410] Tr. 350–51.

[411] Tr. 347–49.

[412] Tr. 811–12.

[413] Compl. ¶¶ 156–59; Enforcement's Post-Hr'g Br. 43–44.

Enforcement argues that William Shopoff "did not speak fully and truthfully" in making these representations through FactRight.[414] Under Section 10(b) and Rule 10b-5 of the securities laws, William Shopoff had a duty to correct the misleading picture presented in the reports.[415] However, the fourth cause alleges, Respondents failed to provide an internal December 2014 financial statement showing the checking account balance of $5,192, "or any other updated financial information," to FactRight.[416]

Respondents reply that the reported balance as of March 31, 2014, was accurate and truthful as of that date, hence not misleading. They reject Enforcement's claim that William Shopoff had a duty to update the financial information in the report. Respondents point to the testimony of FactRight's CEO that FactRight would not have permitted William Shopoff to make changes to the reports based on fluctuations in his bank account balance after March 31, 2014.[417] Respondents also insist that William Shopoff's certifications were truthful: the reports were accurate because his financial condition did not change substantially in 2015.[418]

Additionally, Respondents insist that William Shopoff cannot be held responsible for factual statements in the reports because he did not "make" the statements. FactRight, in sole control of the reports' contents, made the statements.[419] Respondents further assert that the allegedly false statements would be immaterial to a reasonable investor in Land Fund III or Land Fund IV because there is no evidence demonstrating that any prospective investors in the offerings saw the statements. Finally, Respondents argue that FactRight prohibited the downstream broker-dealers that received the reports from providing them to registered representatives or allowing the contents to be disclosed to investors. Thus, the statements could not have formed part of the total mix of information Respondents made available to investors.[420]

In the Panel's view, whether FactRight or William Shopoff was responsible for making the statements relating to cash balances and financial condition in the reports, the statements were accurate and the Compilation's representation of the Shopoffs' available cash on March 31, 2014, was correct.

The FactRight reports did not purport to represent that the Shopoffs had a cash balance of $1.5 million *at the time the reports were published*. By necessity, the reports were prepared some months after the Compilation. As FactRight's CEO explained, it takes time to prepare financial

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[414] Enforcement's Post-Hr'g Br. 42–43.

[415] *Id*. at 43.

[416] Compl. ¶¶ 96–97.

[417] Respondents' Post-Hr'g Br. 45.

[418] *Id*. at 46.

[419] *Id*. at 46–47 (citing *Raab v. Gen. Physics Corp.*, 4 F.3d 286, 289 (4th Cir. 1993) (company not liable for inaccurate statements by third party even when the third party attributes them to company)); *Janus Capital Grp, Inc. v. First Derivative Traders*, 564 U.S. 135, 143 (2011) (to be a maker of a statement one must control its content).

[420] Respondents Post-Hr'g Br. 49.

statements and compilations, and more time for FactRight to finalize a report. The CEO testified, "[W]e spend a tremendous amount of time with financial statements that in this particular case . . . take an inordinate amount of time to produce in and of themselves from the CPA firms. And then we do . . . an extra level of diligence and investigation on top of that."[421] We find relevant the CEO's observation, "Everybody knows that . . . we're dealing with information that has changed, but it's still the best information we can handle in the aggregate at that moment in time."[422] This is why "nobody is under any obligation to continuously update [FactRight] with information on these diligence projects."[423]

The CEO's testimony bears on another key assumption underlying Enforcement's theory of fraud here—that Respondents were obligated to inform FactRight that an internal financial statement showed the Shopoffs' checking account balance fell to $5,000 in December 2014. Cross-examining the FactRight CEO, Enforcement asked if the December 2014 account balance would have been important for him to see when preparing the 2015 report. He responded that he could not say if that fact "in isolation" would have mattered.[424] Significantly, when told the December 2014 financial statement was a statement of financial condition "internally prepared and signed by William Shopoff," and asked if he would have included it in the 2015 FactRight report, he replied, "No. We don't rely on internally prepared, unverified information."[425]

We find nothing fraudulent about the March 31, 2014 transfer of $1.5 million to the Shopoffs' joint checking account. No evidence undermines William Shopoff's explanation that the timing of the $1.5 million distribution presented a good opportunity at the end of the first quarter of 2014 to take a snapshot of the Shopoffs' financial condition for the Land Fund III offering. As Shopoff Realty's former CFO Sciutto testified, transferring $1.5 million into the checking account was not intended to deceive but to temporarily make the Shopoffs' available liquidity more transparent than it would have been in a financial statement listing it as an asset of an entity. Afterward, William Shopoff chose to transfer it out of the bank account and invest or loan the money to Shopoff Realty. Sciutto's testimony directly corroborates William Shopoff, and the FactRight CEO's testimony does so indirectly. These facts underscore that, because the cash was a liquid asset, the Shopoffs were not required to keep such a large sum in a joint checking account used for day-to-day expenses when investing it would better serve the interests of the business and its partners.

In its allegations about the Shopoffs' liquidity, Enforcement incorrectly equates the cash balance in the joint checking account with their solvency and net worth. As the financial statements showed, and William Shopoff convincingly testified, there was ample liquidity in the Shopoff business to tap if needed. We also find that the Shopoffs' financial solvency and net

[421] Tr. 1676.

[422] Tr. 1678.

[423] Tr. 1678–79.

[424] Tr. 1711–12.

[425] Tr. 1709.

worth had not changed substantially by the end of 2015. If anything, they had improved. Therefore, William Shopoff's certification in the 2015 report was not false. The FactRight CEO testified he understood the statement in the 2015 report—that "Management indicated the financial position of William and Cindy Shopoff has not changed significantly since the compilation was prepared"—referred to the Shopoffs' "overall financial position," and not to the balance in their checking account.[426]

Our conclusion that Respondents did not make the due diligence reports fraudulently misleading is dispositive of the allegations of the fourth cause of action. However, lest there be any question about the insufficiency of the evidence of fraud, the charge of fraud also fails because there is no evidence that the reports were used in any sales of Land Fund III or Land Fund IV securities. The Complaint alleges that William Shopoff "caused material overstatements of his and Cindy Shopoff's personal financial liquidity to be made to three retail broker-dealers . . . soliciting investments. These broker-dealers solicited investors."[427] The Complaint does not, because it cannot, allege that any broker made the "material overstatements" to any investor in connection with a Land Fund III or Land Fund IV purchase.[428]

There is no evidence that any broker offering Land Fund III or Land Fund IV read the due diligence report; in fact, brokers were prohibited from reading it. There is no evidence that any broker made any representation to an investor regarding the level of cash in the Shopoffs' joint bank account. Proof of Section 10(b) and Rule 10b-5 violations requires evidence that a material misrepresentation or omission was made to a customer *in connection with the sale or purchase of a security*.[429] The only evidence Enforcement presented in this regard is that three broker-dealers indicated they had received and reviewed the FactRight reports, and that their brokers recommended Land Fund III and Land Fund IV to customers.[430]

In sum, we find the evidence insufficient to establish that Respondents made false representations contained in the Compilation sent to FactRight, or that the 2014 and 2015 FactRight reports were used to solicit investors to invest in Land Fund III and Land Fund IV. The evidence does not support the allegations in this cause of action.

### G. The Evidence of Scienter Is Insufficient

An essential element of the Section 10(b) and Rule 10b-5 violations alleged in the first, second, and fourth causes of action is scienter. To meet the required standard, Enforcement must prove by a preponderance of the evidence that Respondents made material misrepresentations

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[426] Tr. 1721.

[427] Compl. ¶ 158.

[428] No brokers or customers were called as witnesses to establish this element.

[429] *SEC v. Hasho*, 784 F. Supp. 1059, 1106 (S.D.N.Y. 1992) (evidence that defendants made statements meant to persuade customers to purchase securities satisfies the element that they were made in connection with the sale of securities).

[430] CX-80; CX-81; CX-82.

and omissions intending "to deceive, manipulate, or defraud" purchasers of the notes and private placements at issue.[431]

With regard to the first cause of action, Enforcement argues that Respondents made oral representations intentionally omitting adverse financial information about the Shopoffs' liquidity when they solicited purchases of Class C notes.[432] The evidence does not support the allegations of the Shopoffs' illiquidity. Furthermore, the evidence does not establish that Respondents acted with deceptive or fraudulent intent.

Enforcement makes similar arguments in relation to the second cause of action. It stresses that Respondents (i) knew that William and Cindy Shopoff and the Shopoff Trust had low liquidity; (ii) obtained extensions of loans from noteholders without disclosing that Shopoff Enterprises and Shopoff Realty were unable to repay principal and interest; and (iii) intentionally misrepresented that they would use the loan proceeds for business purposes, choosing not to disclose they would use the funds for other, personal purposes.[433] We find the evidence does not establish that Respondents made the alleged material misrepresentations or omissions. The evidence does not establish fraudulent or deceptive intent.

As for the fourth cause of action, Enforcement argues that because William Shopoff knew the joint checking account held the $1.5 million distribution "only temporarily," Shopoff Securities through William Shopoff acted with scienter when, months later, he allowed the FactRight reports to reflect the cash balance as of March 31, 2014. Intentionally withholding accurate information about the actual cash balance, and falsely certifying the reports as accurate, they allegedly prevented FactRight from ascertaining "William Shopoff's true cash position" and reporting it to potential investors."[434] As the evidence shows, however, the reports accurately reflected the cash balance in the account as of March 31, 2014. That balance was not the measure of William Shopoff's net worth and liquidity, nor was it represented to be. The evidence establishes that what mattered was the Shopoffs' overall financial condition and liquidity, which were accurately represented in the FactRight reports.

We find the evidence does not establish that William Shopoff possessed deceptive or fraudulent intent, and therefore conclude that Enforcement did not meet its burden to prove Respondents acted with scienter.

## V. Conclusion

For the reasons set forth in this Decision, the Panel finds the evidence insufficient to sustain the charge that Respondents engaged in the extensive years-long securities fraud

[431] *Ernst*, 425 U.S. at 193–94 & n.12.

[432] Enforcement's Post-Hr'g Br. 32–33.

[433] *Id*. at 39–41.

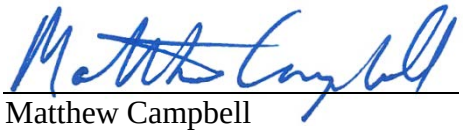
[434] *Id*. at 46–47.

described in the Complaint. Rather, taken as a whole, the evidence "suggests an equally or more compelling inference" than Enforcement urges upon the Panel.[435]

The Panel concludes, therefore, that the evidence fails to support: (i) the allegations of the first cause of action, charging Respondents Shopoff Securities, Inc., William A. Shopoff, and Stephen R. Shopoff, with fraud in the sale of TSG Fund IV Class C notes in violation of Section 10(b), Rule 10b-5 thereunder, and FINRA Rules 2020 and 2010; (ii) the allegations of the second cause of action, charging Respondents Shopoff Securities, Inc., William A. Shopoff, and Stephen R. Shopoff, with fraud in the sale of Shopoff Enterprises notes in violation of Section 10(b), Rule 10b-5 thereunder, and FINRA Rules 2020 and 2010; (iii) the allegations of the third cause of action, charging Respondents Shopoff Securities, Inc., William A. Shopoff, and Stephen R. Shopoff, with making unsuitable recommendations in violation of NASD Rule 2310(b), and FINRA Rules 2111(a) and 2010; and (iv) the allegations of the fourth cause of action, charging Respondent Shopoff Securities, Inc., through William A. Shopoff, with fraud in the sale of Land Fund III and Land Fund IV notes in violation of Section 10(b), Rule 10b-5 thereunder, and FINRA Rules 2020 and 2010.

For these reasons, we dismiss the Complaint.[436]

**SO ORDERED**.



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[435] *Reynolds*, 2001 NASD Discip. LEXIS 17, at *55.

[436] The Panel considered and rejected without discussion all other arguments by the parties.