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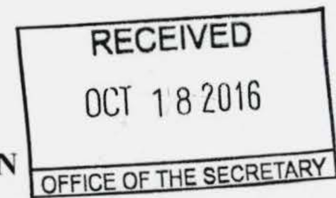

UNITED STATES OF AMERICA
Before the
SECURITIES AND EXCHANGE COMMISSION

ADMINISTRATIVE PROCEEDING
File No. 3-16462

In the Matter of **LYNN TILTON;** **PATRIARCH PARTNERS, LLC;** **PATRIARCH PARTNERS VIII, LLC;** **PATRIARCH PARTNERS XIV, LLC;** **AND** **PATRIARCH PARTNERS XV, LLC,** **Respondents.**	**DIVISION OF ENFORCEMENT'S PRE-HEARING BRIEF**

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I. PRELIMINARY STATEMENT

Investment advisers have fiduciary duties to act with the utmost good faith and in the best interest of their clients – indeed, to put their clients' interests above their own. In addition, the Investment Advisers' Act prohibits fraudulent practices and schemes. Respondents in this case breached those solemn duties, misled their clients, and put their own interests first. In so doing, Respondents kept more than $200 million that properly belonged to their clients and deprived investors of the chance to exercise control over the investment funds. These breaches of fundamental obligations under the Investment Advisers Act warrant serious sanctions.

Respondent Lynn Tilton and the Patriarch entities she controlled were investment advisers. Respondents managed three pooled investment vehicles structured as collateralized loan obligation ("CLO") funds – the Zohar funds. The Zohar funds raised money from investors through the issuance of notes, which are securities, and used those funds to make loans to distressed companies, which would in turn make interest and principal payments back to the Zohar funds. Based upon the disclosures made to them, investors expected regular cash flows and ultimately the return of their principal from their investments.

Tilton represented to investors that she would monitor the value of the Zohar funds' assets (*i.e.*, loans to distressed companies) and categorize those assets according to an objective framework set out in the governing documents. This objective categorization of the Zohar funds' assets was designed to protect both the Zohar funds and the funds' investors, as it afforded certain rights to investors if the funds' assets were not performing well. These rights – triggered by the Zohar funds' assets performing below a certain benchmark – included redirecting payments from Respondents to the Zohar funds and the funds' investors and ultimately giving investors the option to remove Tilton from control of the funds.

As will be demonstrated through documentary and testimonial evidence, Tilton flouted her obligations and consistently and regulatory breached her fiduciary duties. Instead of objectively categorizing the funds' assets as promised, Tilton manipulated their value by categorizing the assets according to her own subjective, personal belief in whether a distressed company would be able to repay the loan sometime in the future. This manipulation was not only undisclosed to investors, it also eviscerated the protections that had been promised in the offering documents. Although many of the Zohar funds' assets were performing poorly and missing substantial interest payments, Tilton concealed these facts by keeping the assets in the highest-performing category based on subjectively "believing" in the company. The Zohar funds' financial statements were similarly false and misleading, as they affirmatively represented Respondents were complying with U.S. GAAP, were performing an impairment analysis on the loans, and that the fair value of the loans was approximately equal to their carrying value. These statements were not true, as no U.S. GAAP-compliant analyses were performed.

Through the manipulation of the disclosed asset valuations, Respondents were able to keep control of the Zohar funds, and continue to reap certain management fees and equity distributions that should have gone to the funds and ultimately to investors – over $200 million since 2009. The Division's case will detail Respondents' false statements and omissions, fraudulent scheme, and breaches of fiduciary duties. The Division will prove that Respondents hid the truth from investors, and in doing so, violated the securities laws, breached their fiduciary duties and standards of care, and took over $200 million that should have gone to investors. The Division will request, and Your Honor should order, appropriate remedial relief, including that Respondents disgorge these monies, pay civil penalties, and be barred from the securities industry so that they can no longer harm investors.

II. RESPONDENTS

Lynn Tilton is a resident of Highland Beach, Florida. Tilton manages each of the Patriarch entities described below and controls their decisions. Tilton is also heavily involved in the management of the companies to which the Zohar CLO funds at issue in this case have made loans.

Patriarch Partners, LLC ("Patriarch") is a Delaware limited liability company with a principal place of business in New York, New York. Patriarch's employees, including Tilton, run the businesses of Patriarch VIII, Patriarch XIV, and Patriarch XV (collectively, the "Patriarch Collateral Managers"). Patriarch is indirectly owned 100% by Tilton.

Patriarch Partners VIII, LLC is a Delaware limited liability company with a principal place of business in New York, New York. Patriarch VIII was registered as a relying investment adviser[1] with the Commission from March 2012 until March 2016, and was the collateral manager for Zohar CDO 2003-1, Limited during the relevant time period. Patriarch VIII is indirectly owned 100% by Tilton and a trust for the benefit of Tilton's daughter.

Patriarch Partners XIV, LLC is a Delaware limited liability company with a principal place of business in New York, New York. Patriarch XIV was registered as a relying investment adviser with the Commission from March 2012 until March 2016, and was the collateral manager for Zohar II 2005-1, Limited during the relevant time period. Patriarch XIV is indirectly owned 100% by Tilton and a trust for the benefit of Tilton's daughter.

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[1] A relying investment adviser is an investment adviser controlled by, or under common control with, an adviser that is registered with the Commission and that together "conduct a single advisory business." *See* American Bar Association, Business Law Section, SEC No-Action Letter (Jan 18, 2012), *available at* https://www.sec.gov/divisions/investment/noaction/2012/aba011812.htm.

Patriarch Partners XV, LLC is a Delaware limited liability company with a principal place of business in New York, New York. Patriarch XV was registered as an investment adviser with the Commission from March 2012 until March 2016 and was the collateral manager for Zohar III, Limited during the relevant time period. Patriarch XV is indirectly owned 100% by Tilton and a trust for the benefit of Tilton's daughter.

III. FACTS

A. Background on the Zohar Funds

This case involves structured finance vehicles called Collateralized Loan Obligation funds. As the name implies, a CLO fund raises money from investors to invest in loans. More specifically, a CLO fund is a securitization vehicle in which a special purpose entity – the issuer – raises capital through the issuance of secured notes to investors and uses the proceeds to purchase or originate a portfolio of commercial loans. A CLO fund has a collateral manager – who is typically an investment adviser – and that collateral manager determines what loans to purchase or originate on behalf of the CLO fund. Cash flows and other proceeds from those loans are used to repay the investor noteholders in the CLO fund. CLOs are securities and carry with them the obligations – including fiduciary duties – that come with managing securities and being an investment adviser.

There are three Zohar CLO funds at issue in this case: the first, referred to as "Zohar I," was launched in 2003; the second, referred to as "Zohar II," was launched in 2005, and the third, referred to as "Zohar III," was launched in 2007. Tilton structured each of the three Zohar funds as CLO funds. The issuer in each case is a corporate entity: Zohar CDO 2003-1, Limited is the issuer for Zohar I ; Zohar II 2005-I, Limited is the issuer for Zohar II; and Zohar III, Limited is the issuer

for Zohar III.[2] These issuer entities, which are all Cayman Island companies, each have their own Board of Directors.

As described above, the Patriarch Collateral Managers (Patriarch Partners VIII, LLC; Patriarch Partners XIV, LLC; and Patriarch Partners XV, LLC) are the collateral managers for their respective Zohar funds. The Patriarch Collateral Managers are owned and controlled by Tilton and entities under her control. The Patriarch Collateral Managers have no employees of their own; rather, Patriarch Partners, LLC – for which Tilton is the CEO and sole principal – employs individuals in various roles to help her manage the Zohar funds. Tilton makes all significant decisions relating to the management of the collateral of the Zohar funds. Put simply, in the words of Tilton herself: "I'm the collateral manager, I am the ultimate decision-maker on many things."

Each Zohar deal is governed by various documents. Two critical governing documents are the indenture and the collateral management agreement ("CMA"). The indenture describes the terms of the offering, including the maturity date of the notes, information reporting requirements, and priority of payments. The indenture also describes the rights of the parties and responsibilities of the collateral manager. The indenture further identifies the Patriarch Collateral Managers as the collateral managers for the funds. As one of the Division's experts, Ira Wagner, has explained in his report and will explain at the hearing, investors in CLOs expect collateral managers to follow the indenture to the letter.

The CMA is also an important document. The CMA, which is a contract between the issuer and the respective Patriarch Collateral Manager, describes the collateral manager's duties and compensation. Tilton signed each CMA as the manager of the respective Patriarch Collateral Manager.

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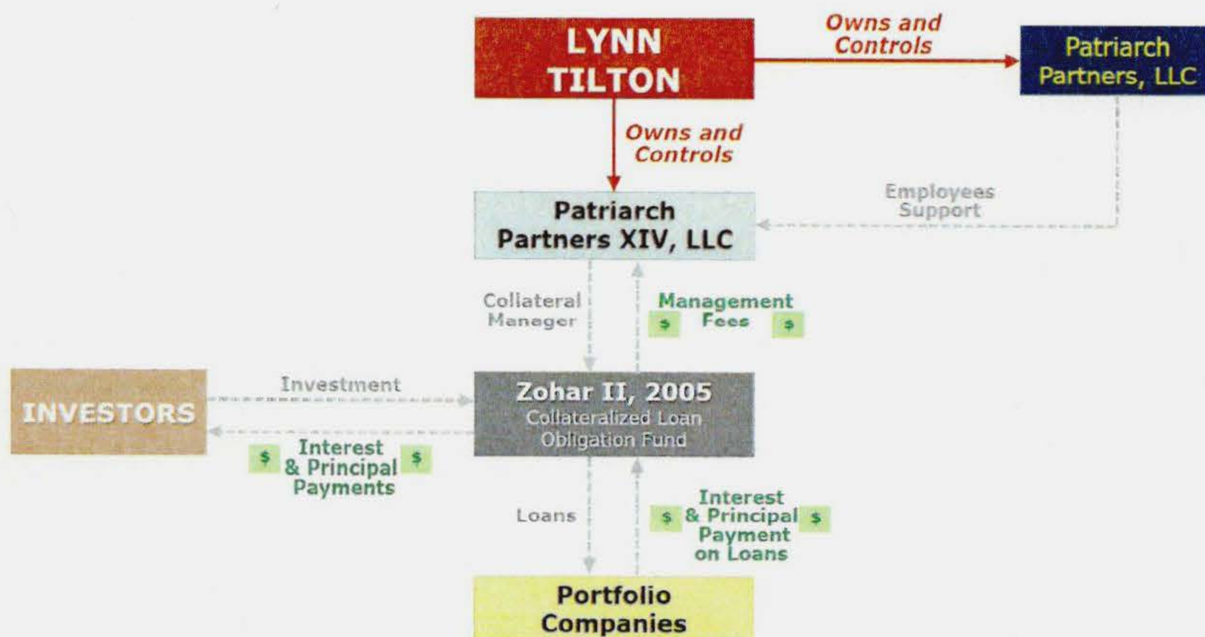
[2] Each fund also had co-issuers and subsidiaries that were also corporate entities.



The Patriarch Collateral Managers – which, as can be seen in the above illustration, are owned by Tilton and entities under her control[3] – earn fees based on the assets in the Zohar deals. Specifically, the Patriarch Collateral Managers receive a Senior Collateral Management Fee, paid quarterly, which is equal to 1% of the fund's assets. The Patriarch Collateral Managers may also receive an additional Subordinated Collateral Management Fee, which is also equal to 1% of the fund's assets. In addition, certain entities controlled by Tilton hold preference shares in the Zohar funds. As more fully described below, both payment of the Subordinated Collateral Management Fee and distributions on preference shares are dependent on the Zohar funds passing certain valuation tests, and thus those valuation tests were of critical importance to both Respondents and investors. These provisions meant that if the funds were performing well, Tilton would benefit financially as collateral manager, while if the funds were performing poorly, the Subordinated Collateral Management Fee and distributions on preference shares would be diverted from Respondents to the funds, and ultimately investors, to protect their investment.

[3] This illustration relates to the Zohar II CLO. The other Zohar funds have similar structures.

Each of the Zohar funds raised a significant amount of money from institutional investors. Zohar I raised approximately $532 million; Zohar II and Zohar III each raised approximately $1 billion. Tilton – through the Patriarch Collateral Managers – used these funds to buy or make loans to primarily private, mid-sized companies that were in distress (the "Portfolio Companies"). Tilton often directed more than one of the Zohar funds to extend loans to the same Portfolio Company.

Repayment of these loans by the Portfolio Companies was and is critical to the investors in the Zohar funds. The Zohar funds are so-called "cash flow" CLOs: repayment of the loans by the Portfolio Companies is the means by which the investors in the Zohar funds are to recover their investments. Every quarter, the investors receive an interest payment, generated from the collective interest payments made by the Portfolio Companies. Although they receive interest payments quarterly, investors are generally not entitled to be repaid their principal until the maturity date of their notes from the Zohar funds. Each of the deals has a 12 year maturity, meaning that investments in Zohar I (launched in 2003) matured last year (but, as noted below, Zohar I defaulted and was unable to repay investors' principal), investments in Zohar II (launched in 2005) will mature in early 2017 (as noted below, Zohar II is also expected to default), and investments in Zohar III (launched in 2007) will mature in 2019.

In addition to directing the Zohar funds to make loans to the Portfolio Companies, Tilton actively manages the business of the Portfolio Companies. Tilton is the CEO or sole manager of many of the Portfolio Companies. She hires and fires their senior employees, provides input on their major operating decisions, and requires that the companies report regularly to her regarding their financial condition and business prospects. In addition to Tilton's management of the Portfolio Companies, Tilton and the Zohar funds obtained equity in the Portfolio Companies.

Tilton's ostensible management strategy for the Zohar funds was to improve the operations of the distressed Portfolio Companies so that the companies could pay off their debt (including their loans from the Zohar funds), increase in value, and eventually be sold for additional profit. Tilton failed in this strategy. In November 2015, Zohar I defaulted on its obligation to repay noteholders their principal investment. In addition, Respondents have represented that Zohar II is likely to default when it matures in early 2017.

B. Respondents Were Investment Advisors and Owed Fiduciary Duties.

Each of the Respondents was an investment adviser to the Zohar funds during the relevant time period. More specifically, as noted above, each of the Patriarch Collateral Managers was registered as an investment adviser with the Commission and received fees in exchange for providing investment advice to the respective Zohar funds.[4] Tilton is an investment adviser as well: she owns and controls the Patriarch Collateral Managers and provided and was compensated for investment advice to the Zohar funds. And Patriarch Partners, LLC employs individuals in various roles to help Tilton and the Patriarch Collateral Managers manage the Zohar funds, making that entity an investment adviser also.

As investment advisers, Respondents owed fiduciary duties to their clients. *See* Section IV.A, *infra*. Indeed, Patriarch Partners, LLC's compliance manual recognizes that investment advisers

> are in a position of trust and confidence with respect to their Clients and have a fiduciary duty to place their Clients' interests before the Firm's and its Employees' interests. This includes an obligation to avoid or minimize both conflicts of interest and the appearance of any conflicts of interest.

[4] As noted above, Patriarch Partners XV, LLC (the collateral manager entity for Zohar III) was registered as an investment adviser. Patriarch Partners VIII, LLC (the collateral manager entity for Zohar I) and Patriarch Partners XIV, LLC (the collateral manager entity for Zohar II) were registered as relying investment advisers.

In addition, the CMA for each Zohar deal provides a standard of care for the collateral manager, requiring the collateral manager to "use reasonable care and the same degree of skill and attention … exercised by institutional investment managers of national standing generally in respect of assets of the nature and character of the Collateral [that is being managed] and for clients having similar investment objectives and restrictions." The CMA also outlines the collateral manager's obligations, including the obligation to not take any action that the collateral manager knows or should know would "cause the [issuer] to violate the terms of the Indenture" or "adversely affect the interests of" the Zohar investors.

C. The Zohar Indentures Prescribed Important, Objective Requirements to Value and Categorize Fund Assets, Which Protected the Funds and the Funds' Investors.

The Zohar funds' controlling documents made clear that investors would receive regular interest payments and the repayment of their principal on a specified maturity date. As a safeguard for investors, the indenture for each of the Zohar funds contains certain tests that must be met over time and that relate to the performance of the fund's loans to the Portfolio Companies. The indentures also prescribe consequences for failing these tests. The results of these tests were communicated to investors each month through reports distributed by the Zohar funds' trustee.

One key test is the Overcollateralization Ratio ("OC Ratio") test. In its simplest terms, the OC Ratio compares the assets of a CLO (*i.e.* the loans the CLO owns) to the liabilities of a CLO (*i.e.* the notes the CLO owes to investors). It is somewhat analogous to a loan-to-value ratio. The higher the OC Ratio, the greater the cushion between the value of the Zohar fund's assets and the amount the fund owes to its investors. As one of the Division's experts, Ira Wagner, has explained in his report and will explain at the hearing, OC Ratios and related tests are significant to investors in CLOs. Mr. Wagner's opinions will be corroborated by various investor witnesses. As those

investor witnesses will explain at the hearing, the OC Ratio is key: it is one of the first things they look at on each month's trustee report to assess the performance of the investment.

In addition to providing information on the performance of the funds' assets, declines in the OC Ratio trigger important protections for investors. Mr. Wagner has outlined those protections in his reports. In brief, as the OC Ratio falls, meaning the value of the Zohar fund's assets declines and comes closer to the amount the fund owes its investors, the chance of an investor suffering losses in its principal grows. For that reason, as the OC Ratio breaches certain test levels, the indentures spell out a number of consequences to insulate investors from further loss. For example, if the OC Ratio falls below an initial prescribed level,[5] cash flow is re-directed *away from* Respondents (in the form of subordinated management fees payable to the collateral manager and preference share distributions to entities Tilton controls) and *toward* the investors (in the form of accelerated payments on their notes). If the OC Ratio falls even further, the indentures provide investors with additional rights, including the option of terminating the collateral manager. Thus, the results of the OC test directly impacted Respondents' ability to obtain management fees as well as to keep control of the Zohar funds.

The indentures require that the OC Ratio be calculated using objective measures. The Zohar funds' assets – the loans to the Portfolio Companies – are required to be categorized by the collateral manager, and that category determines the value of the asset for purposes of the OC ratio. For Zohar I and II, the asset categories range from a "1" to a "4." Category 4 assets are the

[5] That level varies depending on the Zohar fund. The level was set at 105% for Zohar I, 112% for Zohar II, and 112.7% for Zohar III.

strongest; Category 1 assets are the weakest.[6] In the case of Zohar III, the numerical designations were replaced with two categories: "Defaulted Investment" and "Collateral Investment." These are equivalent to Categories 1 and 4, respectively. In either case, loans that are Category 4/Collateral Investments are essentially valued at 100 cents on the dollar for purposes of calculating the OC Ratio; loans that are Category 1/Defaulted Investments are haircut by some amount.[7] This means that, as loans are moved from a Category 4/Collateral Investment to a Category 1/Defaulted Investment, the OC Ratio falls.

Each indenture contains specific, objective definitions for each asset category that turn, in large part, on whether the Portfolio Company is current on its loan interest payments to the Zohar funds. For Zohar I and II, a loan to a Portfolio Company may not be categorized higher than a Category 1 unless, among other things, it is "Current." A loan is not "Current" if it is a "Defaulted Obligation," which is a loan "***with respect to which a default as to the payment of*** principal and/or ***interest has occurred*** (without regard to any applicable grace period or waiver of such default), but only so long as such default has not been cured." Thus, for Zohar I and II, a loan that has failed to make interest payments when due must be classified as a Category 1 asset.[8]

[6] As a practical matter, Categories 2 and 3 were rarely used; categorization was binary as either a 1 or a 4.

[7] In Zohar I, the value of a Category 1 loan is determined by using the loan's Original Purchase Price Percentage, meaning the percentage of the outstanding principal on the loan that the CLO paid to acquire the loan. In Zohar II, the value of a Category 1 loan is determined by using either the Moody's or Standard & Poor's recovery rates, which were typically between 40% and 60%. A Defaulted Investment in Zohar III is valued the same way, *i.e.*, by reference to the Moody's or Standard & Poor's recovery rates.

[8] More precisely, for Zohar I and II, a loan is "Current" if it is not "Non-Current." A "Non-Current" loan is a "Defaulted Obligation" which has "previously deferred and/or capitalized as principal any interest due." Thus, a loan must be placed in Category 1 if the borrower has not been current on its interest payments for two consecutive periods: the first missed payment

Zohar III has similar, objective criteria. A "Defaulted Investment" – the equivalent of a Category 1 loan in Zohar I and II – includes a loan "***with respect to which a default as to the payment of*** principal and/or ***interest has occurred***, but only so long as such default has not been cured." Like Zohar I and II, under the objective definitions in the indenture, a loan that has failed to make interest payments when due must be categorized as a Defaulted Investment.[9]

In sum, the indentures set out specific, objective measures for categorizing loan assets and haircutting the value of loans that are not paying any or all interest. As the Division's expert Ira Wagner has explained in his report and will explain in the hearing, these measures – haircutting assets that are not performing – are common features to CLOs and structured finance transactions generally, which protect investors.

D. Respondents Ignored These Objective Requirements and Instead Categorized Fund Assets Based on Tilton's Subjective Belief in the Prospects of the Portfolio Companies.

Rather than follow the objective definitions required by the indentures, Respondents have categorized assets based on Tilton's subjective, personal belief in whether the underlying Portfolio Company would ultimately be successful. Over the life of the Zohar funds, many Portfolio Companies have repeatedly defaulted on their periodic interest payments: in some cases, they have only paid a fraction of the interest due in a given period, in other cases they have paid no interest at all in a given period. Respondents are well aware of the interest payments Portfolio Companies

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creates a "Defaulted Obligation" by virtue of the "default as to the payment of … interest," and the second consecutive missed payment creates a "Non-Current" loan since it is then a Defaulted Obligation that, because of the missed interest payment in the prior period, "previously deferred … any interest due."

[9] Zohar III does not have the same terms as Zohar I and II, which require that the loan fail to make full interest payments for two consecutive periods. Thus, the first missed interest payment requires a loan in Zohar III to be categorized as a "Defaulted Investment."

make on their loans – indeed, Tilton herself made the ultimate decision to accept less interest than the amount that is due. However, in direct contravention of the indentures, Respondents have not categorized the loans based on whether they are current or have defaulted on their interest payments. Tilton could not have been clearer about this in her investigative testimony, admitting that she substitutes her subjective, personal belief in the long-term prospects of a Portfolio Company for the objective requirements of the indentures. Indeed, she went so far as to claim that the failure to pay interest does not affect a loan's categorization:

> ***A. . . .[C]ategorizations are based on the belief in the future recovery and the reorganization, not based on how much interest is collected. The categorizations are based on the belief in the ultimate reasonableness of the recovery and the future.***
>
> Q. And where was that – that concept of the ultimate reasonableness of recovery, how is that reflected in the indenture?
>
> A. I'd have to review the indenture, but there – ***the categories, we have discretion over choosing the categories***; and for us in control situations, the categories are binary. ***A Category 1 is either – it's a formal restructure of bankruptcy, or we believe that despite efforts in additional funding, that the value or the performance of the company will still decline in time. And a Category 4 is that we have reasonable belief to conclude that with additional funding and additional effort, that the performance of the company will improve with time.***

As a result of this subjective, personal belief assessment, Respondents have classified very few loans lower than Category 4/Collateral Investment. For example, as of January 2014, more than one hundred loans in the Zohar II portfolio were classified as Category 4 while only 16 loans were categorized as Category 1. Moreover, as of the time of the institution of these proceedings, all of the Zohar funds reported OC Ratios that were passing the prescribed test levels.

Respondents were acutely aware of the OC Ratio, and were interested in keeping it high. For example, in early July 2009, Tilton communicated with another Patriarch employee about the restructuring of a particular Portfolio Company. Tilton pressed the employee to explain what that

restructure "mean[s] in OC pickup." When the employee responded that other events would cause the OC Ratio to fall, Tilton scolded the employee to "get to me in advance if OC will retreat so radically. I need to know this before the end of the month so I can see if there is anything I want to do to change things. We need to be proactive before the month closes."[10] Similarly, in late 2008, in a communication with a different Patriarch employee, Tilton wrote, "I[']ll take any OC where I can get it."[11]

As discussed below, Respondents' subjective, personal belief categorization approach – which was not disclosed to the Zohar funds' investors – allowed Respondents to "be proactive" in manipulating the OC Ratio and resulted in materially higher OC Ratios than the ratios that should have been reported had Respondents followed the objective, disclosed terms of the indentures.

E. Respondents' Subjective Belief Approach Resulted in Respondents Improperly Retaining $200 Million in Fees and Preference Share Distributions, as Well as Control over the Funds.

Had Respondents followed the objective categorization methodology required by the indentures – rather than categorizing assets based on Tilton's subjective, personal belief in the Portfolio Companies – the number of loans categorized as Category 1/Defaulted Investment, as well as the OC Ratio, would have looked very different. One of the Division's experts, Michael G. Mayer, calculated what the OC Ratio should have been each quarter had Respondents been properly categorizing the loans based on whether the Portfolio Companies were current on their interest payments on the loans from the Zohar funds. Mr. Mayer's analysis shows that the OC Ratio was materially misstated in numerous periods, that the OC Ratio fell below the level that should have re-directed cash flows away from Respondents (in the form of subordinated

[10] Division Ex. 147.

[11] Division Ex. 138.

management fees and preference share distributions) and toward investors (in the form of additional payments on their notes), and that in the case of Zohar II, the OC Ratio fell even further, to the level where investors would have had the option to terminate the collateral manager.

For Zohar II, Mr. Mayer's analysis shows that by the middle of 2009, the properly-calculated OC Ratio (denoted as "CRA Adjusted" in the chart below) diverged significantly from the OC Ratio that was reported to the funds and the funds' investors and that was based on Respondents' subjective, personal belief in the Portfolio Companies (denoted as "Original" in the chart below):[12]

Zohar II OC Ratio Test Results by Quarter

Zohar II CLO					
Year	Quarter Ending	Original	CRA Adjusted	Minimum	Pass/Fail
2005	Jul-05	118.38%	118.38%	112.00%	Pass
	Oct-05	113.95%	113.95%	112.00%	Pass
2006	Jan-06	118.49%	118.36%	112.00%	Pass
	Apr-06	122.53%	122.41%	112.00%	Pass
	Jul-06	122.39%	122.27%	112.00%	Pass
	Oct-06	123.86%	123.74%	112.00%	Pass
2007	Jan-07	123.12%	122.78%	112.00%	Pass
	Apr-07	123.36%	123.02%	112.00%	Pass
	Jul-07	120.50%	119.40%	112.00%	Pass
	Oct-07	122.97%	122.59%	112.00%	Pass
2008	Jan-08	122.06%	121.47%	112.00%	Pass
	Apr-08	121.45%	121.00%	112.00%	Pass
	Jul-08	123.57%	120.85%	112.00%	Pass
	Oct-08	121.97%	119.15%	112.00%	Pass
2009	Jan-09	125.93%	121.93%	112.00%	Pass
	Apr-09	124.38%	120.35%	112.00%	Pass
	Jul-09	121.19%	111.65%	112.00%	Fail
	Oct-09	121.88%	107.82%	112.00%	Fail
2010	Jan-10	121.66%	105.59%	112.00%	Fail
	Apr-10	120.45%	103.69%	112.00%	Fail
	Jul-10	120.07%	101.80%	112.00%	Fail
	Oct-10	120.36%	101.77%	112.00%	Fail
2011	Jan-11	119.44%	100.73%	112.00%	Fail
	Apr-11	120.29%	101.11%	112.00%	Fail
	Jul-11	120.26%	100.47%	112.00%	Fail
	Oct-11	120.41%	100.94%	112.00%	Fail
2012	Jan-12	119.72%	99.91%	112.00%	Fail
	Apr-12	120.23%	100.02%	112.00%	Fail
	Jul-12	120.56%	100.07%	112.00%	Fail
	Oct-12	118.23%	98.52%	112.00%	Fail
2013	Jan-13	118.03%	98.26%	112.00%	Fail
	Apr-13	115.26%	95.40%	112.00%	Fail
	Jul-13	115.35%	95.35%	112.00%	Fail
	Oct-13	115.45%	95.30%	112.00%	Fail
2014	Jan-14	115.54%	95.51%	112.00%	Fail
	Apr-14	115.29%	97.76%	112.00%	Fail
	Jul-14	115.60%	97.64%	112.00%	Fail
	Oct-14	114.79%	97.76%	212.00%	Fail

In addition to the OC Ratio being materially misstated, starting in July 2009, the OC Ratio fell below the specified level – 112% – that should have re-directed cash flows away from Respondents and toward investors. And starting in July 2010, the OC Ratio fell below 102%, which is the level that triggers an "Event of Default" and gives the Zohar II investors the right to terminate the collateral manager.

[12] This chart is from Mr. Mayer's expert report (Div. Ex. 117) at page 56.

Mr. Mayer's analysis shows similar results for Zohar III. For Zohar III, the properly-calculated OC Ratio (again denoted as "CRA Adjusted" in the chart below) began diverging significantly from the OC Ratio Respondents were reporting (again denoted as "Original" in the chart below) in early 2009:[13]

Zohar III OC Ratio Test Results by Quarter

Zohar III CLO					
Year	Quarter Ending	Original	CRA Adjusted	Minimum	Pass/Fail
2007	Dec-07	110.33%	109.48%	112.70%	N/A
2008	Mar-08	107.58%	106.74%	112.70%	N/A
	Jun-08	127.38%	126.77%	112.70%	Pass
	Sep-08	122.78%	118.08%	112.70%	Pass
	Dec-08	127.31%	122.53%	112.70%	Pass
2009	Mar-09	127.04%	115.00%	112.70%	Pass
	Jun-09	122.75%	110.31%	112.70%	Fail
	Sep-09	123.99%	109.17%	112.70%	Fail
	Dec-09	125.19%	110.19%	112.70%	Fail
2010	Mar-10	125.06%	109.77%	112.70%	Fail
	Jun-10	125.28%	109.21%	112.70%	Fail
	Sep-10	125.27%	109.04%	112.70%	Fail
	Dec-10	125.28%	109.08%	112.70%	Fail

Zohar III CLO					
Year	Quarter Ending	Original	CRA Adjusted	Minimum	Pass/Fail
2011	Mar-11	126.12%	109.81%	112.70%	Fail
	Jun-11	123.18%	107.56%	112.70%	Fail
	Sep-11	124.44%	108.43%	112.70%	Fail
	Dec-11	124.41%	109.18%	112.70%	Fail
2012	Mar-12	124.32%	108.99%	112.70%	Fail
	Jun-12	120.97%	107.38%	112.70%	Fail
	Sep-12	121.50%	107.44%	112.70%	Fail
	Dec-12	121.46%	107.47%	112.70%	Fail
2013	Mar-13	119.62%	105.42%	112.70%	Fail
	Jun-13	120.05%	105.37%	112.70%	Fail
	Sep-13	120.39%	105.31%	112.70%	Fail
	Dec-13	120.63%	105.21%	112.70%	Fail
2014	Mar-14	116.79%	105.67%	112.70%	Fail
	Jun-14	118.74%	107.28%	112.70%	Fail
	Sep-14	117.83%	105.71%	112.70%	Fail
	Dec-14	118.13%	105.82%	112.70%	Fail

As with Zohar II, beginning in June 2009 the OC Ratio fell below the specified level – 112.7% – that should have re-directed cash flows away from Respondents and toward investors.[14]

As a result of Tilton's improper subjective, personal belief categorization approach, Respondents retained significant sums that should have been re-directed to the Zohar funds and those funds' investors. As. Mr. Mayer demonstrates through his analysis, Respondents were paid

[13] This chart is from Mr. Mayer's expert report (Div. Ex. 117) at page 57.

[14] While many of the Zohar I loans to Portfolio Companies were not current on their interest payments, because the "haircut" made to the value of such loans was minimal under the terms of the Zohar I indenture, *see supra* n. 7, Zohar I would not have failed the OC Ratio test even if the collateral had been categorized correctly.

more than ***$200 million*** in subordinated management fees and preference share distributions to which they were not entitled:[15]

Preference Share Distributions and Subordinated Collateral Management Fees Paid During the Period in which Zohar II and Zohar III Failed their OC Ratio Tests

CLO	OC Ratio Test Fail Period	Preference Share Distributions	Subordinated Collateral Manager Fees	Total
Zohar II	Jul 2009 - Dec 2014	$0	$76,012,349	$76,012,349
Zohar III	Jun 2009 - Dec 2014	$41,000,000	$91,403,522	$132,403,522
Total		$41,000,000	$167,415,871	$208,415,871

F. Investors Were Not Aware of Respondents' Subjective Belief Approach or the Conflict of Interest it Created.

Respondents did not disclose Tilton's subjective, personal belief categorization approach. As investor witnesses will explain at the hearing, they expected Respondents to follow the objective terms of the indenture to categorize assets for purposes of the OC Ratio. They were not aware that Respondents were categorizing loans based on, in Tilton's words, "the belief in the ultimate reasonableness of the recovery and the future." Moreover, the investor witnesses will explain that this information – knowing that Respondents were categorizing loans based on Tilton's subjective, personal belief in the Portfolio Company's ultimate success rather than following the objective terms of the indentures – would have been important to their investment decision.

In addition to concealing Tilton's subjective, personal belief approach, this approach to categorization created a significant conflict of interest. Respondents made decisions in a way that allowed them to collect money from the funds and retain absolute control over their management, despite the poor performance of the funds' assets. More specifically, Tilton controlled the Portfolio

[15] This chart is from Mr. Mayer's expert report (Div. Ex. 117) at page 63.

Companies, controlled the decision whether to allow those Portfolio Companies to pay less interest than was due, and (based on Tilton's undisclosed, subjective, personal belief in the underlying Portfolio Company) controlled the decision whether to move a loan from a Category 4/Collateral Investment to a Category 1/Defaulted Investment for purposes of the OC Ratio, regardless of whether or not the loan was paying its interest. This approach gave Respondents absolute discretion to keep loans that were not making full interest payments from being downgraded, thereby artificially keeping the OC Ratio above the point where the investor protections were triggered. Put simply, Respondents' approach to categorization eviscerated the investor protections afforded by the OC Ratio tests while directing more than $200 million to Respondents that should have been re-directed to the funds and their investors. Despite this, Respondents did not disclose this subjective, personal belief approach that they employed to categorize assets and the glaring conflict of interest that arose from this approach.

G. Respondents Caused the Zohar Funds' Financial Statements to be False and Misleading.

In addition to prescribing objective standards for categorizing assets for the OC Ratio, the indenture for each of the Zohar funds also required that the respective funds provide quarterly financial statements prepared in accordance with U.S. GAAP. Relatedly, in each of the funds' financial statements, Respondents represented that the fair value of the loans to Portfolio Companies was approximately equal to their carrying value. However, the financial statements were not U.S. GAAP compliant, and the representations about fair value were false and misleading because Respondents had no basis to make any such disclosure.

Each of the Zohar fund's indenture required the publication of quarterly financial statements in accordance with U.S. GAAP. The financial statements were prepared by Patriarch's accounting department, approved by Tilton, and then provided to the trustee, which in turn made

them available to investors. Each financial statement contained a cover page and certification signed by Tilton. The certification (also required under the terms of the indentures) provided, in part, that the balance sheet and income statement were prepared in accordance with U.S. GAAP, and that Tilton had reviewed the balance sheet and income statements and that those documents fairly presented the financial position of the relevant Zohar fund in all material respects.[16]

Contrary to the indenture and Tilton's certifications, the balance sheet and income statements were not prepared in accordance with U.S. GAAP. Specifically, Patriarch did not perform U.S. GAAP-compliant impairment analyses, but represented that it did. U.S. GAAP requires certain affirmative steps to account for loan impairment, which Respondents did not follow. Here, loans to Portfolio Companies were recorded on the Zohar funds' financial statements at cost. These loans make up the vast majority of the assets on the balance sheet, and have a corresponding payable to investors in the Zohar funds. Consistent with U.S. GAAP, and as required by the indentures, Patriarch was required to perform an impairment analysis. Under U.S. GAAP, a creditor is required to record a loss when it is probable that a loan is impaired as of the date of the financial statement. A loan is impaired, and must be measured for the amount of impairment loss, when, based on current information and events, it is probable that a creditor will be unable to collect all amounts due according to the contract with the debtor.

Respondents did not follow these requirements, and did not impair loans, but instead would only write them off if and when Tilton determined that she would no longer support a

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[16] Although Patriarch did hire an outside accounting firm – Anchin, Block & Anchin, LLP ("Anchin") – Patriarch did not employ Anchin to ensure the financial statements were prepared in accordance with U.S. GAAP. In fact, the engagement letter makes explicit that Anchin would "take no responsibility regarding the accuracy or completeness of such statements, computation or data or whether such statement or data comply with generally accepted accounting principles."

Portfolio Company. Indeed, Tilton explicitly directed that loan values were not to be written down, but rather that loans were only to be written off after she so directed, and only after there was debt forgiveness or extinguishment. As Tilton bluntly put it in an email to Patriarch's controller: "[W]e do not write up or write down – we write off."[17] Thus, while Tilton continued to represent to investors that the fund's financial statements were compliant with U.S. GAAP, they were not. Instead, consistent with her improper subjective, personal belief approach to categorizing loans for purposes of the OC Ratio, Tilton would not write down impaired loans until she subjectively gave up on a company, an approach that was inconsistent with the indenture, her quarterly certifications, and U.S. GAAP.

Moreover, even though Respondents did not conduct a U.S. GAAP-compliant impairment analysis, they told investors that they did. For example, Respondents disclosed in the footnotes to their financial statements that where "the anticipated future collections are determined to be less than the carrying value of the loan, the Company will record an impairment loss . . ." However, Respondents did not analyze future collections, but instead relied on Tilton's subjective judgment to determine when an asset was impaired.

In addition, Respondents misrepresented that the fair value of the loans was approximately equal to their carrying value. The notes to the Zohar funds' financial statements represent that "[f]or substantially all of the Collateral Debt Obligations, [ ], fair values are based on estimates using present value of anticipated future collection or other valuation techniques." However, Tilton did not direct, and the accounting department did not engage in, any analysis of present value of anticipated future collections. Nor was there any other valuation technique applied to determine the

[17] Division Ex. 162.

fair value of the loans. Instead, Respondents made assertions to investors about the fair value of loans without any substantiation or basis for doing so.

Notably, after the Division initiated this action, the Zohar funds' financial disclosures changed significantly. The references to U.S. GAAP were removed and the "fair value" and "anticipated future collection" language was changed to disclose that the loans were simply carried at cost. As one of the Division's experts, Steven Henning, has explained in his report and will explain at the hearing, the fact that the financial disclosures eliminated these references to U.S. GAAP compliance – without changes in the underlying accounting methodologies – is an acknowledgement by the Respondents that the prior reporting departed from U.S. GAAP.

H. Current Status of the Zohar Funds and Respondents

As noted above, the Zohar funds have not performed well. In November 2015, Zohar I defaulted on its obligation to repay noteholders their principal investment.[18] In addition, Respondents have represented that Zohar II is likely to default when it matures in early 2017. In early 2016, Respondents resigned as collateral manager for the various Zohar funds. The replacement collateral manager has sued Respondents, alleging that Respondents will not provide them "critical documents and information needed to assess the state of the Zohar Funds' investments and to manage those investments to obtain maximum value for investors."[19]

IV. ARGUMENT

A. Section 206 of the Investment Advisers Act

Respondents are charged with violations of Section 206 of the Investment Advisers Act. Generally speaking, Section 206 establishes a federal fiduciary standard for investment advisers,

[18] Many, if not all, of the investors in Zohar I and II had their positions insured.

[19] Verified Complaint, *Zohar CDO 2003-1, LLC et al. v. Patriarch Partners, LLC et al.*, Civ. Action No. 12247-VCS (Del. Ch. Apr. 22, 2016).

which includes the obligations to exercise the utmost good faith in dealing with their clients, to disclose to their clients all material facts, and to employ reasonable care to avoid misleading their clients. *See, e.g.*, *SEC v. Capital Gains Research Bureau, Inc.*, 375 U.S. 180, 194 (1963). Given the "delicate fiduciary nature of . . . [the] investment advisory relationship," Section 206 places "an affirmative duty" of "utmost good faith" on all investment advisers, part of which requires "full and fair disclosure of all material facts, as well as an affirmative obligation to employ reasonable care to avoid misleading." *Id.* Investment advisers have a duty "to eliminate, or at least expose, all conflicts of interest which might incline [them] – consciously or unconsciously – to render advice which was not disinterested." *Id.*

Specifically, Respondents are charged with violating Sections 206(1), (2), and (4), along with Rule 206(4)-8. Section 206(1) of the Advisers Act prohibits an investment adviser from "employ[ing] any device, scheme, or artifice to defraud any client or prospective client[,]" and Section 206(2) prohibits an investment adviser from "engag[ing] in any transaction, practice, or course of business which operates as a fraud or deceit upon any client or prospective client[.]" Section 206(4) prohibits a registered investment adviser from engaging "in any act, practice, or course of business which is fraudulent, deceptive, or manipulative[,]" including those defined by the Commission.

Scienter is required for a violation of Section 206(1), but negligent conduct is actionable under Sections 206(2) and 206(4).[20] *See, e.g.*, *SEC v. Treadway*, 430 F. Supp. 2d 293, 338 (S.D.N.Y. 2006); *SEC v. C.R. Richmond & Co.*, 565 F.2d 1101, 1105 (9th Cir. 1977). Recklessness satisfies the scienter standard under Section 206(1) and is established where there

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[20] *See* Order, Admin. Proc. Rel. No. 4245, dated Oct. 12, 2016 (noting that the OIP alleged violations of each of these sections and that the Division could proceed with evidence of intentional, reckless, and/or negligent conduct).

has been an "extreme departure from the standards of ordinary care." *SEC v. Steadman*, 967 F.2d 636, 641 (D.C. Cir. 1992) (citation omitted); *see also Vernazza v. SEC*, 327 F.3d 851, 860 (9th Cir. 2003) (investment adviser violated Section 206(1) because "investment advisers are knowledgeable enough to recognize [when] an arrangement . . . creates potential conflicts of interest"). Moreover, violations of the antifraud provisions of Section 206 do not require a showing of actual injury to any client. *SEC v. Capital Gains Research Bureau Inc.*, 375 U.S. 180, 195 (1963).

The standard for materiality under the Advisers Act is whether there is a substantial likelihood that a reasonable investor would have considered the information important. Amendments to Form ADV, Advisers Act Rel. No. 3060 (2010) n. 35 (*citing Steadman*, 967 F.2d at 643); *see also Basic, Inc. v. Levinson*, 485 U.S. 224, 231-32 (1988). Generally speaking, the existence of a conflict of interest is a fact that an investment adviser, as a fiduciary, must disclose. *Vernazza*, 327 F.3d at 859. In addition, the value of the collateral in an investment is a material fact that an investor would consider important. *See, e.g., SEC v. Mannion*, 789 F.Supp.2d 1321, 1334 (N.D. Georgia 2011) (inflation of net asset value by investment adviser could support materiality requirement under federal securities laws).

Section 206 protects both the fund and the fund's investors. The "client" to whom Sections 206(1) and 206(2) refer is the fund, rather than the fund's investors. *See Goldstein v. SEC*, 451 F.3d 873, 881-82 (D.C. Cir. 2006). By contrast, Section 206(4) and Rule 206(4)-8 apply to misconduct against investors in a fund. *Id.* at n.6. Rule 206(4)-8 specifically prohibits an investment adviser from making false or misleading statements, and from engaging in "any act, practice, or course of business that is fraudulent, deceptive, or manipulative[,]" with respect to investors in pooled investment vehicles.

B. Respondents Are Investment Advisers, the Zohar Funds are Their Clients, and the Investors in the Zohar Funds are Investors in Pooled Investment Vehicles.

The Advisors Act contains a "broad definition" of an investment adviser. *See, e.g.*, *In the Matter of Donald L. Koch et.al.*, S.E.C. Rel. No. 3836, 2014 WL 1998524, *18 (Comm. Op. 2014). Specifically, Section 202(a)(11) of the Advisers Act defines an investment adviser as "any person who, for compensation, engages in the business of advising others ... as to the value of securities or as to the advisability of investing in, purchasing, or selling securities." Each of the Respondents falls within this broad definition.

The Patriarch Collateral Managers acted as the funds' investment advisers by selecting and managing collateral, among other obligations, for compensation from the funds' inception until they resigned in March 2016. Indeed, the Patriarch Collateral Managers were registered as investment advisers with the Commission from March 2012 until March 2016. In addition, because Tilton owns and controls the Patriarch Collateral Managers and provided and was compensated for investment advice to the Zohar funds, she is also an investment adviser. *See, e.g.*, *SEC v. Berger*, 244 F. Supp. 2d 180, 193 (S.D.N.Y. 2001) (finding that present and sole shareholder of investment adviser entity who "effectively controlled [the investment adviser] and its decision making" was "properly labeled an investment adviser within the meaning of the Advisers Act"). And finally, since Patriarch Partners, LLC's employees performed all relevant investment advisory services for the Patriarch Collateral Managers, Patriarch also meets the statutory definition of an investment adviser. *See, e.g.*, *In the Matter of John J. Kenny, et al.*, SEC Rel. No. IA-2128, n. 54 (May 14, 2003) (Comm. Op.) (an individual associated with an investment adviser entity "may be charged as a primary violator under Section 206 where the activities of the associated person cause him or her to meet the broad definition of 'investment adviser.'").

Further, each of the Zohar funds is the client of the Patriarch Collateral Manager designated as its collateral manager. *See, e.g.*, *Goldstein*, 451 F.3d at 881-82. Each fund is also a client of Tilton and Patriarch, since they are also investment advisers and advised each fund. Finally, each of the Zohar funds is a "pooled investment vehicle" under Rule 206(4)-8(b).[21] As a result, each of the fund's investors are protected under Advisers Act Section 206(4) and Rule 206(4)-8.

C. Respondents Made False and Misleading Statements, Engaged in Fraudulent and Deceptive Valuation Practices and Courses of Business, and Breached Fiduciary Duties.

Respondents violated Section 206 of the Advisers Act by misleading the Zohar funds and the funds' investors regarding core information concerning the value of the funds' assets. Respondents' fraudulent conduct took three related forms. First, Respondents disregarded the objective standards for categorizing assets that they agreed to in the indenture, and instead categorized assets based on Tilton's subjective, personal belief in the future of the underlying Portfolio Company. This approach was not disclosed, and resulted in artificial – and material – inflation of the OC Ratios. In addition, it allowed Respondents to keep control over the funds and over $200 million in fees and distributions that should have flowed to the funds and the funds' investors. Second, Respondents breached their fiduciary duties by failing to disclose the significant conflict of interest that resulted from Respondents' undisclosed, subjective, personal belief approach. That is, Respondents' approach allowed them to keep control over the funds and tens of millions of dollars that otherwise would have flowed to the funds and the funds' investors. And

[21] Each of the Zohar funds is a pooled investment vehicle because it would be an investment company but for its reliance on an exclusion from the definition of investment company provided by Sections 3(c)(1) and (7) of the Investment Company Act. These sections provide exclusions for investment company issuers – like the Zohar funds – that do not make a public offer and have fewer than 100 security holders or whose outstanding shares are owned exclusively by qualified purchasers.

third, Respondents misled investors by stating that the funds' financial statements were U.S. GAAP compliant when, for example, no U.S. GAAP-compliant impairment analyses were performed and, instead, Respondents were simply impairing loans when they subjectively and personally decided to no longer support the Portfolio Companies.

1. False and Misleading Categorizations and OC Ratio Test Results in Trustee Reports.

For years, Respondents failed to properly categorize the assets of the Zohar funds. Every month, Respondents provided information to the trustee, which prepared a report that was disseminated to investors. In that report, each of the Zohar fund's assets were ostensibly categorized according to the requirements of the indenture.

However, as noted above, Respondents did not follow the indenture when categorizing the investments. Instead of applying the objective criteria relating to failure to make interest payments, Respondents categorized assets based on Tilton's subjective, personal belief in the prospects of the underlying Portfolio Company. This approach was never disclosed to investors, and was wholly inconsistent with disclosures that were made. Moreover, as a result of this approach, the asset categories for a number of Portfolio Companies – and the resulting OC Ratios – were materially misstated to the Zohar funds and their investors. These misstatements and omissions allowed Respondents to avoid the consequences of failing the OC Ratio test, and thereby to continue to receive tens of millions of dollars of fees and distributions as well as to maintain control over the funds. Since Respondents regularly followed the same undisclosed approach when categorizing assets each period, these actions represent a fraudulent and deceptive scheme, practice, and course of business toward the Zohar funds and the funds' investors.

2. Failure to Disclose Facts Creating Conflict of Interest.

As set forth above, as investment advisors, Respondents owed fiduciary duties to the Zohar funds. Moreover, pursuant to the CMAs, respondents had the obligation to "use reasonable care and the same degree of skill and attention . . . exercised by institutional investment managers of national standing generally in respect of assets of the nature and character of the Collateral and for clients having similar investment objectives and restrictions."

Respondents repeatedly breached their duties by failing to disclose to the Zohar funds and their investors the facts that led to a conflict of interest inherent in Respondents' undisclosed approach to categorization. Specifically, so long as Respondents used Tilton's undisclosed, subjective, personal belief to categorize enough assets as Category 4/Collateral Investments, Respondents were able to impermissibly collect the subordinated fee and preference share payments that would have otherwise been redirected to the funds and their investors, and to improperly retain absolute control over the funds. Respondents' method of categorization was clearly inconsistent with the objective approach communicated to the funds and their investors through the indenture, and therefore rendered the indenture test materially misleading. Moreover, Respondents' approach to categorization eviscerated the important OC Ratio test, which is designed to protect investors when investors' principal becomes at risk.

Respondents have never disclosed the facts that create this conflict of interest, much less provided an opportunity for their clients to independently consider whether to consent to it. Because the conflict of interest involved Tilton's own interests, Tilton never had the authority to consent to it on behalf of the Zohar funds.[22]

[22] The Division anticipates Respondents will argue – as they did in their motion for summary disposition – that because Tilton is or was the ultimate owner of Patriarch and the Zohar funds, she

Furthermore, Tilton's knowledge of her approach cannot be imputed to the Zohar funds or their investors, especially since Tilton was not acting in their interest. Generally, as a matter of law, knowledge of an action by an agent is imputed to the principal. However,

> [t]here is . . . a well-established exception to this general rule, where the conduct of the agent is such as to raise a clear presumption that [s]he would not communicate to the principal the facts in controversy, as where an agent is in reality acting in [her] own business or for [her] own personal interest and adversely to the principal.

Ruberoid Co. v. Roy, et al., 240 F. Supp. 7,9 (E.D. La. 1965) (citations omitted). This is often referred to as the common law agency doctrine of the "adverse interest exception," which generally precludes the imputation of the agent's knowledge to its principal whenever "an agent acts adversely to its principal." *Bank of China v. NBM LLC,* 359 F.3d 171, 179 (2d Cir. 2004) (applying New York law). Indeed, the Second Circuit has held that a conflicted fiduciary cannot give him or herself consent. *See SEC v. DiBella,* 587 F.3d 553, 563 (2d Cir. 2009) ("[t]hird party disclosure to an agent is not imputed to the principal when the agent is acting adversely to the principal's interest and the third party has notice of this" (citing *Arlinghaus v. Ritenour,* 622 F.2d 629, 636 (2d Cir. 1980))).[23]

As a result, Respondents failed to comply with their fiduciary duties and the contractual standard outlined in the CMAs. A fiduciary investment adviser, and a similarly situated

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could not have defrauded them. However, the Zohar funds are distinct legal entities that have their own Boards of Directors. In fact, those directors opposed an involuntary bankruptcy petition filed by Tilton (as a creditor of Zohar I) after the fund defaulted on its obligation to repay investor principal in November 2015 and while Tilton was still collateral manager. *See* Answer and Motion of Alleged Debtors for an Order Dismissing Involuntary Chapter 11 Petitions or, In the Alternative, Abstaining Pursuant to 11 U.S.C. § 305, *In re Zohar CDO 2003-1, Corp.*, Case No. 15-23681 (Bankr. S.D.N.Y. December 14, 2015).

[23] In any event, Respondents' misstatements and omissions to the funds' investors – which are undoubtedly separate from Respondents – are actionable under Section 206(4) and Rule 206(4)-8.

collateral manager of national standing, would not act as Respondents did, in a manner that put their own interests above those of the funds and their investors, and would not fail to disclose the conflict inherent in Respondents' subjective, personal belief approach to categorizing the collateral.

3. False and Misleading Financial Statements.

Finally, as discussed above, the Zohar funds' financial statements were false and misleading and furthered the fraudulent scheme and course of business, because Patriarch failed to perform any impairment analyses of loans to the Portfolio Companies while falsely representing that the financial statements conformed with U.S. GAAP, and Patriarch disclosed that reported loan assets approximated fair value while failing to perform any valuation analyses of the loan assets. Through Tilton and accounting employees, Patriarch prepared the financial statements for the Zohar funds on behalf of the Patriarch Collateral Managers and provided them to the trustee for distribution to the noteholders. Tilton signed a certification for each fund's quarterly financial statements, on behalf of the relevant Patriarch Collateral Manager, confirming that they conformed with U.S. GAAP and fairly presented the financial position of the Zohar funds. These statements were false and misleading,

D. The Misstatements Were Material.

Rule 206(8) prohibits investment advisers from making materially false or misleading statements to investors. *See* 17 C.F.R. 275 § 206(4)-8 ("It shall constitute a fraudulent, deceptive, or manipulative act, practice, or course of business within the meaning of section 206(4) ... for any investment adviser to a pooled investment vehicle to ... [m]ake any untrue statement of a material fact or omit to state a material fact necessary to make the statements made, in light of the circumstances under which they were made, not misleading ...."). The Respondents' false

and misleading statements regarding how assets were being categorized and valued, and the resulting false and misleading statements related to the OC Ratio and financial statements, were material. Each of these items provided information relating to the value of the funds' investments, and, in the case of the OC Ratio, the likelihood that investors' principal would be repaid. Respondents' conflict of interest in using the undisclosed, subjective, personal belief approach to asset categorization was also critical information since it allowed Respondents to put their own interests ahead of the funds' and the funds' investors. *See, e.g., Vernazza v. SEC*, 327 F.3d at 859 (existence of a conflict of interest is a material fact that an investment adviser, as a fiduciary, must disclose); *SEC v. Mannion*, 789 F.Supp.2d 1321, 1334 (N.D. Georgia 2011) (inflation of net asset value by investment adviser could support materiality requirement under federal securities laws).

E. Respondents' Conduct Was Knowing, Intentional, Reckless, or at a Minimum Negligent.

Respondents have at all times been aware of the indentures' categorization requirements, the OC Ratio test and its consequences, and the actual interest payments by the Portfolio Companies. Instead of following the criteria for categorization set forth in the indentures, however, Respondents categorized assets based on Tilton's subjective, personal belief in the future of the Porfolio Companies.[24] In addition, although Respondents clearly knew how they were categorizing assets, and knew – or at a minimum should have known – that this approach was undisclosed, was contrary to the terms of the indenture, and created a significant conflict of interest, Respondents did nothing to adequately disclose this approach to the funds or their investors, or to seek their consent for the conflict.

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[24] Because Tilton controls Patriarch and the Patriarch Collateral Managers, her scienter is imputed to those entities.

Tilton also certified the Zohar funds' financial statements every quarter during the relevant period. Despite her knowledge of the financial condition of the Portfolio Companies and Patriarch's actual accounting practices, she allowed the financial statements to be published without conducting impairment analyses and while including false or misleading disclosures relating to the valuation of assets. She certified the financial statements, knowing that she applied her own standards for impairment without regard to standards prescribed by U.S. GAAP.

Adding to the evidence of Respondents' scienter is evidence the Division expects will be adduced from investor witnesses. Certain of these investor witnesses will explain the difficulty they had obtaining information from Respondents. For example, Jaime Aldama of Barclays is expected to testify that, when he attempted to obtain additional information from Respondents regarding the underlying Portfolio Companies, Respondents insisted that Barclays sign not only a non-disclosure agreement, but a litigation waiver that would prevent Barclays from suing Respondents based on any information that was provided. Such conduct corroborates Respondents' scienter: it strongly suggests that Respondents knew the disclosure of their conduct would result in litigation and therefore sought to coerce investors into abstaining from litigation in exchange for honest disclosure.

Respondents' knowledge and conduct demonstrates that they acted intentionally, recklessly, or at a minimum negligently with respect to their false and misleading statements fraudulent or deceptive practices, and course of business.

F. As a Result of This Conduct, Respondents Violated, Aided and Abetted, and/or Caused Violations of Sections 206(1), 206(2), and 206(4) of the Advisers Act and Rule 206(4)-8 Thereunder.

By failing to disclose that Respondents were not following the objective terms of the indenture, but rather were categorizing assets based on Tilton's subjective, personal belief in the future of the Portfolio Companies, by collecting fees to which Respondents were not entitled, by

failing to disclose the facts underlying their conflict of interest, and by making false and misleading statements regarding the asset categorization approach, the OC Ratio, and the financial statements, Respondents violated Sections 206(1) and 206(2) of the Advisers Act by defrauding the three Zohar funds, and violated Section 206(4) and Rule 206(4)-8 thereunder by defrauding the investors in the Funds.[25]

G. Respondents' Anticipated Defenses Do Not – and Cannot – Excuse Their Conduct.

In the face of overwhelming evidence that Respondents, contrary to the objective requirements of the indentures, categorized assets based on Tilton's subjective, personal belief in the future of the Portfolio Companies and performed no U.S. GAAP-compliant impairment or valuation analyses of the loans to Portfolio Companies, the Division anticipates Respondents will attempt to mount a defense based on distractions and hypotheticals. For example, based on Respondents' amended witness list, it appears that Respondents intend to present numerous witnesses from the Portfolio Companies themselves. While the relevance of these witnesses is not

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[25] Alternatively, to the extent Your Honor disagrees that the evidence shows that Patriarch Partners, LLC is itself an investment adviser, Patriarch aided and abetted and/or caused these violations. To establish aiding and abetting liability, the Division must show: (1) "that a principal committed a primary violation; (2) that the aider and abettor provided substantial assistance to the primary violator, and (3) that the aider and abettor had the necessary 'scienter'-*i.e.* that she rendered such assistance knowingly or recklessly." *Graham v. SEC*, 222 F.3d 994, 1000 (D.C. Cir. 2000). Negligence is sufficient to establish liability for causing a violation when a person is alleged to have caused a primary violation that does not require scienter. *In re KPMG Peat Marwick*, Exchange Act Rel. No. 43862 (Jan. 19, 2001), *aff'd, KPMG v. SEC*, 289 F.3d 109 (D.C. Cir. 2002). In an administrative proceeding, a finding that a respondent aided and abetted a primary violation necessarily makes that respondent a "cause" of those violations. *See In the Matter of Clarke T. Blizzard, et al.*, Advisers Act Rel. No. 2253, 2004 SEC LEXIS 1298, at *16 n.10 (June 23, 2004) (Comm. Op.). Patriarch aided and abetted and/or caused the other Respondents' violations by providing substantial assistance to Tilton and the other entities. For example, Patriarch's employees provided all information to the trustee, including the misleading information relating to categorization of the assets and the false financial statements.

immediately clear – as distinct from the Division's investor witnesses – the Division expects Respondents may attempt to put on evidence about their efforts to turn those Portfolio Companies around and to "save American jobs." But whether Respondents were attempting to – or successful in – saving jobs at the Portfolio Companies provides no defense. This case is about Respondents' conduct with respect to the Zohar funds and those funds' investors. Your Honor should not be distracted from the proper focus of this case: Respondents' breaches of obligations imposed by the indentures and duties owed to the Zohar funds and the funds' investors, subjects as to which the Division's witnesses will directly testify.

The Division also anticipates that Respondents will focus heavily on their numerous expert witnesses. However, Respondents' experts opinions are not based on what Respondents actually did – *e.g.*, their failure to follow the requirements of the indentures and their categorization of assets based on the subjective, personal belief in the underlying Portfolio Companies – but on hypotheticals of what Respondents could have done. Again, this case is properly focused on what actually occurred: Respondents flouted the objective categorization standards of the indenture, categorized assets based on Tilton's subjective, personal belief in the future of the Portfolio Companies, and failed to perform GAAP-complaint impairment and valuation analyses.

The Division further anticipates that Respondents will argue that they had unlimited discretion to amend loan terms under a particular and ostensibly unique provision of the Zohar indentures – Section 7.7(a).[26] But this argument is a red herring. While Section 7.7(a) does give

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[26] Section 7.7(a) provides:

The Zohar Obligors (or the Collateral Manager on behalf of such Person) may, without the consent of the Holders of any Notes or the Credit Enhancer, enter into any amendment, forbearance or waiver of or supplement to any Underlying Instrument included in the Collateral, so long as such amendment, forbearance, waiver or supplement does not contravene the

respondents flexibility to amend loans, the evidence will show that Respondents were not amending loans when Portfolio Companies failed to pay or paid less than required interest. Rather, Tilton has admitted that Respondents were simply allowing the Portfolio Companies to not pay the interest required, and then categorizing those loans based on her subjective, personal belief in the underlying company. Moreover, as one of the Division's experts, Ira Wagner, has explained in his report and will explain at the hearing, Section 7.7(a) is not unique in the *discretion* it gave Respondents, as collateral managers, to modify loans – that sort of discretion is common in structured transactions. Rather, what is unique about Section 7.7(a) is that it allows the Zohar funds to acquire and hold certain securities that otherwise would not satisfy the indenture requirements. Thus, Respondents argument that the discretion outlined in Section 7.7(a) was so unique to the Zohar deals that it trumped all other provisions of the indentures is, simply, wrong. In any event, Section 7.7(a) says nothing about *categorization* of loans for purposes of the OC Ratio, nor does it grant Respondents the authority to categorize assets based on a subjective, personal belief or to thoroughly disregard their fiduciary duties. And Section 7.7(a) certainly cannot be read to disclose what actually occurred: Tilton's improper subjective, personal belief categorization approach to categorizing the Zohar funds' loans.

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provisions of any Transaction Document or contravene any applicable law or regulation. For the avoidance of doubt and notwithstanding anything else contained herein, the parties hereto acknowledge and agree that the Collateral Debt Obligations will consist of stressed and distressed loans that may be the subject of extensive amendment, workout, restructuring and/or the other negotiations and, as a consequence thereof, the Issuer or the Zohar Subsidiary may receive by way of amendments, modifications, exchanges and/or supplements to such Collateral Debt Obligations, Equity Kickers, Equity Workout Securities and/or the relevant Underlying Instruments (i) interests in loans, debt securities, letters of credit or leases that do not satisfy the provisions of the definition of "Collateral Debt Obligation" and/or the Eligibility Criteria and/or (ii) Equity Workout Securities.

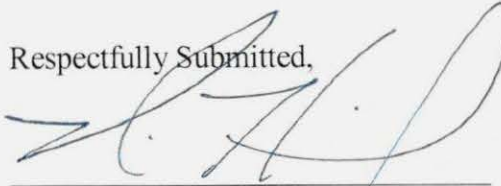
Finally, the Division expects Respondents to argue that investors could have uncovered their scheme because investors could easily have figured out, from the trustee reports, that certain loans were not current on their interest payments and thus could have figured out the OC Ratio was inflated. As a threshold matter, investors would have needed to analyze substantial amounts of data on a monthly basis to replicate the OC Ratio calculations – something that investors in cash-flow bonds would have no reason to do. But even if an investor could have figured out that Respondents were not properly following the objective requirements of the indenture, they could not have figured out what Respondents were actually doing: categorizing assets based on Tilton's subjective, personal belief in the future of the Portfolio Companies, which allowed them to retain more than $200 million in fees and distributions and control of the Zohar funds. And in any event, arguing that investors could have determined that they were being lied to by their investment adviser is a curious – and failing – defense to these charges.

V. RELIEF REQUESTED

The Division requests remedial action consistent with Section 203 of the Advisers Act and the Section 9 of the Investment Company Act. Such remedial action may include, without limitation, disgorgement and prejudgment interest, civil penalties, cease-and-desist orders, and industry and collateral bars. The Division will recommend specific remedial action in its post-trial briefing or at the hearing if requested by the law judge.

Dated: October 17, 2016

Respectfully Submitted,



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CERTIFICATE OF SERVICE

I hereby certify that a true copy of the **DIVISION OF ENFORCEMENT'S PREHEARING BRIEF** was served on the following on this 17th day of October, 2016, in the manner indicated below:

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