UNITED STATES OF AMERICA
Before the
SECURITIES AND EXCHANGE COMMISSION

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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 POST-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 acts, practices, or schemes directed toward an adviser's clients or investors. The evidence in this case showed that Respondents breached those solemn duties, misled investors, and put their own interests first. In so doing, Respondents kept more than $200 million that properly belonged to their clients and investors 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 was demonstrated through documentary and testimonial evidence, Tilton flouted her obligations and consistently and regularly breached her fiduciary duties and her responsibilities to investors. Instead of objectively categorizing the funds' loan 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 at some indeterminate time 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 not making substantial interest payments that remained due and owing (which even Patriarch admitted were unlikely to be collected), Tilton concealed these facts by keeping the assets in the highest-performing category based on subjectively "believing" in the distressed company borrower. The Zohar funds' financial statements were similarly false and misleading, as they affirmatively misrepresented that the financial statements were prepared in accordance with U.S. GAAP, were performing a U.S. GAAP-compliant loan impairment analysis and were performing a U.S. GAAP-compliant fair value analysis of the loans. These statements were not true, as no such analyses were performed, much less U.S. GAAP-compliant analyses. Indeed, by failing to perform the disclosed fair value analysis and impairment on the loan assets, and by continually changing the methodology for accruing interest on the Zohar funds' balance sheet, Patriarch similarly concealed that portfolio companies were not paying interest, and were not expected to be able to pay their past due interest, but were categorized as current for purposes of the OC Ratio.

Respondents' defense is essentially that they disclosed enough piecemeal bits of information, in various locations, that sophisticated investors should have figured out what Tilton was doing. But this in no way satisfied Respondents' fiduciary obligations or constituted full and fair disclosure. An investment adviser's clients and investors are not expected to ferret out information from their investment advisers. The law does not require investors to seek out disclosures; rather, the obligation to provide disclosure is placed on people who solicit and manage investors' money.

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 evidence put on by the Division detailed Respondents' false statements and misleading omissions, fraudulent acts and scheme, and breaches of fiduciary duties. The Division proved that Respondents hid the truth from investors (tellingly, Respondents did not call a single investor witness to support their case), 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 requests, 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. (Answer ¶ 20.) Tilton manages each of the Patriarch entities described below and controls their decisions. (FOF ¶ 270.) 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. (FOF ¶ 271.)

Patriarch Partners, LLC ("Patriarch Partners") is a Delaware limited liability company with a principal place of business in New York, New York. (FOF ¶ 254; Answer ¶ 11.) Tilton and Patriarch Partners' employees ran the business of Patriarch VIII, Patriarch XIV, and Patriarch XV, when those entities (the "Patriarch Collateral Managers") were collateral managers of the Zohar funds. The Patriarch Collateral Managers have not had employees of their own, but were operated by Tilton with the assistance of Patriarch Partners employees. (FOF ¶ 255.) Tilton owns, controls, and acts on behalf of Patriarch Partners. (FOF ¶ 256.) Tilton founded Patriarch in 2000, originally with a partner, but has run the company herself since 2002. (*Id.*) Tilton refers to Patriarch Partners as a distressed private equity firm. (*Id.*)

Patriarch Partners VIII, LLC is a Delaware limited liability company with a principal place of business in New York, New York. (FOF ¶ 257; Answer ¶ 12.) 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. (*Id.*) Patriarch VIII is indirectly owned 100% by Tilton and a trust for the benefit of Tilton's daughter. (*Id.*)

Patriarch Partners XIV, LLC is a Delaware limited liability company with a principal place of business in New York, New York. (FOF ¶ 259; Answer ¶ 13.) 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.

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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.

(*Id.*) Patriarch XIV is indirectly owned 100% by Tilton and a trust for the benefit of Tilton's daughter. (*Id.*)

Patriarch Partners XV, LLC is a Delaware limited liability company with a principal place of business in New York, New York. (FOF ¶ 261; Answer ¶ 14.) 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. (*Id.*) Patriarch XV is indirectly owned 100% by Tilton and a trust for the benefit of Tilton's daughter. (*Id.*)

III. FACTS

A. Background on the Zohar Funds

This case involves structured finance vehicles called Collateralized Loan Obligation funds. (FOF ¶ 263.) A CLO fund raises money from investors to invest in loans. (*Id.*) 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. (Answer ¶ 15.) 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. (*Id.*) Cash flows and other proceeds from those loans are used to repay the investor noteholders in the CLO fund. (*Id.*) CLOs issue securities and CLO managers carry with them the obligations – including fiduciary duties – that come with being investment advisers. (FOF ¶¶ 274-75.)

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. (FOF ¶¶ 257, 259, 261.) Tilton structured each of the three Zohar funds as CLO funds. (FOF ¶ 263.) 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] (FOF ¶¶ 257, 259, 261.) These issuer entities, which are all Cayman Island companies, each has its own Board of Directors. (DX 44-46.)

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. (FOF ¶¶ 257, 259, 261.) The Patriarch Collateral Managers are owned and controlled by Tilton and entities under her control. (FOF ¶¶ 257, 259, 261.) 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. (FOF ¶ 255.) Tilton makes all significant decisions relating to the management of the collateral of the Zohar funds. (FOF ¶¶ 270, 281.) Put simply, in the words of Tilton herself: "I'm the collateral manager, I am the ultimate decision-maker on many things. . . ." (DX 219 at 83 (Tilton Testimony Day 2 at 27:19-20).)

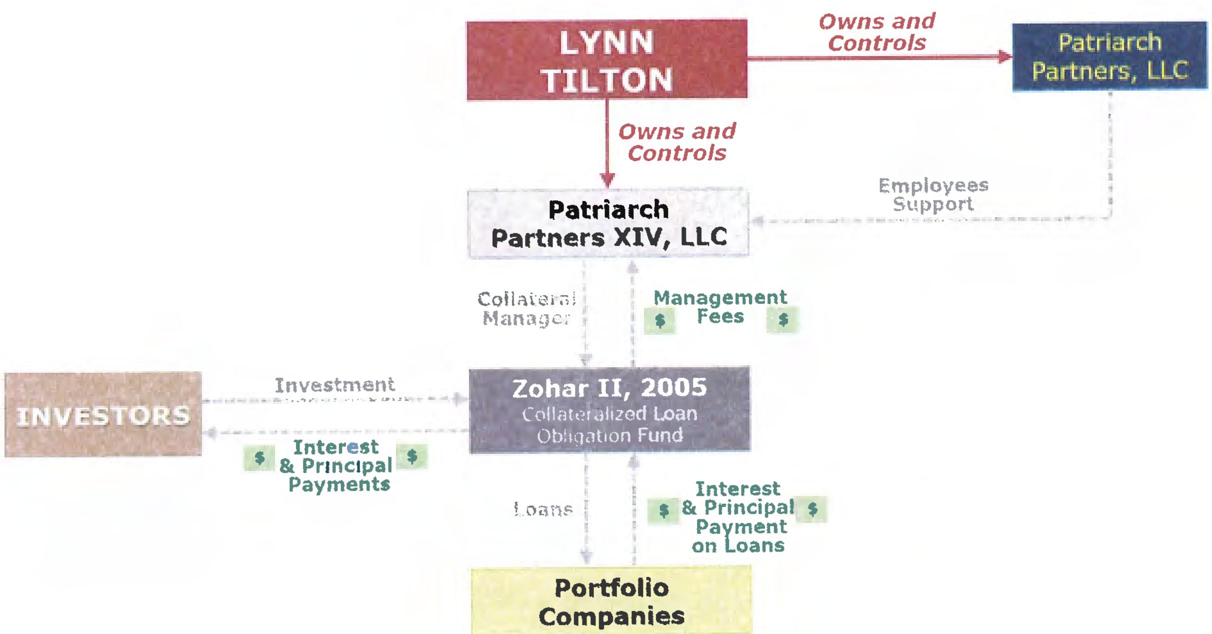
Each Zohar deal is governed by various documents. (FOF ¶ 266; Answer ¶ 17.) Two critical governing documents are the indenture and the collateral management agreement ("CMA"). (*Id.*) The indenture describes the terms of the offering, including the maturity date of the notes, information reporting requirements, and priority of payments. (FOF ¶ 267; Answer ¶ 18; DX 1-3.) The indenture also describes the rights of the parties and responsibilities of the collateral manager. (*Id.*) The indenture further identifies the Patriarch Collateral Managers as the collateral managers for the funds. (*Id.*) As one of the Division's experts, Ira Wagner, has explained, investors in CLOs expect collateral managers to follow the indenture to the letter. (FOF ¶ 331.)

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

And, indeed, the Zohar Funds' investors testified that they also expected that the collateral manager would follow the indenture. (FOF ¶¶ 15, 78, 242.)

The CMA is also an important document. (FOF ¶¶ 266, 268; Answer ¶¶ 19-20.) The CMA, which is a contract between the issuer and the respective Patriarch Collateral Manager, describes the collateral manager's duties and compensation. (*Id.*) Tilton signed each CMA as the manager of the respective Patriarch Collateral Manager. (*Id.*)

The Patriarch Collateral Managers – which, as can be seen in the below illustration, are owned by Tilton and entities under her control[3] – earn fees based on the assets in the Zohar deals.



(FOF ¶¶ 255, 270.) Specifically, the Patriarch Collateral Managers receive a Senior Collateral Management Fee, paid quarterly, which is equal to 1% of the funds' assets. (FOF ¶ 270.) The Patriarch Collateral Managers may also receive an additional Subordinated Collateral Management Fee, which is also equal to 1% of the funds' assets. (*Id.*) In addition, certain entities controlled by Tilton hold preference shares in the Zohar funds. (FOF ¶ 271; Answer ¶ 27.) As more fully

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

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. (FOF ¶ 271.) These valuation tests 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 investments. (*Id.*)

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. (FOF ¶¶ 258, 260, 262.) 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"). (FOF ¶ 263; Answer ¶ 20.) Tilton often directed more than one of the Zohar funds to extend loans to the same Portfolio Company. (Answer ¶ 20.)

Repayment of these loans by the Portfolio Companies was and is critical to the investors in the Zohar funds. (FOF ¶ 71.) 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. (FOF ¶¶ 264, 324-26.) Every quarter, the investors were to receive an interest payment, generated from the collective interest payments made by the Portfolio Companies. (*Id.*) Although they received interest payments quarterly, investors were generally not entitled to be repaid their principal until the maturity date of their notes from the Zohar funds. (*Id.*) 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. (FOF ¶ 265; Answer ¶ 16.)

In addition to directing the Zohar funds to make loans to the Portfolio Companies, Tilton actively controlled (and still manages) the business of Portfolio Companies. (FOF ¶ 272.) Tilton is and was the CEO or sole manager of many of the Portfolio Companies. She is and was involved with hiring and firing of employees, making major operating decisions, and requiring that the companies regularly report their financial condition and business prospects; she was aware of the extent to which interest payments were or were not being made to the Zohar funds by the Portfolio Companies. (*Id.*) In addition to Tilton's management of the Portfolio Companies, Tilton obtained equity in the Portfolio Companies. (FOF ¶ 269.)

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. (Answer ¶ 22.) Tilton failed in this strategy: In November 2015, Zohar I defaulted on its obligation to repay noteholders their principal investments. In addition, Respondents have represented that Zohar II is likely to default when it matures in early 2017. (FOF ¶ 265.)

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. (FOF ¶¶ 255, 256, 257, 259, 261, 270; Answer ¶¶ 12-14.) 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] (*Id.*) 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. (*Id.*) 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. (FOF ¶ 255.)

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.

(DX 37, 39, 41 at p. 20 § 5B.)

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." (DX 13, 14, 15 § 2.4.) 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. (*Id.* at § 2.6.)

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[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. (FOF ¶¶ 255, 256, 257, 259, 261, 270; Answer ¶¶ 12-14.)

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. (FOF ¶ 264.) As a safeguard for investors, the indenture for each of the Zohar funds contains certain objective tests that must be met over time and that relate to the performance of the fund's assets – the loans to the Portfolio Companies. (FOF ¶¶ 271, 284, 293.) The indentures also prescribe consequences for failing these tests. (FOF ¶¶ 271, 337, 339, 348, 357.) The results of these tests were communicated to investors each month through reports distributed by the Zohar funds' trustee. (FOF ¶ 334.)

One key test is the Overcollateralization Ratio ("OC Ratio") test. (FOF ¶¶ 271, 293, 334, 335, 339.) 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). (FOF ¶ 338.) 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. (FOF ¶¶ 271, 334, 337, 339, 348, 357.) As one of the Division's experts, Ira Wagner, explained in his report and at the hearing, OC Ratios and related tests are significant to investors in CLOs. (*Id.*) Wagner's opinions were corroborated by all of the Division's investor witnesses. As those investor witnesses explained, the OC Ratio is important: it is one of the first things they review on each month's trustee report to assess the performance of the investment. (FOF ¶¶ 17, 74, 231.)

In addition to providing information on the performance of the funds' assets, declines in the OC Ratio trigger important protections for investors. (FOF ¶¶ 271, 337, 339, 349.) Wagner outlined those protections in his reports. (FOF ¶¶ 337, 339, 349.) In brief, as the OC Ratio falls, meaning the value of the Zohar fund's loan assets declines and comes closer to the amount the fund owes to its investors, the chance of an investor suffering losses in its principal grows. (*Id.*) For that reason, as the OC Ratio breaches certain test levels, the indentures impose a number of consequences to insulate investors from further loss. (*Id.*) For example, if the OC Ratio falls below an initial prescribed level,[5] cash flow is re-directed *away from* Respondents (by restricting 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). (*Id.*) If the OC Ratio falls even further, the indentures provide investors with additional rights, which for Zohar I and II include the option of terminating the collateral manager. (*Id.*) Thus, the results of the OC test directly impacted Respondents' ability to obtain management fees as well as to maintain a position of control over the Zohar funds. (*Id.*; *accord* FOF ¶ 271.) In total, Tilton collected about $600 million in collateral management fees and preference share distributions from the Zohar funds. (FOF ¶ 271.)

The indentures require that the OC Ratio be calculated using objective measures. (FOF ¶¶ 29, 75, 236, 284, 293, 343, 344; DX 1 at 13; DX 2 at 11-12; DX 3 at 9-10.) 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. (FOF ¶¶ 281, 284, 343-346.) For Zohar I and II, the asset categories range from a "1" to a "4." (FOF ¶ 284.) Category 4 assets are the strongest; Category 1 assets are the weakest.[6] (*Id.*) In the case of

[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.

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

Zohar III, the numerical designations were replaced with two categories: "Defaulted Investment" and "Collateral Investment." (*Compare* DX 1 & 2 definitions with DX 3 definitions.) These are equivalent to Categories 1 and 4, respectively. (*Id.*) 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] (FOF ¶¶ 340-343, 346, 347.) This means that, as loans are moved from a Category 4/Collateral Investment to a Category 1/Defaulted Investment, the OC Ratio falls. (*Id.*; FOF ¶¶ 63, 64, 319.)

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. (FOF ¶ 284, 293; DX 1-3.) 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." (DX 1 at 10, 23-24, 38; DX 2 at 8-9, 22-23, 44.) 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." (*Id.* (emphasis added).) 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] (*Id.*)

[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

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." (DX 3 at 20, 21, 41 (emphasis added).) Thus, 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] (*Id.*) As investor witnesses explained at the hearing, they expected Respondents to follow the objective terms of the indenture to categorize assets for purposes of the OC Ratio. (FOF ¶¶ 29, 75, 240.)

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 explained in his report and at the hearing, these measures – haircutting the value of assets that are not performing to redirect payments to investors – are common features of CLOs and structured finance transactions generally and provide critical investor protection. (FOF ¶¶ 271, 334, 337, 339, 348, 357.)

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

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been current on its interest payments for two consecutive periods: the first missed payment 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 borrower 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."

Company would ultimately be successful. (FOF ¶¶ 296, 297, 305, 321.) Over the life of the Zohar funds, many Portfolio Companies have repeatedly defaulted on their periodic interest payments: in some cases, they have paid only a fraction of the interest due in a given period, in other cases they have paid no interest at all in a given period. (FOF ¶ 313.) Respondents were well aware of the piecemeal and often minimal interest payments Portfolio Companies made on their loans – indeed, Tilton herself made the ultimate decision to accept less interest than the amount that was due, and would do so only after the respective portfolio company's management travelled to New York to meet with Tilton, explained why the company could not make its interest payments, and presented a 12-month business plan. (FOF ¶¶ 273, 397.) However, despite Tilton's plain awareness that the portfolio company was incapable of satisfying its contractual obligations, in direct contravention of the indentures, Respondents did not categorize the loans based on whether interest payments were current or defaulted. (FOF ¶¶ 296, 321.) Tilton could not have been clearer about this in her testimony, repeatedly admitting that she substituted 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.***

(DX 219 at Tilton Testimony Day 2 at 88:14-89:10; *accord* FOF ¶¶ 296, 321.)

> Q Can you tell me how that practice -- how did that practice get established?
>
> A I can't tell you exactly when it got established, but basically if we're supporting a company and we are effectuating a turnaround, they are usually paying some form of interest, and ***in those instances where*** they are paying interest, and ***we are continuing our support with a reasonable belief of recovery, we keep it a Category 4. At what time we don't, it becomes a Category 1.***

(DX 219 at Tilton Testimony Day 1 at 182:17-183:1.)

> Q Okay. So you said when you are active in a turnaround, you are putting money and effort in it, and there's time, and so ***what changes would cause you to go from saying there's a reasonable chance of recovery to no reasonable chance?***
>
> A That we're no longer going to provide the capital it needs, that we have given up on the turnaround, that we're not putting our efforts anymore, we're not hiring management teams, we are not on the ground, you know, making certain that they have the operational expertise. We basically said, you know, this takes a deep concentrated effort and ***we believe that the capital it will take and the effort it will take is not worth the journey and the winding road to get there.*** And there are times when, given what's going on in the portfolio, we take that stance.
>
> Q ***And who makes that decision?***
>
> A ***Ultimately I do*** because I make the decisions on additional funding.

(DX 219 at Tilton Testimony Day 1 at 177:6-24.) (emphasis added to all)

As a result of Tilton's subjective, personal belief assessment approach, Respondents classified very few loans lower than Category 4/Collateral Investment, regardless of the poor performance of the funds. (DX 7, 8, and 9 (Zohar I, II, and III Trustee Reports).) 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. (*Id.*; Answer ¶42.) 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. (DX 7, 8, and 9.)

Respondents were acutely aware of the OC Ratio, were interested in keeping it high, and proactively managed it. (FOF ¶¶ 273, 292; DX 138, 147.) 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[t] in OC pickup." (*Id.*) 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." (*Id.*) Similarly, in late 2008, in a communication with a different Patriarch employee, Tilton wrote, "I[']ll take any OC where I can get it." (*Id.*)

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 to report materially higher OC Ratios than the actual ratios under the objective, disclosed terms of the indentures.

E. Respondents' Subjective Belief Approach Resulted in Respondents Improperly Obtaining $200 Million in Fees and Preference Share Distributions, as Well as Retaining 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 properly categorized the loans based on whether the Portfolio Companies were current in their interest payments. (FOF ¶¶ 63-64.) 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 (by restricting subordinated 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 to the level where investors should have had the option to terminate the collateral manager. (*Id.*)

For Zohar II, 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 reported OC Ratio that was based on Tilton's subjective, personal belief in the Portfolio Companies (denoted as "Original" in the chart below):

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%	118.33%	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

Zohar II CLO					
Year	Quarter Ending	Original	CRA Adjusted	Minimum	Pass/Fail
2010	Jan-10	121.86%	105.39%	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%	100.32%	112.00%	Fail
	Jul-12	120.56%	100.07%	112.00%	Fail
	Oct-12	118.23%	98.32%	112.00%	Fail
2013	Jan-13	118.03%	98.26%	112.00%	Fail
	Apr-13	115.26%	98.40%	112.00%	Fail
	Jul-13	115.36%	98.35%	112.00%	Fail
	Oct-13	115.45%	98.30%	112.00%	Fail
2014	Jan-14	115.54%	98.51%	112.00%	Fail
	Apr-14	115.29%	97.78%	112.00%	Fail
	Jul-14	115.60%	97.64%	112.00%	Fail
	Oct-14	114.79%	97.78%	212.00%	Fail

(FOF ¶¶ 63-64; DX 17 at 56.) 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. (*Id.*) 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. (*Id.*)

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:

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%	[illegible].48%	112.70%	N/A
2008	Mar-08	107.58%	106.74%	112.70%	N/A
	Jun-08	127.36%	126.77%	112.70%	Pass
	Sep-08	122.78%	118.06%	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	128.12%	109.81%	112.70%	Fail
	Jun-11	123.18%	107.56%	112.70%	Fail
	Sep-11	124.44%	103.43%	112.70%	Fail
	Dec-11	124.41%	109.18%	112.70%	Fail
2012	Mar-12	124.32%	108.99%	112.70%	Fail
	Jun-12	120.37%	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	118.79%	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%	105.62%	112.70%	Fail

(FOF ¶¶ 63-64; DX 17 at 57.) 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.[10] (*Id.*)

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. (FOF ¶ 66.) As Mayer demonstrates through his analysis, Respondents

[10] 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. Still, the improper categorization of assets in Zohar 1 misled investors about their performance.

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

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	$167,445,871	$208,415,871

(FOF ¶ 66; DX 17 at 63.)

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, and came nowhere near meeting the exacting standards imposed upon fiduciaries. (FOF ¶¶ 29, 76, 238.) As investor witnesses explained at the hearing, they expected Respondents to follow the objective terms of the indenture to categorize assets for purposes of the OC Ratio. (FOF ¶¶ 29, 75, 240.) 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." (FOF ¶¶ 29, 76, 238.) Moreover, the investor witnesses explained 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. (FOF ¶¶ 32, 76, 239.)

In addition to concealing the actual performance of the Zohar funds' assets, Tilton's subjective, personal belief 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 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 of 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 the borrower was paying interest due. (FOF ¶¶ 270-273, 281, 309.) This approach gave Respondents absolute discretion to prevent downgrades of loans that were not making full interest payments, thereby artificially inflating the OC Ratio above the point where the investor protections were triggered. (*Id.*) Put simply, Respondents' approach to categorization eviscerated the investor protections afforded by the OC Ratio tests, directing more than $200 million to Respondents that should have flowed to the funds and their investors. (FOF ¶¶ 295; 350.) Despite this impact, Respondents did not disclose Tilton's subjective, personal belief approach that they employed to categorize assets and the glaring conflict of interest it created. (FOF ¶¶ 29, 76, 238.)

G. The Zohar Funds' Financial Statements Were 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. (FOF ¶ 134.) Also, 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. (FOF ¶ 147.) 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. (FOF ¶¶ 183-190.)

Each of the Zohar fund's indenture required the publication of quarterly financial statements prepared in accordance with U.S. GAAP. (FOF ¶ 134.) 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. (FOF ¶ 131, 135, 298.) Each financial statement contained a cover page and certification signed by Tilton. (FOF ¶ 298.) 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, 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.[11] (DX 10-12.)

Contrary to the indenture and Tilton's certifications, the balance sheet and income statements were not prepared in accordance with U.S. GAAP. (FOF ¶¶ 183-190.) Specifically, Patriarch did not perform U.S. GAAP-compliant impairment analyses, but represented that it did. (FOF ¶¶ 183-190.) U.S. GAAP requires certain affirmative steps to account for loan impairment, which Respondents did not follow. (FOF ¶¶ 183-190.) Here, loans to Portfolio Companies were recorded on the Zohar funds' financial statements at cost. (FOF ¶ 148.) These loans made up the vast majority of the assets on the balance sheet, which also included a corresponding payable to investors in the Zohar funds. (DX 10-12.) To conform with U.S. GAAP, as required by the indentures, Patriarch was required to perform an impairment analysis. (FOF ¶ 178, 179.) Under

[11] 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. (FOF ¶¶ 99, 137-140, 299.) In fact, the engagement letter makes explicit that Anchin's "[f]inancial statements services shall consist of reading and commenting on financial statements, computations or other financial data compiled by Patriarch employees" and the Anchin firm 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." (FOF ¶¶ 94, 95, 301; DX 34.)

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. (FOF ¶ 178.) 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. (*Id.*)

Respondents did not follow these requirements, and did not impair loans, but instead only wrote the loan (or a portion of the loan) off if and when Tilton determined that she would no longer support a Portfolio Company. (FOF ¶ 144, 145, 302; DX 162.) 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 debt forgiveness or extinguishment. (*Id.*) As Tilton bluntly put it in an email to Patriarch's controller: "[W]e do not write up or write down – we write off." (*Id.*) Thus, while Tilton continued to represent to investors that the funds' financial statements were compliant with U.S. GAAP, they were not. (FOF ¶¶ 183-190.) 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 contradicted the indentures, her quarterly certifications, and U.S. GAAP. (*Id.*)

Notably, after the Division provided a Wells notice to Respondents, the Zohar funds' financial statement disclosures and the related certifications signed by Tilton changed significantly. (FOF ¶¶ 112-116; 142-143; 191-195). The references to U.S. GAAP were removed and the notes to the Zohar funds' financials were changed to include disclosures that the loan assets would not be impaired until, in the judgment of the collateral manager, principal losses could be conclusively determined. As one of the Division's experts, Steven Henning, explained in his report and 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. (FOF ¶¶ 191-195). Regardless, the "conclusively determined" standard does not comport with U.S. GAAP, which requires a creditor to record a loss when it is *probable* that a loan is impaired as of the date of the financial statements. (FOF ¶ 178.)

Moreover, even though Respondents did not conduct a U.S. GAAP-compliant impairment analysis, they told investors that they did. (DX 10-12.) 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 . . ." (*Id.*) However, Respondents did not use any analysis of future collections for this purpose, but instead relied on Tilton's subjective judgment to determine when an asset was impaired. (FOF ¶¶ 133, 141-146.)

Respondents' abandonment of their obligation to perform U.S. GAAP-compliant impairment analyses informs their conduct with respect to the manipulation of the OC Ratio. As noted herein, the portfolio companies began missing large amounts of interest payments, especially during and after the Financial Crisis. (FOF ¶ 165.) A U.S. GAAP-compliant impairment analyses would have forced Tilton and Patriarch to impair loan assets because numerous portfolio companies were not making their interest payments. Such a disclosure, combined with the representation that the OC Ratio was passing, may have alerted investors that the OC Ratio was being manipulated, that the Zohar funds were not performing well, or both. To avoid such a disclosure, and to conceal these facts, Patriarch performed no U.S. GAAP-compliant impairment analyses, but represented that it did.

In addition, Respondents misrepresented that the fair value of the loans was approximately equal to their carrying value, which was the cost to purchase or the dollar amount of the loan to the portfolio company. (FOF ¶¶ 147-150; 187-190.) The notes to the Zohar funds' financial statements represented 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." (DX 10-12.) However, Tilton did not direct, and the accounting department did not engage in, any analysis of the present value of anticipated future collections. (FOF ¶¶ 105, 147-150, 152, 188-190, 306.) Nor did they apply any other valuation technique to determine the fair value of the loans. (*Id.*) Instead, Respondents made assertions to investors about the fair value of loans without any substantiation or basis for doing so. (FOF ¶¶ 147-150; 187-190.) To the extent that Respondents claim that their valuations were based on cost, this misses the point because "fair value" and "cost" are not the same thing. (FOF ¶¶ 150, 410, 413.)

As noted above, after the Division initiated this action, the Zohar funds' financial statement disclosures changed significantly. (FOF ¶¶ 112-116; 191-195). 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. (Id.) As Dr. Henning explained in his report and at the hearing, the fact that the financial statement 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. (FOF ¶¶ 191-195). Regardless, as acknowledged by Respondents' expert, if an entity represents that its financial statements present the results of a legitimate U.S. GAAP-compliant fair value analysis, the entity should actually conduct a fair value analysis. (FOF ¶ 413.)

H. Respondents' Post-Hoc Arguments are Inconsistent with their Conduct.

At trial, Respondents' relied on a post-hoc, ever-shifting series of arguments that their conduct was both proper and disclosed. However, their arguments in support of their defenses are inconsistent with their prior conduct. Perhaps most indicative of these inconsistences – with respect to both the manipulation of the OC Ratio and their purposeful misrepresentations on loan impairment and fair value – is demonstrated by their treatment of accrued interest on the Zohar funds' financial statements. Patriarch's treatment of accrued interest, viewed in conjunction with their post-hoc arguments, demonstrates inherent inconsistency in Respondents' arguments that loans were "amended," that the portfolio companies were current, and that Respondents believed they would obtain the interest due on the loans. Put another way, Respondents' treatment of accrued interest directly rebuts Respondents' claims that they were not manipulating the OC Ratio.

Accrued interest is interest that was owed to the Zohar funds, but not collected (*i.e.* interest the portfolio companies owed but could not pay). (FOF ¶ 153.) The Zohar funds' balance sheet contained a line item for accrued interest, along with a "net of an allowance for uncollectible items." (FOF ¶ 154.) At one time the Zohar funds' financial statements disclosed the entirety of accrued interest (*i.e.* the total amount of interest owed to the respective Zohar fund but not collected). (FOF ¶ 155.) However, by 2010, this practice – and the transparency it afforded to investors – had ceased at the direction of Tilton. (FOF ¶¶ 156, 159.) Instead, because the accrued interest figure was not a number that was "meaningful to investors," Patriarch changed its policy to omit the total accrued interest figure and only disclose on the balance sheet what Patriarch "actually expected to collect." (FOF ¶¶ 158, 159, 164.)

In 2010 there was an "uptick" in portfolio companies that could not pay their owed interest and there was a reduction in what Patriarch expected to collect. Thus, the accrued interest figure began to grow. (FOF ¶ 165.) Patriarch's Controller, Carlos Mercado, therefore sought guidance from Tilton on changing the methodology as to how Patriarch calculated accrued interest. (FOF ¶ 166.) Tilton directed that the methodology be changed after Mercado sent an email explaining that under the current methodology the accrued interest figure would increase by more than $4 million from the previous quarter. As outlined in Mercado's email, the methodology change would "maintain a more consistent accrual level" that "results in accrual that is in line with the prior period," and then broke out how the new figure would be similar to the prior quarters. (DX 218; FOF ¶¶ 167, 169.) According to Mercado, this methodology change was allegedly made for the benefit of investors. (FOF ¶ 169).

Respondents' conduct with respect to accrued interest rebuts Respondents' proffered defenses in this case, and shows the inherent inconsistencies in their arguments. First, Respondents' treatment of accrued interest is at odds with their argument that loans were being amended (i.e. they were no longer technically due so there was no technical default), and that Patriarch ultimately believed it would obtain the funds from the portfolio companies, thereby justifying the "current" status for the OC Ratio. As Respondents explicitly recognized in their own internal accounting, this interest was due, this interest was not paid, and this interest was so unlikely to ever be paid that it warranted near complete omission of the interest from the Zohar funds' balance sheet. Indeed, as even acknowledged by Respondents' own expert, "because there's so much uncertainty as to collection, you really don't have a collectible," and therefore the accrued interest did not belong on the balance sheet. (FOF ¶¶ 416, 417.) Inexplicably, the very same companies missing interest payments that were not expected be collected continued to be classified as "current" with respect to the OC Ratio.

Second, Respondents' treatment of accrued interest is at odds with their arguments that they were not concealing missed interest payments from investors. Indeed, an internal email between Tilton and Patriarch's controller (DX 218) makes explicit that the accrued interest methodology was changed for the specific purpose of creating an "accrual that is in line with the prior period." As the email makes crystal clear, this methodology change was made in order to actively conceal the "uptick" in portfolio companies missing interest payments in 2010, which would have resulted in a more than $4 million increase in the accrued interest line item on the balance sheet. (DX 218; FOF ¶¶ 165, 166.) Such conduct is inconsistent with Respondents' arguments that they were freely disclosing that portfolio companies were missing interest payments but were still treated as current for purposes of the OC Ratio. Indeed, if Respondents did not in fact fear disclosing missed interest payments alongside a Portfolio Company's categorization as current for purposes of the OC ratio, there would have been no need to change the accrued interest methodology to "result[] in accrual that is in line with the prior period. (DX 218; FOF ¶¶ 167, 169.) As Patriarch's controller conceded, the goal of a financial statement is to accurately reflect the entity at that point in time, not to have the statement be consistent with past statement. (FOF ¶ 168.)

Third, Respondents' treatment of accrued interest is at odds with their arguments that Respondents' believed that their not engaging in impairment or a fair value analyses was proper. It is not a coincidence that Patriarch *did* impair accrued interest by recognizing it was unlikely to be collected and not to be considered an asset. This practice, which removed the bulk of uncollectible accrued interest figures from the balance sheet, was inconsistent with the practice of not impairing the principal of loans. Indeed, it is telling that impairing the interest, and not impairing the principal, had the same effect: concealing that portfolio companies were not making their loan payments. It is therefore not surprising that Tilton told Patriarch's controller that discussing Patriarch's lack of loan impairment was "not an email discussion." (FOF ¶ 145; DX 162.) Again, Respondents' conduct with respect to accrued interest makes clear that the allegations herein were not simple oversights, but rather a calculated effort to conceal from investors that portfolio companies were not making interest payments, but were continued to be classified as current with respect to the OC Ratio. Respondents' failure to engage in any analyses for impairment of loan principal or fair value simply corroborate that Respondents' conduct of concealing missed interest payments, and their manipulation of the OC ratio, was no accident.

I. Current Status of the Zohar Funds

As noted above, the Zohar funds have failed. In November 2015, Zohar I defaulted on its obligation to repay noteholders their principal investment.[12] (FOF ¶ 265; Answer ¶ 16.) In addition, Respondents have represented that Zohar II is likely to default when it matures in early 2017. (*Id.*) In early 2016, Respondents resigned as collateral manager for the various Zohar funds. (FOF ¶¶ 255, 257, 159, 261.) 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."[13]

IV. ARGUMENT

A. Section 206 of the Advisers Act

Respondents are charged with violating Advisers Act Sections 206(1), (2), and (4), and 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[.]"

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

[13] 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).

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.

"The purpose of the Advisers Act and its rules is to protect investors, not investment advisers." *SEC v. Nutmeg Group LLC*, 162 F. Supp. 3d 754, 777 (N.D. Ill. 2016) (citing *SEC v. DiBella*, 587 F.3d 553, 567 (2d Cir. 2009)). Section 206 of the Advisers Act "establishes 'federal fiduciary standards' to govern the conduct of investment advisers." *Transamerican Mortg. Advisors, Inc. v. Lewis,* 444 U.S. 11, 17 (1979). In recognition of the "delicate fiduciary nature of an investment advisory relationship," Section 206 places an "affirmative duty" on advisers of "utmost good faith, and fair disclosure of all material facts, as well as an affirmative obligation to employ reasonable care to avoid misleading." *SEC v. Capital Gains Research Bureau, Inc.*, 375 U.S. 180, 191, 194 (1963) (internal quotation marks omitted). A "fundamental purpose of [the Advisers Act is] to substitute a philosophy of full disclosure for the philosophy of caveat emptor and thus to achieve a high standard of business ethics in the securities industry." *In the Matter of The Robare Group, Ltd.* et al., Adv. Act Rel. No. 4566 at 7 (Nov. 7, 2016) (quoting *Capital Gains* 375 U.S. at 186). In addition, the provisions of the Advisers Act exist to "'eliminate, or at least to expose, all conflicts of interest which might incline an investment adviser—consciously or unconsciously—to render advice which was not disinterested.'" *SEC v. Nutmeg Group LLC*, 162 F. Supp. 3d at 772 (quoting *SEC v. DiBella*, 587 F.3d at 567).

To commit fraud, a fiduciary need not make an affirmative misstatement; fraud can also be:

> conduct that is deceptive because it is inconsistent with a fiduciary duty. In claims of this kind, the fiduciary duty serves as a sort of standing false representation by the fraudster, who deceives the victim by violating the commitment associated with her fiduciary duty. Acceptance of a fiduciary duty creates an understanding that the fiduciary will behave in certain ways; if the fiduciary allows this understanding to continue while acting inconsistently with her obligations, she has deceived the victim.

In re Refco Capital Markets Ltd. Brokerage Customer Secs. Litig., 2007 WL 2694469 at *7 (S.D.N.Y. Sept. 13, 2007) (citing *SEC v. Zandford,* 535 U.S. 813, 821 (2002)).

Moreover, an investment adviser's clients and investors are not expected to ferret out information from their investment advisers. "'[T]he law does not put the onus on investors to seek out disclosures; it puts the obligation to provide disclosures on people who solicit and manage investors' money.'" *In the Matter of ZPR Investment Management, Inc. et al.*, 2016 WL 3194778 (Comm. Order Denying Mot. for Reconsideration, June 9, 2016) (quoting *SEC v. Nutmeg Group LLC*, 162 F. Supp. 3d at 780). In addition, 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).

Scienter is required for a violation of Section 206(1), but negligent conduct is sufficient under Sections 206(2) and 206(4). *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 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").

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; *Robare Group et al.,* Advisers Act Rel. No. 4566 at 8 (November 7, 2016) (citing *IMS/CPAs & Assocs.*, Exchange Act Rel. No. 45109, 2001 WL 1359521 at *8) (Economic conflicts of interest are material facts that must be disclosed by investment advisers.). In addition, the value of the collateral for 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 also 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 Advisers 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 time of 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 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' employees performed all relevant investment advisory services for the Patriarch Collateral Managers, Patriarch Partners 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 Partners, 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).[14] As a

[14] 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.

result, each of the fund's investors is protected under Advisers Act Section 206(4) and Rule 206(4)-8.

C. Respondents Made False and Misleading Statements and Engaged in Fraudulent and Deceptive Practices and Courses of Business.

1. Categorization of Fund Assets and Reporting of the OC Ratio Test Results

Pursuant to the documents governing the Zohar deals, Respondents were required to categorize the fund assets. The indentures clearly spelled out the criteria for each category. Rather than follow the objective definitions required by the indentures, Respondents categorized assets based on Tilton's subjective, personal belief in whether the underlying Portfolio Company borrower would ultimately be successful. (FOF ¶¶ 296, 297, 305, 321.) This is not consistent with the practice disclosed to investors.

Investors were promised an objective categorization method—that a loan would be classified as a Category 4 or Collateral Investment only when it was "Current." Correspondingly, they were also promised that a loan would be categorized as a Category 1 or a Defaulted Obligation when a "default as to the payment of principal and/or interest has occurred." Instead of following the indenture, Tilton admits that she made the ultimate decision as to whether to accept less than the full amount of interest owed and, if she did so, the loan would not be considered defaulted. (FOF ¶¶ 273, 321.)

As a result of the improper and undisclosed categorization method, Respondents made numerous misstatements to the funds and their investors regarding the categorization of the funds' collateral. First, Respondents' statements in the indentures and other governing documents about asset categorization were false and misleading since Respondents were not engaging in the objective categorization methodology disclosed in those documents. Further, in each monthly trustee report, the category of each loan is separately reported. By improperly reporting the categories for the funds' collateral, Respondents made misstatements month after month. In addition, due to the false categorizations, Respondents improperly reported the funds' OC Ratios, which were derived from the categorization of the collateral.

Moreover, the failure of Respondents to appropriately categorize the loans obscured the financial condition of the Zohar funds from investors. For example, investor David Aniloff testified that the OC Ratio measures the value of the loans held in a CLO relative to the amount invested, and a change to the OC Ratio would provide a reflection of how the underlying collateral is performing. (FOF ¶¶ 16, 19.) Because of Respondents' improper approach to the categorization, investors did not get this important information.

These acts – consistently categorizing loans in a way that was contrary to the Zohar governing documents and was undisclosed to investors – also represent a fraudulent, misleading, and deceptive scheme, practice, and course of business toward the Zohar funds and their investors. *See SEC v. Mannion,* 789 F.Supp.2d at 1339 (recognizing that overvaluation of fund assets can constitute a scheme under Section 206 of the Advisers Act).

2. Failure to Disclose Circumstances Giving Rise to a Conflict of Interest

Tilton's approach to categorization gave rise to an unambiguous, significant conflict of interest: she was incentivized to keep loans categorized as a 4 even when borrowers were not paying current interest in order to keep the OC Ratio test passing, to continue to receive subordinated management fees, and to retain control of the funds—categorizations that were not in the best interest of the funds. Respondents improperly failed to disclose this conflict and the facts giving rise to it.

The law could not be more clear on this point: investment advisers who stand to benefit financially from their advisory activities must fully and completely disclose the circumstances surrounding their advisory services. Indeed, as the Supreme Court has explained, a conflict exists where a relationship "might incline a[n] investment adviser—*consciously or unconsciously*—to render advice which was not disinterested." *Capital Gains,* 375 U.S. at 191-92 (emphasis added).

For example, the Commission recently found that an adviser violated Section 206 of the Advisers Act by failing to disclose to its clients that it would receive compensation when it made certain investment decisions on behalf of its clients. *Robare Group et al.*, Advisers Act Rel. No. 4566 (November 7, 2016). Similarly, where payments "obtained from client funds" were "used to benefit an investment adviser," the Commission found that such an arrangement must be disclosed pursuant to Section 206. *JS Oliver Capital Management*, Rel. No. 4431 at 7, 21016 WL 3361166 at *8 (June 17, 2016).

The evidence is clear that Respondents stood to gain financially from Tilton's categorization practice but did not disclose that practice.[15] The investors who testified had no understanding that Tilton would continue to categorize assets as a Category 4 or Collateral Investment even where contractual interest payments had not been made. In fact, investors testified to precisely the opposite—that they expected a loan to be considered defaulted where it had not paid contractually agreed-upon interest. (FOF ¶¶ 23, 75, 234.) Likewise, the investors had no understanding that Tilton would categorize assets based on her subjective belief in the company's future prospects. (FOF ¶¶ 29, 76, 238.) However, as described above, Tilton was handsomely compensated through this practice—she alone decided when an asset would be categorized as Category 1 or a Defaulted, and entities she controlled received subordinated

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[15] Although the governing documents did disclose some conflicts of interest inherent in the funds' structure, the specific conflict alleged by the Division—Tilton's approach to categorization—was not disclosed. "A fiduciary cannot avoid its obligation of full disclosure by disclosing a different conflict of interest." *Edgar R. Page and Page One Financial, Inc.*, SEC Rel. No. 4400 at 5, 2016 WL 3030845 at *7 (May 27, 2016).

management fees and preference share distributions because of her categorization method. The law requires disclosure of such a glaring conflict of interest.

3. False and Misleading Financial Statements

Respondents also prepared and distributed false and misleading financial statements, which further obscured the poor performance of the collateral underlying the Zohar funds. Pursuant to a requirement in the indentures, Tilton signed a certification that the financial statements prepared by the Funds complied with U.S. GAAP. As described above, Respondents, under Tilton's direction, failed to perform a U.S. GAAP-compliant impairment analysis and also failed to conduct the type of impairment analysis that it disclosed it had done. Instead of reviewing assets for impairment when indicators of impairment were present, Respondents waited until a definitive event occurred indicating the certainty of a loss and then wrote off that loan, or a portion of that loan. (FOF ¶¶ 183, 184.) Respondents' practice of waiting until a loss was certain is inconsistent with U.S. GAAP. (FOF ¶ 185.) Moreover, Respondents disclosed that they would perform a U.S. GAAP-compliant impairment analysis based on a cash flow analysis of anticipated future collections, which they did not. (FOF ¶ 183, 203).

Respondents also failed to conduct a fair value analysis of the loans to Portfolio Companies, despite disclosing that it had done so. Instead, Respondents merely represented that the fair value of the loans approximated the cost of the loans, which was the reported amount on the balance sheet. Investors, however, were told that Respondents conducted a fair value analysis. Curiously, at trial, Respondents claimed that a fair value analysis was conducted, but the controller—Patriarch's senior accounting officer—testified that he had never participated in any such analysis over the course of many years, nor had external accountant Peter Berlant. (FOF ¶ 152.) Indeed, there is not a single shred of evidence in the record that Patriarch's external or internal accountants were involved in Patriarch's phantom U.S. GAAP-compliant fair value analyses. Regardless of Respondents' post-hoc arguments at trial, Respondents' amended financial statement disclosures made clear that the loan assets were "recorded at cost and the company's equity interests in portfolio companies are not recorded on the consolidated balance sheet[,]" after all references to any disclosed fair value were removed. (Div. Ex. 18 at 24-25.)

D. Respondents' Misstatements Were Material.

Respondents' false and misleading statements and omissions regarding how assets were categorized and valued, the resulting false and misleading statements and omissions related to the OC Ratio, and the false and misleading statements and omissions in the financial statements, were all obviously material.

Investor testimony supports a finding of materiality. First, investors testified that it was important for the collateral manager to follow the requirements of the indentures, including properly and objectively categorizing the portfolio company loans for OC Ratio purposes. (FOF ¶¶ 14, 15, 20, 75, 78, 240, 242.). Indeed, investors all testified that the OC Ratio was very important to their investment decisions, and as one investor, David Aniloff, described it, the OC Ratio was "the most important ratio in a CLO, by far." (FOF ¶¶ 17, 18, 28, 74, 77, 231.) Had investors known that Tilton would categorize loans based on her personal belief in the portfolio companies rather than using the method disclosed in the indentures, that would have been important information to them, and likely would have changed their investment decisions. (FOF ¶¶ 29, 31, 35, 76, 77, 239.) Second, several investors also testified that the disclosures in the financial statements were important to them, including the disclosures regarding fair value and U.S. GAAP compliance. (FOF ¶¶ 50, 83.)

Furthermore, it is apparent that there is a substantial likelihood that a reasonable investor would have considered these misrepresentations and omissions important given their subject matter. The OC Ratio compares the assets of a CLO to its liabilities: it provides a snapshot of the financial health of the CLO. (FOF ¶¶ 74, 338.) Additionally, declines in the OC Ratio beyond a certain level would trigger investor protections, including funds being directed away from Respondents to the investors, and in certain instances, the ability to remove the collateral manager. (FOF ¶¶ 271, 337, 339, 349.) Disclosures related to the financial health of an investment and investor protections are plainly material to investors. Additionally, Respondents' manipulation of the OC Ratio to inflate it and avoid redirecting funds to investors is a significant conflict of interest that would necessarily be material to investors.

With respect to the financial statements, Respondents disclosed that the fair values of the loans to the portfolio companies, taken as a whole, were approximately equal to the carrying value presented on the balance sheet, when in fact no such calculation was done. (FOF ¶¶ 180-190.) And Respondents claimed to use a U.S. GAAP-compliant impairment methodology, when they did not. (*Id.*) A reasonable investor would consider it material that a CLO fund – whose ability to repay principal rests on the financial condition of the underlying loans – had not actually engaged in a fair value calculation of the loans that it claimed to have done, and had not used a U.S. GAAP-compliant impairment methodology that it claimed to have used. Respondents' false and misleading disclosures on these topics in the financial statements were also therefore material.

E. Respondents' Conduct was Intentional, Reckless, or at Least Negligent.

Respondents acted intentionally, recklessly, or at least negligently. Respondents knew (or at least had information showing) what the indentures required with respect to categorization, that hundreds of millions of dollars of interest was unpaid, that the collection of this interest was "doubtful." Yet they continued to categorize these loans in the highest category. Remarkably, Respondents also claimed that they were fully "transparent" with investors even though the evidence plainly belies such a claim. Particularly in the context of an investment adviser with fiduciary duties and obligations of candor, the record evidence shows that Respondents acted with scienter or, at a minimum, negligently.

Tilton and Respondents have at all relevant times controlled the Zohar funds and known of the indentures' categorization requirements, the OC Ratio test and its consequences, and the actual interest payments by the portfolio companies. (FOF ¶¶ 255, 256, 270-273.) And Tilton and the other Respondents were well aware of their fiduciary obligations and standard of care. (FOF ¶¶ 274-276.) But instead of following the criteria for categorization set forth in the indentures, Respondents categorized assets based on Tilton's subjective, personal belief in the future of the portfolio companies.[16] (FOF ¶ 296; DX 219.) 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. They also failed to disclose or seek any consent to their significant conflict of interest.

Respondents' undisclosed, subjective categorization approach manifested its investor-harming consequences during the Financial Crisis, when the Zohar funds' portfolio companies lost 30 to 35 percent of their revenues and did not pay their interest due, yet Tilton still kept the

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

loans to these portfolio companies categorized as a 4 or current. (FOF ¶ 316.) Indeed, Tilton allowed hundreds of millions dollars of unpaid interest to accrue. (FOF ¶ 313.) Moreover, Respondents acknowledged that the collection of this unpaid interest was "doubtful," and yet they continued to categorize the loans as a 4 or current. (FOF ¶ 312.) This conduct – keeping myriad loans with millions of dollars in unpaid, "doubtful" interest in the highest-performing category – further evidences that Respondents acted with scienter or, at a minimum, negligently.

Tilton had significant motivation to keep the OC Ratios artificially inflated. By improperly categorizing the loans, she was able to keep the OC Ratio for each fund passing, thus avoiding the consequences of OC Ratio failure, including the increased rights to control the fund assets afforded the insurer or the noteholders in the event of an OC Ratio failure. To the extent that these other parties gained control of the funds and could potentially force asset sales, Tilton stood to lose the enormous potential equity upside that she held in the portfolio companies. (FOF ¶ 269.)

As for the financial statements, Tilton personally signed the officer's certificate verifying the accuracy of the financial statements for the Zohar Funds. Patriarch took responsibility for the financial statements. (FOF ¶¶ 298, 301.) But Tilton and Respondents did not analyze fair value or impairment as they claimed in the financial statements. (FOF ¶¶ 302, 304, 305, 306.) At one point, as accrued interest grew, Tilton and Respondents even changed the numbers in the financial statements so they looked the same, despite the significantly larger amount of unpaid interest. (FOF ¶ 311.) Despite her knowledge of the financial condition of the Portfolio Companies and Patriarch's actual accounting practices, Tilton allowed the financial statements to be published without anyone 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 subjective standards for impairment without regard to standards prescribed by U.S. GAAP. These intentional and deceptive acts are strong evidence of Respondents' scienter.

Rather than helping Respondents, Tilton's specious claims that she did, in fact, "transparently" disclose what she was doing in the categorization process further underscores that Respondents were purposefully acting to keep information from investors. Tilton's defense boils down to her false claim that "Category 4 just meant that it wasn't defaulted. And if I agreed to accept less interest than the stated amount on the credit agreement, I had amended and it wasn't defaulted." (FOF ¶ 321.) This bizarre approach was not disclosed in the indentures, nor was her subjective method to categorize loans based on her personal belief in the portfolio companies. (*Id.*)

Instead of simply disclosing her actual practice in straightforward terms, Tilton merely disclosed – in different portions of the trustee report and ratings agency reports – certain information about cash flows, which she calls "transparency." (*Id.*) Tilton's "transparency" included stating in an investor call that "things could be done to elongate the time needed to be able to create the most amount of value to pay off the loans." (*Id.*) And she now claims that that was a disclosure of her purported practice of amending by course of performance, which she claims "everyone knew, everyone saw it, everyone understood." (*Id.*) In fact, no evidence was presented that Tilton disclosed her subjective categorization method to any investor, which falls manifestly short of the high standard imposed under the Advisers Act. Rather, investors testified that they did not know about Tilton's subjective method. Perhaps most damningly, Tilton did not call a single investor to back up her false claim that she disclosed her deceptive practice. (*Id.*) She instead relied on a post-hoc, ever-shifting series of arguments at trial that investors should have spent untold hours piecing together fragments of information to divine her true practices.

Respondents hid the truth from investors, and this is the strongest evidence of scienter. Tilton knew that allowing companies to pay less than interest due without re-categorizing the loans was contrary to the indentures, but she never disclosed to investors that she was doing this. Rather, she kept the loans categorized as 4s or current, kept her money coming in, and stayed in control of the funds. Her only defense is a *post hoc* lawyer-created argument that because she disclosed some incomplete information about cash flows, investors should have figured out that she was not following the indentures.[17] (FOF ¶ 309, 310.) But she had countless opportunities to disclose her actual subjective categorization practice, and never did, which evidences her true intent.

In addition, Respondents' conduct was reckless or at a minimum negligent since it was inconsistent with the actions that a reasonable investment adviser would take. Through the Zohar governing documents, Respondents told investors that loans would be categorized based on whether they were making their interest payments. Investors testified that they understood – as is common in the industry – that if a loan did not pay its interest, and specifically if a loan did not pay its stated coupon rate, it should be categorized as defaulted. (*See, e.g.*, FOF ¶¶ 23-25, 234-236, 251.) Even so, Respondents kept loans with tens of millions of dollars in unpaid interest categorized as Category 4/ Collateral Investments, because of Tilton's subjective belief that, ultimately, these Portfolio Companies would turn around. Moreover, Respondents did not fully and candidly disclose to investors what they were doing; indeed, every investor who testified explained that they did not understand what Respondents were doing. In addition, a reasonable investment adviser would not certify that financial statements were prepared in accordance with U.S. GAAP when they were not, and would not obfuscate the value of the fund assets on the financial

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[17] In all of her testimony that Tilton gave in 2013, her first testimony in this case, she did not say that she was amending by course of performance. (DX 219.)

statements. No reasonable investment adviser would have acted this way, and violated their standard of care. (FOF ¶¶ 276, 360.) Thus, in addition to Respondents' actions being done with scienter, their actions were negligent.

Respondents' 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. Respondents Violated Section 206 of the Advisers Act or Aided and Abetted and/or Caused a Violation.

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.[18]

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[18] 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

G. Respondents' Defenses Have No Merit.

1. Respondents Did Not Disclose Their Categorization Method.

Tilton testified extensively that investors understood what she was doing with respect to categorization. She further argues that her categorization method was accurately disclosed because investors could determine that companies were not paying full interest if they reviewed the trustee reports. This defense is without merit.

As a threshold matter, the trustee reports did not disclose Tilton's subjective categorization approach. Indeed, they did not even explicitly disclose that companies categorized as a 4 or current were not making interest payments at the stated rates. Rather, to come to this conclusion, an investor would be required to undertake a multi-step analysis for each loan, on a monthly basis, requiring them to: 1) review the principal balance on a particular loan; 2) review the contractual rate of interest on that loan; 3) review the amount actually paid for the period; and 4) review the category assigned to that loan.[19] (FOF, ¶ 282.) Although investors in Zohar II and III may have been able to determine from the trustee reports that loans were not paying their contractual rate of interest at times, investors could not determine the method that Tilton was using to categorize the loans (which was different from the disclosed method) or easily determine what the actual OC Ratio was (which was different from the reported ratio).

In addition – and critically – investors did not expect that they would need to recalculate the reported categories or OC Ratio. (FOF ¶ ¶ 43, 81.) And, as discussed above, the law does not require them to do so. "[T]he law does not put the onus on investors to seek out disclosures; it puts

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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.

[19] Each Zohar Fund issued a report monthly. Each report covered about 90 loans in the case of Zohar I and about 150 loans in the case of Zohar II and III. *See* DX 7-9. The Zohar I cash flows do not appear in the trustee reports.

the obligation to provide disclosures on people who solicit and manage investors' money." *In the Matter of ZPR Investment Management, Inc., and Max E. Zavanelli*, SEC Rel. No. 4417 at 6 (June 9, 2016) (quoting *SEC v. Nutmeg Group, LLC*, 162 F. Supp. 3d 754, 780 (N.D. Ill. 2016)). The disclosure that Respondents claim was provided, was simply not sufficient. "Full and fair disclosure cannot be achieved through piecemeal release of subsidiary facts which if stated together might provide a sufficient statement of the ultimate fact." *Kennedy v. Tallant*, 710 F.2d 711, 720 (1983).

Tilton further argues that her method was "disclos[ed]" because on an investor call in 2011, she stated that "things could be done to elongate the time needed to be able to create the most amount of value to pay off the loans." (FOF ¶ 321.) But this statement is not even remotely a candid and transparent disclosure of Tilton's categorization approach.

Respondents make the same claims about disclosure as the Defendants did in *SEC v. Nutmeg Group*, 162 F. Supp. 3d 754 (N.D. Ill. 2016), which were rejected by the court. In that case, Defendants claimed that where investors wrote checks to and received distributions from the investment advisory firm rather than the specific fund in which they invested, they were properly on notice that their assets would be commingled with assets of the firm and/or assets of other funds. The Court disagreed, noting that this argument "reflect[s] a basic misunderstanding of what constitutes meaningful disclosure to investors." *Id.* at 780. In addition, the Defendants in *Nutmeg Group* also claimed that the investors knew what they were doing, but, as here, failed to offer any evidence other than their own testimony that this was the case. *Id.* Finally, as here, Defendants in *Nutmeg Group* claim that they would have answered questions had they been asked. However, appropriately, the Court noted that "a willingness to disclose is a poor substitute for actual disclosure." *Id.* at 779-80.

2. Tilton Was Not Amending the Loans.

The primary justification asserted by Tilton for retaining loans as Category 4 or Collateral Investments when the borrowers were not paying current contractual interest is that those loans were "amended by course of performance" whenever she did not collect the full interest due from the borrower. These "amendments" are not documented through any written agreement and, puzzlingly, do not even amend the underlying loans. Tilton's explanation is simply preposterous. Tilton was not actually amending the loans when she accepted less than full interest—she was just accepting less than full interest and failing to properly recategorize the loans.[20] The unpaid interest remained due and owing, but was omitted from the Zohar funds' financial statements because the collection of the funds was claimed to be doubtful.

As an initial matter, Tilton's claim is that accepting less than full interest was an amendment by course of performance simply does not make sense. When these purported "amendments" occurred, the loan terms did not change. (FOF ¶¶ 309, 366.) The credit agreement was not amended. (FOF ¶, 309, Tr. 2524: 1-6.) And the interest rate disclosed in the trustee reports remained the same. (FOF ¶ 366). Tilton attempted to explain this type of "amendment," stating that "[i]t was a different type of amendment, but it was still an amendment. But we didn't amend the actual credit agreement, because we were keeping the contractual materials the same, and then making that decision on a monthly basis on whether to amend and defer until a later date." (Tr. 2523:20-2524:8.) This explanation simply defies credulity: one cannot amend a loan without amending the contractual credit agreement. As the Division's expert witness Ira Wagner explained, "an amendment but not an amendment to the credit agreement just really doesn't make any sense." (Tr. 2978:20-2979:7.)

[20] There were many documented amendments to loans to portfolio companies. However, the acceptance of less than the contractually-owed interest by Tilton was generally not documented. (FOF ¶366(a).)

Further, the indentures specify certain actions that must be taken by the collateral manager when a loan is amended. Specifically, the indenture dictates that the collateral manager will notify the trustee when "any term or condition" of a loan has "been amended or waived, and the effect of such amendment or waiver was to change the interest rate. . . " (DX 2 at PP050451.) Likewise, the indenture required Respondents to notify rating agencies of amendments, and submit an amended loan for re-rating. Respondents did not do any of these things, significantly undercutting the claim that Tilton's actions were "amendments." (FOF ¶ 366.) Respondents did provide written amendments to both the rating agencies and the trustees. What they did not do is provide notice of the unwritten "amendments" – that is, the purported agreements not to collect interest due – to those parties. The reason for this is clear: these were not actual amendments, but instead are a post-hoc legal fiction created to justify Tilton's approach to categorization. Tilton herself struggled to explain why certain amendments were provided to the rating agencies, but others were not.

Lastly, Tilton's amendment argument is at odds with Patriarch's own internal accounting records on accrued interest, which makes clear that interest payments were missed, remained due and owning, but were not included as an asset on the Zohar funds' balance sheet because the interest was so unlikely to be collected. It is nonsensical that Tilton amended the loan so the amount was no longer due and owing, but at the same time the amount was considered due and owing for accounting purposes, but unlikely to be collected.

3. At the Very Least, Respondents' Conduct Was Misleading.

Even if Your Honor determines to credit Tilton's argument that she was amending loans by course of performance, her conduct rendered the statements Respondents made incredibly misleading to investors. As described above, Respondents continually failed to disclose the true condition of the Zohar funds' collateral to investors through the misstatements of the categories of collateral, the improperly-reported OC Ratio, and the false and misleading financial statements. In addition, despite clear language in the Zohar governing documents that loans would be categorized as Category 1s or Defaulted Investments if borrowers defaulted on a payment of interest, Tilton allowed Portfolio Companies to miss tens of millions of dollars in unpaid interest – interest she herself said was "doubtful" to be collected – and yet continued to categorize those loans as Category 4s or Collateral Investments. Put simply, investors could not tell what was happening with their investments or what Tilton was doing.

At Tilton's direction, loans with tens of millions of dollars in unpaid interest were reported as current on the trustee reports. Respondents' practice of simply reporting loans as current and the OC Ratio as passing, provided investors with the false comfort that the principal on their investments would ultimately be recoverable. However, as noted above, Zohar I has already defaulted on that obligation and Zohar II is expected to default in January 2017. At Tilton's direction, loans were not being analyzed for impairment. Again, had loans been appropriately impaired, investors would have had some indication that repayment of their principal was in danger. At Tilton's direction, the method for reporting interest accrual was changed so that investors could not see a large amount of unpaid interest.

4. <u>Respondents Do Not Have a Reliance Defense</u>

Respondents' arguments that they "relied" on external accountant Peter Berlant are meritless. "Good faith reliance on the advice of an accountant or an attorney has been recognized as a viable defense to scienter in securities fraud cases." *SEC. v. Caserta*, 75 F. Supp. 2d 79, 94 (E.D.N.Y. 1999) (citing cases). "To establish the defense, the defendant should show that he/she/it made a complete disclosure, sought the advice as to the appropriateness of the challenged conduct, received advice that the conduct was appropriate, and relied on that advice in good faith." *Id.* (citing cases). In such cases, "good faith reliance" is "not a complete defense, but only one factor for consideration." *Markowski v. SEC*, 34 F.3d 99, 105 (2d Cir.1994).

As an initial matter, as acknowledged by Patriarch's controller, Berlant was not reviewing or opining on whether the Zohar funds' financial statements complied with U.S. GAAP, and was not testing whether the Zohar funds' financial statements complied with U.S. GAAP. Rather, Berlant was providing instruction as to whether or not there was an issue that Patriarch needed to incorporate into the financial statements, or "consider to be included into the financial statements." (FOF ¶ 139.) This was corroborated by Berlant who testified that he had no knowledge of whether the Zohar funds' financial statements were prepared in accordance with U.S. GAAP because he was never asked to interpret, or given an opportunity to research and consider, whether the Zohar funds' financials were U.S. GAAP-compliant. (FOF ¶ 99.)

This was further corroborated by Anchin's engagement letter, signed by both Tilton and Berlant, which defined what Anchin would and would not do, and where Anchin's responsibilities lie and where Patriarch's responsibilities lie: "Financial statements services shall consist of reading and commenting on financial statements, computations or other financial data compiled by Patriarch employees." (DX 34; FOF ¶¶ 94, 95, 301.) The Engagement Letter made explicit that Anchin and Berlant would "take no responsibility regarding the accuracy or completeness of such statements, computations or data, or whether such statements or data comply with generally accepted accounting principles or any other specified basis of accounting." (*Id.*)

The amount of time Berlant had with the financial statements, and his practice of picking up the phone and calling a Patriarch employee with any comments, further corroborates that he could not have been performing any meaningful tasks outside the scope of his engagement letter.

As explained by Patriarch's controller, Berlant typically had about two days to look at and comment on the draft financials, and this time frame would not have allowed him to perform an audit, review or compilation of the Zohar funds' financial statements. (FOF ¶¶ 136, 299.) Rather, according to Mercado, Berlant merely checked the "accuracy" (meaning "what was in the [Patriarch] work papers was being reflected on the financial statement document") of Patriarch's work papers and the financial statements and provided any commentary with respect to accounting issue that he felt were relevant to the Zohar funds' financial statements. (FOF ¶¶ 136-138).

This was corroborated by Berlant who similarly testified that he received draft financial statements and an electronic set of work papers (all prepared by Patriarch) and would spend approximately one or two hours making sure dates were updated correctly, numbers added up correctly, and that the financial statements had been updated and were internally consistent. He would then typically make a phone call to the controller or CFO at Patriarch and provide comments, which were typically due within 24 to 48 hours after he received the financials. (FOF ¶¶ 96, 97). Thus, it was not possible for Berlant to perform the type of services that would sustain a reliance defense with respect to the challenged conduct.

Furthermore, Respondents' alleged reliance defenses appear to be little more than a post-hoc attorney created defense. When Patriarch made changes to the Zohar funds' financials by removing references to U.S. GAAP and inserting new disclosures, Berlant was not asked to opine on whether this language should be removed, and was never told that he was doing a poor job, that he missed things in past financial statements, that changes were made because of his work, or that anybody at Patriarch was unsatisfied with his work. Rather, Patriarch continued to send the Zohar funds' financial statements to Berlant and pay him for his services after the changes in disclosures. (FOF ¶¶ 116-119).

Lastly, it strains credulity that Tilton – who had been a financial analyst for years looking at financial statements, understanding them, deciphering them, breaking them apart, and interpreting them – was confused on whether Patriarch needed to comply with U.S. GAAP and their own representations of engaging in a fair value analysis. Her recent attempt to blame the external accountant – who spent a few hours each month looking at draft financial statements – is meritless. (FOF ¶¶ 119-120). Berlant was not hired to test or opine on whether Patriarch's internal procedures complied with their representations to investors, and Tilton has enough experience with financials to know that Berlant could not have been testing or opining because of the engagement letter that she signed, and because Berlant spent merely a few hours per month looking over draft financials. Simply put, there can be no credible dispute that Berlant did not perform the services necessary to support a reliance defense.

Respondents did not (and cannot) show that they made complete disclosure about their lack of impairment and fair value analyses to Berlant, that they every sought advice from Berlant on representing they were engaging in the analyses but were failing to actually perform them, that Berlant advised such conduct was appropriate, and that Respondents relied on such advice. *See SEC. v. Caserta*, 75 F. Supp. 2d at 94. Put simply, Respondents did (and cannot) show they meet any of the elements for reliance, much less all of them.

5. <u>The Division's Claims Properly Consider the Purpose of the Zohar CLOs.</u>

Respondents argue that the Division's approach fundamentally misconstrues the purpose of the Zohar funds. But this argument also fails.

At the outset, it is uncontroverted that investors did expect companies to pay current interest. (FOF ¶ 72.) Moreover, the portfolio companies understood that they were expected to pay their interest. Specifically, according to portfolio company witness Jean Luc Pelissier, interest "must be paid," is a "critical item that each of the company must comply to," and that paying less than full interest is "[a]lways a difficult process to justify and be in front of Lynn Tilton and explain why a company has failed or why a company is not always in position of not being able to do those interest payment." (Tr. 3082:11-3083:9.). Similarly, portfolio company witness John Harrington testified that the priority on a portfolio's company cash was payroll, payroll taxes, and payment of interest. Portfolio companies did 13 week cash flow projections; if the cash flow indicated those three things could not be paid, the company's management would need to put together a 12 month business plan, go to New York to meet with Tilton, and present the plan. These meetings were brutal and long, sometimes lasting days. (Tr. 3533:1-3535:6; 3535:23-3536:7; 3557:17-3559:9)]

If the portfolio companies were not paying current interest, investors expected that their loans would be categorized correctly. (FOF ¶ 24, 30.) Investors bargained for this protection. Indeed, portfolio companies largely paid their interest until the financial crisis hit. (FOF ¶ 278.)

Finally, investors' expectation that Tilton would follow the terms of the indenture did not mean that Tilton would be unable to manage the funds or the portfolio companies. Respondents could still exercise remedies as a lender, and could also originate new loans to the same portfolio company. (FOF ¶¶ 371, 372, 376.) There is no automatic outcome when a loan is made a Category 1 or a Defaulted Obligation. (FOF ¶¶ 371-377). Thus, Respondents' assertion is wholly speculative and without merit.

V. REMEDIES

In determining whether the public interest requires sanctions, the following factors are to be considered: the egregiousness of the actions; the isolated or recurrent nature of the infractions; the degree of scienter involved; the sincerity of a respondent's assurances against future violations; a respondent's recognition of the wrongful nature of his or her conduct; and the likelihood that a respondent's occupation will present opportunities for future violations. *See Steadman v. SEC,* 603 F.2d 1126, 1140 (5th Cir. 1979); *see also ZPR Opinion of Commission at* *27. Other factors include the age of the violations and the degree of harm to investors and the marketplace, *see Marshall E. Melton,* Advisers Act Rel. No. 2151, 2003 WL 21729839, at *2 (July 25, 2003), as well as the extent to which a sanction will have a deterrent effect and the likelihood of future violations. *Mark Feathers,* Initial Dec. Rel. No. 605, 2014 WL 2418472, at *3 (May 30, 2014), *affd* SEC Release No. 7634, 2014 WL 6449870 (Nov. 18, 2014) (citing *Schield Mgmt. Co.,* Exchange Act Rel. No. 53253, 2006 WL 231642, at *8 & n.46 (Jan. 31, 2006)).

A. A Cease and Desist Order Should Issue.

In determining whether a cease-and-desist order is appropriate and in the public interest, in addition to the *Steadman* factors listed above, the Commission further considers: "whether there is a risk of future violations, whether the violation is recent, the degree of harm to investors or the marketplace resulting from the violation, and the remedial function to be served by the cease-and-desist order in the context of any other sanctions being sought in the same proceedings." *Steven E. Muth,* Initial Dec. Rel. No. 262, 2004 WL 2270299, at *39 (Oct. 8, 2004) (citing *KPMG Peat Marwick LLP,* Exchange Act Rel. No. 1360, 2001 WL 47245 (Jan. 19, 2001)). In applying these factors, the Commission has held that "although some risk of future violation is necessary, it need not be very great to warrant issuing a cease-and-desist order and . . . in the ordinary case and absent evidence to the contrary, a finding of past violation raises a sufficient risk of future violation." *KPMG Peat Marwick LLP,* Exchange Act Rel. No. 1374, 2001 WL 223378, at *6 (Mar. 8, 2001) (internal quotation marks and citation omitted).

A cease-and-desist order is appropriate in this proceeding. Respondents' violations of their statutory duties were serious, repeated, and committed with the requisite scienter. There is no assurance against future misconduct, as Tilton has never acknowledged that her approach to managing the Zohar funds was inappropriate in any way. Instead, she has created post hoc justifications for her improper actions and blamed investors for failing to uncover her fraud. Moreover, Tilton will continue to have opportunities to commit future violations given her age and long career in the securities industry. Although the Patriarch Collateral Managers have withdrawn their registration as investment advisers, Tilton has given no assurances that she will not enter the securities industry again. Indeed, given her role as the top executive at many private companies, it seems likely that she will again attempt to avail herself of funding opportunities provided by the financial markets that are regulated by the Commission.

B. Respondents Should Disgorge Certain Advisory Fees.

Sections 203(j) and 203(k)(5) of the Advisers Act authorize an order to disgorge ill-gotten gains. 15 U.S.C. §§ 80b-3(j), 80b-3(k)(5).[21] "[D]isgorgement's underlying purpose is to make lawbreaking unprofitable for the law-breaker[.]" *SEC v. Contorinis,* 743 F.3d 296, 301 (2d Cir. 2014). To determine the appropriate amount of disgorgement, the Division need only offer a reasonable approximation of the profits from the violative conduct. *See SEC v. First City Fin. Corp.,* 890 F.2d 1215, 1231 (D.C. Cir. 1989). The burden then shifts to the respondent to show that the approximation is inaccurate. *Id.* at 1232. All doubts concerning the determination of the disgorgement figure are to be construed against Respondents. *E.g., SEC v. Lorin,* 76 F.3d 458, 462 (2d Cir. 2006).

[21] Authority for a disgorgement order here also stems from Section 9(e) of the Investment Company Act of 1940 ("Company Act"), 15 U.S.C. § 80a-9(e). *See* OIP at III (C).

The Division has presented evidence that Respondents profited substantially as a result of their violative conduct. Specifically, the Division's expert Michael Mayer calculated that if Tilton had appropriately categorized Zohar fund assets, the OC Ratio Test would have failed for Zohar II by July 2009 and Zohar III by June 2009. As a result, Respondents received over $208 million in subordinated management fees and preference share distributions that they otherwise should not have received. (FOF ¶ 66.) Respondents have put forward no competing calculation.

Finally, the disgorgement order should be joint and several as to the Patriarch entities and Tilton in light of Tilton's ownership of all of them and her role as the responsible individual for the misconduct. *SEC v. First Jersey Secs., Inc.*, 101 F.3d 1450, 1475-76 (2d Cir. 1996).

C. Third-Tier Penalties Should Be Assessed.

Under Section 203(i) of the Advisers Act, the Commission may impose a civil money penalty on a respondent who willfully violated (or aided and abetted a violation of) the Advisers Act, if the penalty is in the public interest.[22] A violation is willful if the respondent "intentionally commit[ed] the act which constitutes the violations." *ZPR Investment Mgmt.*, 2015 WL 6575683 at *27 (quoting *Wonsover v. SEC*, 205 F.3d 408, 414 (D.C. Cir. 2000)). There is no requirement that the respondent "also be aware" that he or she "violat[ed] the of the Rules or Acts." *Id.* Public interest is assessed with respect to these statutory factors: (1) deceit, manipulation, or deliberate or reckless disregard of a regulatory requirement; (2) harm to others; (3) unjust enrichment; (4) prior violations; (5) the need for deterrence; and (6) such other matters as justice may require. 15 U.S.C. § 80b-3(i)(3); *see also Hector Gallardo,* Exchange Act Rel. No. 65422, 2011 WL 4495006, at *10 (Sept. 28, 2011). "Not all factors may be relevant in a given case, and the factors need not all carry

[22] Penalty authority here also derives from Section 9(d) of the Investment Company Act, 15 U.S.C. § 80a-9(d).

equal weight." *Robert G. Weeks,* Initial Dec. Rel. No. 199, 2002 WL 169185, at *58 (Feb. 4, 2002).

A three-tier system establishes the maximum per-violation penalty. 15 U.S.C. § 80b-3(i)(2). Second-tier penalties are imposed in cases involving fraud, deceit, manipulation, or deliberate or reckless disregard of a regulatory requirement. *Id.* Third-tier penalties are imposed in cases where such state of mind is present *and* where the conduct directly or indirectly (i) resulted in substantial losses, *or* (ii) created a significant risk of substantial losses to other persons, *or* (iii) resulted in substantial pecuniary gain to the violator. *Id.* During the lengthy period at issue, the third tier penalties for each violation for a natural person range from a maximum of $120,000 for the earliest part of the misconduct to $178,156 for violations occurring after November 2, 2015. For an entity, the range is from $600,000 to $890,780. See 17 C.F.R.§ 201.1003 & Pt. 201, Subpart E, Table III; "Adjustments to Civil Monetary Penalty Amounts" Sec. Act. Rel. No. 33-10104 (June 27, 206) at 14-15.

The conduct here should be subject to third-tier penalties given the level of scienter and the tremendous pecuniary gains to Respondents, as described above. In addition, Tilton's callous disregard for her advisory obligations created a very significant risk of harm to others. Due to Tilton's actions in managing the Zohar funds, the funds and their investors were deprived of significant fees and distributions that should have flowed to them.

There are many ways to count violations, and Respondents' potential exposure here is enormous. The Court could impose a penalty on Respondents for each misrepresentation of the category of an asset in each trustee report. Likewise, the court could impose a penalty for each improperly represented OC Ratio. In addition, the Court could impose a penalty for each financial statement misrepresentation. *See, e.g., Muth,* 2004 WL 2270299, at *41 ("each fraudulent misrepresentation to each investor constitutes a separate act or omission" since the "statutory maximum is not an overall limitation, but a limitation per violation."); *Kevin H Goldstein,* Initial Dec. Rel. No. 243, 2004 WL 69156, at * 19 (Jan. 16, 2004) (in fraudulent offering of securities, each fraudulent misrepresentation to each investor counted as a separate act or omission);

No matter how the penalty is computed, it should consider the need for a strong deterrent message to ensure that investment advisers deal truthfully and honestly with their clients and investors and disclose all conflicts of interest, regardless of the context.

D. Associational Bars Are Appropriate.

Sections 203(e) and (f) of the Advisers Act authorize the Commission to revoke the registration of a registered investment adviser, and to bar a person from association with an investment adviser, for willfully violating (or aiding and abetting a violation of) the federal securities laws. 15 U.S.C. § 80b-3(e), (f). The selection of an appropriate sanction includes an assessment of the deterrent effect it may have in upholding and enforcing standards of conduct in the securities business. An industry bar is particularly important in this case given the importance to the investment adviser industry of maintaining honest fiduciary relationships. *See Steadman,* 603 F.2d at 1142 (in determining appropriate sanction, Commission entitled to consider "violations occurring in the context of a fiduciary relationship to be more serious than they otherwise might be"); *James* C. *Dawson,* Advisers Act Rel. No. 3057, 2010 WL 2886183, at *4 (July 23, 2010) ("We have consistently viewed misconduct involving a breach of fiduciary duty or dishonest conduct on the part of a fiduciary ... as egregious.").[23] *See Don Warner Reinhard,* Exchange Act Rel. No. 3139, 2011 WL 121451, at *8 (Jan. 14, 2011); *Mark S. Parnass,* Exchange Act Rel. No. 65261,2011 WL 4101087, at *3 (Sept. 2, 2011) ("the function of a bar order is not limited to

[23] Company Act Section 9(b), 15 U.S.C. § 80a-9(b), also authorizes bars relating to registered investment companies.

merely preventing future identical violations, but is more broadly designed to achieve the goals of deterrence, both specific and general, to address the risks of allowing a respondent to remain in the industry"); *see also Gary M Kornman,* Exchange Act Rel. No. 59403, 2009 WL 367635 at *7 (Feb. 13, 2009) ("The securities industry presents continual opportunities for dishonesty and abuse and depends heavily on the integrity of its participants and on investors' confidence.").

Permanent bars are appropriate here and have been ordered in analogous cases. For example, the Commission upheld the imposition of a bar where an investment adviser failed to act in its clients' best interest by allocating profitable trades to its own account rather than that of its clients, in violation of its fiduciary duties. *JS Oliver Capital Mgmt,* SEC Rel. No. 4431, 2016 WL 3361166 at *10 (March 7, 2016). Likewise, in *ZPR Investment Management,* the Commission upheld an industry bar against an associated person of an investment adviser who misled clients by misrepresenting that the adviser had complied with national standards for advertising guidelines failed to acknowledge the wrongfulness his conduct, but instead argued that investors "could have found" the relevant disclosures "elsewhere." *ZPR Investment Management*, SEC Rel. No. 4249, 2015 WL 6575683 (October 20, 2015).

In this case, Respondents, through Tilton, elevated their own interests over those of their clients and investors rather than following the requirements of the funds' governing documents or disclosing their actual approach to the OC Ratio. Moreover, Respondents failed to comply with both the standard of care applicable to similarly-situated investment advisers and with U.S. GAAP, all the while claiming that investors could figure out what Tilton was doing if they took the time to piece bits of information together. Permanent bars will provide investors with much better protection from these Respondents in the future.

VI. CONCLUSION

The Division requests that Your Honor rule in its favor and granted the relief requested.

Dated: December 16, 2016

Respectfully Submitted,

Amy Sumner

Dugan Bliss, Esq.
Nicholas Heinke, Esq.
Amy Sumner, Esq.
Mark L. Williams, Esq.
Division of Enforcement
Securities and Exchange Commission
Denver Regional Office
1961 Stout Street, Ste. 1700
Denver, CO 80294

CERTIFICATE OF SERVICE

I hereby certify that a true copy of the **DIVISION OF ENFORCEMENT'S POST-HEARING BRIEF** was served on the following on this 16th day of December, 2016, in the manner indicated below:

Securities and Exchange Commission
Brent Fields, Secretary
100 F Street, N.E.
Mail Stop 1090
Washington, D.C. 20549
(By Facsimile and original and three copies by UPS)

Hon. Judge Carol Fox Foelak
100 F Street, N.E.
Mail Stop 2557
Washington, D.C. 20549
(By Email)

Randy M. Mastro, Esq.
Lawrence J. Zweifach, Esq.
Barry Goldsmith, Esq.
Caitlin J. Halligan, Esq.
Reed Brodsky, Esq.
Monica K. Loseman, Esq.
Gibson, Dunn & Crutcher LLP
200 Park Avenue
New York, New York 10166
(By email pursuant to the parties' agreement)

Susan E. Brune, Esq.
Brune Law PC
450 Park Avenue
New York, NY 10022
(By email pursuant to the parties' agreement)

Martin J. Auerbach
Law Firm of Martin J. Auerbach, Esq.
1330 Avenue of the Americas
Ste. 1100
New York, NY 10019
(By email pursuant to the parties' agreement)

Nicole L. Nesy