

UNITED STATES OF AMERICA
Before the
SECURITIES AND EXCHANGE COMMISSION

SECURITIES ACT OF 1933
Release No. 9375 / December 17, 2012

INVESTMENT ADVISERS ACT OF 1940
Release No. 3515 / December 17, 2012

ADMINISTRATIVE PROCEEDING
File No. 3-15135

In The Matter Of

JOSEPH A. SCHLIM,

Respondent.

**ORDER INSTITUTING CEASE-
AND-DESIST PROCEEDINGS
PURSUANT TO SECTION 8A OF
THE SECURITIES ACT OF 1933
AND SECTION 203(k) OF THE
INVESTMENT ADVISERS ACT
OF 1940, MAKING FINDINGS,
AND IMPOSING A CEASE-AND-
DESIST ORDER**

I.

The Securities and Exchange Commission (“Commission”) deems it appropriate that cease-and-desist proceedings be, and hereby are, instituted pursuant to Section 8A of the Securities Act of 1933 (“Securities Act”) and Section 203(k) of the Investment Advisers Act of 1940 (“Advisers Act”) against Joseph A. Schlim (“Schlim” or “Respondent”).

II.

In anticipation of the institution of these proceedings, Respondent has submitted an Offer of Settlement (the “Offer”) which the Commission has determined to accept. Solely for the purpose of these proceedings and any other proceedings brought by or on behalf of the Commission, or to which the Commission is a party, and without admitting or denying the findings herein, except as to the Commission’s jurisdiction over him and the subject matter of these proceedings, which are admitted, Respondent consents to the entry of this Order Instituting Cease-and-Desist Proceedings Pursuant to Section 8A of the Securities Act of 1933 and Section 203(k) of the Investment Advisers Act of 1940, Making Findings, and Imposing a Cease-and-Desist Order (“Order”), as set forth below.

III.

On the basis of this Order and Respondent’s Offer, the Commission finds that:

A. SUMMARY

1. This case involves complex structured financial products known as collateralized debt obligations (“CDOs”). CDOs are securities backed by debt obligations including, for example, subprime residential mortgage-backed securities. The underlying mortgage-backed, or other, securities are packaged and generally held by a special purpose vehicle that issues notes entitling their holders to payments derived from the underlying assets.

2. In late 2006, Aladdin Capital Management LLC (“Aladdin Management”) marketed to its clients two CDOs that it was managing and stated that it would co-invest in the same CDOs. Aladdin Management did not co-invest as it represented. Aladdin Capital LLC (“Aladdin Capital”) collected a placement fee from the CDOs’ underwriters. At the pertinent times, Schlim had responsibility for ensuring that Aladdin Management co-invested alongside its clients, but ultimately failed to ensure that Aladdin Management did so with respect to these two CDOs.

B. RESPONDENT AND RELATED ENTITIES

3. **Schlim**, age 47, of New Canaan, Connecticut is a former principal and CFO of Aladdin Capital and Aladdin Management. Schlim has obtained, and currently possesses, Series 4, 7, 24, 27 and 63 licenses issued by the Financial Industry Regulatory Authority.

4. **Aladdin Management** is an SEC-registered investment adviser based in Stamford, Connecticut. During the relevant time period, Aladdin Management had assets under management of approximately \$20 billion, which consisted predominantly of cash and synthetic CDOs, collateralized loan obligations (“CLOs”), several credit hedge funds, and separately managed accounts. Aladdin Management’s typical practice was to act as the collateral manager for CDOs and CLOs underwritten by major investment banks.

5. **Aladdin Capital**, during the relevant time period, was an SEC-registered broker-dealer based in Stamford, Connecticut. Aladdin Capital primarily placed CDO and CLO securities. On January 30, 2012, Aladdin Capital filed a Form BDW with the Commission, thus seeking to terminate its registration as a broker-dealer. It became effective on March 30, 2012.

C. FACTS

Aladdin’s MAST Program and Marketing Statements

6. In 2005, Aladdin Management began an investment advisory program called the “Multiple Asset Securitized Tranche” (“MAST”) program. Schlim, along with two Aladdin Capital registered representatives, created the MAST program. Under the MAST program, Aladdin Management and its clients signed investment management agreements by which Aladdin Management agreed to render investment management services, and the client agreed to commit to invest in the equity tranche of certain upcoming CDO or CLO deals that would be managed by Aladdin Management. Aladdin Management did not receive a separate advisory fee from its MAST clients; rather it received a management fee from the CDOs and CLOs in which the MAST clients invested. Aladdin Capital placed the equity interest with its customer and

typically received a negotiated (usually ten-percent) placement fee or commission from the CDOs' or CLOs' underwriters for doing so.

7. When marketing the MAST program, Aladdin Management and Aladdin Capital stated that Aladdin Management would co-invest in the same equity tranches of each CDO or CLO alongside its clients. Schlim was personally involved in creating the co-investment feature of the MAST program. Schlim knew that Aladdin Management's co-investment representation was a key feature of, and selling point for, the MAST program. For example, Aladdin Management explained in marketing material that, "[w]e align our interests with MAST investors by co-investing in every transaction with them. And don't forget, we are not investing in other firms' transactions. Instead, we only invest in deals where we can control the management of the collateral – our own programs." In the same marketing piece, Aladdin Management also posed the question, "[w]hy is an investor better off just investing in Aladdin sponsored CLOs and CDOs?" Aladdin answered by emphasizing that the "most powerful response I can give to your question is that Aladdin co-invests alongside MAST investors in every program. Putting meaningful 'skin in the game' as we do means our financial interests are aligned with those of our MAST investors." Aladdin Capital also emphasized that Aladdin Management would co-invest in the same products when marketing specific CDOs to potential MAST participants.

8. Schlim was significantly involved in the MAST program on a day-to-day basis. He made sales calls on potential MAST clients, and he negotiated with CDO and CLO underwriters about the amount of equity in those securities that Aladdin Capital could place with its customers, or purchase for itself. Schlim also negotiated the placement fees to be received by Aladdin Capital for securing MAST investments in the equity tranches of each CDO or CLO.

9. As Aladdin Management explained in its marketing materials, co-investing in the same CDO deals as its clients was one of the most "powerful" statements it could make because it showed that Aladdin Management had "skin in the game" and that its financial interests were aligned with those of its clients. Also, because the equity tranche of the CDOs were typically the riskiest tranche and in the first loss position, having the CDO manager as an investor in the same tranche gave investors additional assurances that they could trust the CDO.

Aladdin Management Stated It Would Co-Invest Alongside Each MAST Participant in the Fortius and Citius CDOs

10. Despite the centrality of its representations that it would co-invest, and had co-invested, in CDOs alongside its MAST clients, Aladdin Management failed to co-invest in two CDOs that it offered to MAST clients in late 2006. In particular, Aladdin Management failed to co-invest in the Fortius II Funding, Ltd. ("Fortius") CDO and the Citius II Funding Ltd. ("Citius") CDO despite the fact that three MAST clients invested in the equity tranches of those CDOs.

Aladdin Management Did Not Co-Invest Alongside a Municipal Retirement Plan in the Fortius CDO

11. One potential MAST client that Aladdin Management pursued was a retirement plan for approximately 10,000 employees of a municipal transportation agency (the “Municipal Retirement Plan”). Aladdin Management and Aladdin Capital began pitching the MAST program to the Municipal Retirement Plan in 2005 or 2006.

12. When pitching the MAST program, Aladdin Management and Aladdin Capital emphasized that Aladdin Management would co-invest alongside the Municipal Retirement Plan’s CDO investments. Aladdin made such representations at key points in the Municipal Retirement Plan’s decision-making process. For example, in early 2006, Aladdin highlighted to the Municipal Retirement Plan that Aladdin Management invested alongside MAST participants in the same investments. Subsequently, in April 2006, one of the Municipal Retirement Plan’s representatives recommended that the Plan invest in MAST in part based on the “key feature” that MAST had a “significant alignment of interest with [Aladdin Management] co-investing alongside MAST investors.”

13. During the process of soliciting the Municipal Retirement Plan’s investment in the MAST program, Aladdin Management and Aladdin Capital (including Schlim) continued to emphasize the co-investment benefit of the MAST program. In particular:

- a. On May 11, 2006, Schlim and another Aladdin Capital registered representative presented an “Aladdin overview” and “MAST summary” to the Municipal Retirement Plan. Schlim personally stated that Aladdin Management co-invests in the equity tranche of CDOs in the MAST program, up to at least ten percent of the client’s MAST investment;
- b. On May 12, 2006, an Aladdin Capital registered representative sent an email, which was copied to Schlim, to the Municipal Retirement Plan stating that: “As Joe Schlim mentioned yesterday, Aladdin also co-invests in the identical equity tranches up to at least 10 % of your MAST allocation, further aligning our economic interests with those of our clients in this regard;”
- c. On July 18, 2006, another Aladdin Capital registered representative (who was also an Aladdin Management employee) emailed to the Municipal Retirement Plan a MAST “executive summary” and other marketing material. Both documents highlighted Aladdin Management’s co-investment representation. In the cover email, the employee noted: “[a]s outlined in the enclosures, we also co-investment [sic] in the same CDO equity tranches as our clients, which we believe helps to align our economic interests;”
- d. On August 3, 2006, Aladdin Management provided the Municipal Retirement Plan with a sample MAST report, which contained the co-investment representation.

14. Even after the Municipal Retirement Plan signed an investment agreement to participate in the MAST program, Aladdin continued to represent that it would invest alongside the Municipal Retirement Plan in the particular CDO programs its client had chosen.

15. Aladdin Capital offered the Municipal Retirement Plan an investment in the Fortius CDO. On November 21, 2006, a former Aladdin Capital registered representative specifically informed the Municipal Retirement Plan that Aladdin Management would co-invest in Fortius. On December 6, 2006, the Municipal Retirement Plan purchased \$5,000,000 in the equity tranche of the Fortius CDO directly from the underwriter of the Fortius CDO. Aladdin Management did not make the required \$500,000 investment in the Fortius CDO.

16. When Aladdin Management made its statements to the Municipal Retirement Plan that it would co-invest in the Fortius CDO, it had taken no steps to make that co-investment. To the contrary, by November 3, 2006, which was the pricing date for the Fortius CDO, Schlim knew that the Fortius CDO's underwriter had preliminarily allocated \$5,000,000 of the equity tranche of the Fortius CDO to Aladdin and/or its clients. Promptly after being informed that the Fortius CDO's underwriter had allocated \$5,000,000 of the Fortius CDO's equity tranche to Aladdin, Schlim instructed his subordinates to ensure that the Municipal Retirement Plan would purchase that entire \$5 million allocation. Schlim took no steps, either internally or in communications with the Fortius CDO's underwriter, to reserve for Aladdin a portion of the equity tranche of the Fortius CDO. To the contrary, during November 2006, Aladdin Capital communicated to the underwriter of the Fortius CDO that the Municipal Retirement Plan would instead purchase Aladdin's entire allocation of the Fortius CDO's equity tranche.

17. Soon after the Municipal Retirement Plan's \$5 million purchase of the Fortius CDO, upon Schlim's request, Aladdin Capital communicated with the underwriter for the Fortius CDO and requested that it be paid the previously agreed-upon 10 percent placement fee (in the amount of \$500,000) for its work in placing Fortius securities with the Municipal Retirement Plan. The underwriter paid Aladdin that fee in December 2006. Schlim was aware of that payment.

Aladdin Management Did Not Co-Invest Alongside Two Other MAST Program Participants in the Citius CDO

18. In December 2006, Aladdin Capital sold investments in the equity tranche of the Citius CDO to two MAST participants as part of the MAST program. The two clients were a pension plan for a chain of retail stores (the "Pension Plan"), and an individual entrepreneur who invested his personal funds and also the funds of his charitable foundation in the MAST program (the "Individual Client").

19. Both the Pension Plan and the Individual Client decided to participate in the MAST program, and were informed that Aladdin Management would co-invest alongside them in each CDO investment they made as part of the MAST program. Schlim was generally aware of these representations that Aladdin Management would co-invest.

20. Specifically, in 2005, Aladdin Management sent the Individual Client a "letter of intent" concerning his plan to participate in the MAST program and thus invest in CDOs

managed by Aladdin Management. The letter of intent contained a provision representing that “Aladdin will co-invest with Client in the identical Preference Share equity tranches in the MAST program. Aladdin’s investment, in aggregate, will be equal to at least 10 % of Client’s total Preference Share investment in the MAST program.” After receiving this letter, the Individual Client agreed to participate in the MAST program, and invested in several CDOs and CLOs in late 2005 and early 2006. Aladdin Management co-invested in each of these CDOs and CLOs. Throughout 2006, Aladdin Management sent the Individual Client MAST investment reports indicating that Aladdin co-invests in each CDO investment made as part of the MAST program.

21. Beginning in September 2006, Aladdin Capital offered the Individual Client an investment in the Citius CDO. On December 1, 2006, Aladdin Capital – on behalf of the Individual Client – purchased \$4,100,000 in the equity tranche of the Citius CDO from the underwriter of the Citius CDO. Subsequently, in early 2007, Aladdin transferred the entire investment to the Individual Client. Aladdin Management did not make the required \$410,000 co-investment in the Citius CDO.

22. Despite its statements in MAST materials about its co-investments with clients, Aladdin Management took no steps to co-invest in the Citius CDO. In mid-2006, when Aladdin Management was engaged to manage the Citius CDO by its underwriter, Aladdin Management committed to the underwriter that it or its clients would purchase at least 25% of the \$16 million equity tranche of the Citius CDO.

23. By September 26, 2006, Aladdin Management had taken no action to reserve for itself a portion of the equity tranche of the Citius CDO. Another party had agreed to underwrite \$8 million in the equity and Aladdin Capital sought to place the remaining \$8 million with its own customers for a placement fee without investing any of its own money. On September 26, 2006, Schlim informed the underwriter for the Citius CDO that Aladdin Capital wanted to “soft circle the remaining 4.1 mm in equity and get paid 10 pts [points]” for selling it. In response to the underwriter’s question about when Aladdin Capital would be firm on selling the remaining portion of the equity tranche, Schlim responded that he should know by the end of the “week” and could know by “tomorrow.”

24. Also on September 26, 2006, an Aladdin Capital registered representative offered a \$4,100,000 investment in the Citius CDO to the Individual Client, and the Individual Client agreed to make that investment. Schlim was informed about the offer of \$4,100,000 in the equity tranche of the Citius CDO to the Individual Client.

25. Schlim took no steps, either internally or in communications with the Citius CDO’s underwriter to reserve for Aladdin Management an investment of \$410,000 in the equity tranche of the Citius CDO.

26. On or about December 1, 2006, the underwriter for the Citius CDO paid Aladdin Capital a \$410,000 placement fee for its work in placing Citius securities with the Individual Client.

27. With respect to the Pension Plan, Aladdin pitched the MAST program to this client in July 2005. The Pension Plan received the standard MAST program letter of intent, and other standard MAST marketing materials, which included the co-investment representation.

28. In 2005, the Pension Plan agreed to participate in the MAST program.

29. In approximately October 2006, Aladdin Capital offered to sell to the Pension Plan an investment in the equity tranche of the Citius CDO. The Pension Plan agreed to invest in the equity tranche of the Citius CDO, in the amount of \$3,900,000.

30. On or about December 1, 2006, the underwriter for the Citius CDO paid Aladdin Capital a \$390,000 placement fee for its work in placing Citius securities with the Pension Plan. Schlim was aware of this payment.

31. Despite being involved in, and primarily responsible for, communications with the underwriters for both the Fortius CDO and the Citius CDO about Aladdin Capital's commitment to place a portion of the equity tranche of those securities, and the communications with those underwriters in which Aladdin made sure to reserve the amount to be purchased by MAST clients, Schlim made no effort to communicate with the underwriters for these two CDOs to reserve an amount to be purchased by Aladdin Management pursuant to its co-investment obligations.

32. Schlim, as the CFO of Aladdin, was responsible for reserving Aladdin Management funds with which to co-invest alongside its MAST clients. With respect to the Fortius CDO and the Citius CDO, although he did not supervise Aladdin's Legal or Compliance departments, Schlim failed to ensure that Aladdin Management reserved or allocated its funds to make co-investments alongside Aladdin Management's clients in either CDO.

33. Schlim knew that Aladdin used the co-investment representation as a significant marketing feature of its pitches to MAST clients. Schlim was also aware when the representation that Aladdin Management co-invested alongside all of its clients in MAST programs was made to MAST clients and potential MAST clients. Schlim failed to take any action to ensure that such representations were accurate when they were made.

D. VIOLATIONS

35. Section 17(a)(2) of the Securities Act prohibits any person "in the offer or sale of any securities or securities-based swap agreement . . . [from] obtain[ing] money or property by means of any untrue statement of material fact or any omission to state a material fact necessary in order to make the statements made, in light of the circumstances under which they were made, not misleading." Scierter is not required to establish violations of Section 17(a)(2). *See Aaron v. SEC*, 446 U.S. 680, 697 (1980). Instead, violations of this section may be established by showing negligent conduct. *SEC v. Hughes Capital Corp.*, 124 F.3d 449, 453-54 (3d Cir. 1997).

36. Section 206(2) of the Advisers Act prohibits investment advisers from "engag[ing] in any transaction, practice, or course of business which operates as a fraud or deceit upon any client or prospective client." Proof of scierter is not required to establish a violation of Section 206(2), but rather a violation "may rest on a finding of simple negligence." *SEC v.*

Steadman, 967 F.2d 636, 643 n.5 (D.C. Cir. 1992) (citing *SEC v. Capital Gains Research Bur., Inc.*, 375 U.S. 180, 194-95 (1963)); *see also SEC v. Wash. Inv. Network*, 475 F.2d 392, 396 (D.C. Cir. 2007).

37. As a result of the negligent conduct described above, Schlim violated Section 17(a)(2) of the Securities Act.

38. As a result of the negligent conduct described above, Schlim caused Aladdin Capital's violations of Section 17(a)(2) of the Securities Act and caused Aladdin Management's violation of Section 206(2) of the Advisers Act.

IV.

In view of the foregoing, the Commission deems it appropriate to impose the sanctions agreed to in the Respondent's Offer.

Accordingly, pursuant to Section 8A of the Securities Act and 203(k) of the Advisers Act, it is hereby ORDERED that:

A. Schlim shall cease and desist from committing or causing any violations and any future violation of Section 17(a)(2) of the Securities Act and Section 206(2) of the Advisers Act;

B. Schlim shall, within 10 days of the entry of this Order, pay a civil money penalty in the amount of \$50,000 to the Securities and Exchange Commission. If timely payment is not made, additional interest shall accrue pursuant to 31 U.S.C. §3717. Payment must be made in one of the following ways: (1) Respondent may transmit payment electronically to the Commission, which will provide detailed ACH transfer/Fedwire instructions upon request; (2) Respondent may make direct payment from a bank account via Pay.gov through the SEC website at <http://www.sec.gov/about/offices/ofm.htm>; or (3) Respondent may pay by certified check, bank cashier's check, or United States postal money order, made payable to the Securities and Exchange Commission and hand-delivered or mailed to Enterprise Services Center, Accounts Receivable Branch, HQ Bldg., Room 181, AMZ-341,6500 South MacArthur Boulevard, Oklahoma City, OK 73169. Payments by check or money order must be accompanied by a cover letter identifying Respondent's name as a Respondent in these proceedings, and the file number of these proceedings; a copy of the cover letter and check or money order must be sent to John T. Dugan, Associate Regional Director, Division of Enforcement, Securities and Exchange Commission, Boston Regional Office, 33 Arch Street, 23rd Floor, Boston, MA 02110;

C. Pursuant to Section 308(a) of the Sarbanes-Oxley Act of 2002, as amended, a Fair Fund is created for the disgorgement, prejudgment interest and penalties referenced in paragraph B above. Regardless of whether any such Fair Fund distribution is made, amounts ordered to be paid as civil money penalties pursuant to this Order shall be treated as penalties paid to the government for all purposes, including all tax purposes. To preserve the deterrent effect of the civil penalty, Respondent agrees that in any Related Investor Action, he shall not argue that he is entitled to, nor shall he benefit by, offset or reduction of any award of compensatory damages by the amount of any part of Respondent's payment of a civil penalty in this action ("Penalty Offset"). If the court in any Related Investor Action grants such a Penalty Offset, Respondent agrees that he shall, within 30 days after entry of a final order granting the Penalty Offset, notify

the Commission's counsel in this action and pay the amount of the Penalty Offset to the United States Treasury or to a Fair Fund, as the Commission directs. Such a payment shall not be deemed an additional civil penalty and shall not be deemed to change the amount of the civil penalty imposed in this proceeding. For purposes of this paragraph, a "Related Investor Action" means a private damages action brought against Respondent by or on behalf of one or more investors based on substantially the same facts as alleged in the Order instituted by the Commission in this proceeding.

By the Commission.

Elizabeth M. Murphy
Secretary