

UNITED STATES OF AMERICA
Before the
SECURITIES AND EXCHANGE COMMISSION

SECURITIES ACT OF 1933
Release No. 9252 / August 25, 2011

INVESTMENT ADVISERS ACT OF 1940
Release No. 3261 / August 25, 2011

ADMINISTRATIVE PROCEEDING
File No. 3-14514

In the Matter of

GSCP (NJ), L.P.

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 GSCP (N.J.), L.P. (“GSC” 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 it 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 finds¹ that:

Summary

1. These proceedings arise out of the structuring and marketing of the Squared CDO 2007-1 ("Squared") collateralized debt obligation ("CDO"), which was offered to investors in early 2007. J.P. Morgan Securities LLC (f/k/a J.P. Morgan Securities Inc.) ("J.P. Morgan Securities") structured and marketed Squared, a largely synthetic CDO whose assets consisted primarily of Credit Default Swaps ("CDSs") whose reference securities were other CDOs. GSC served as collateral manager in connection with the selection of assets for and managing of the Squared portfolio. Synthetic CDO squareds were designed to, and did, result in leveraged exposure to the housing market and therefore magnified losses when the United States housing market experienced a downturn.

2. GSC failed to ensure that investors were adequately informed that the hedge fund Magnetar Capital LLC ("Magnetar"), with economic interests adverse to investors in Squared, played a significant role in the portfolio selection process. While participating in the selection of CDO securities for the investment portfolio, Magnetar (who also invested \$8.9 million in the subordinated notes, or equity) took the short position for CDO securities with a notional value of approximately \$600 million, representing approximately half of Squared's investment portfolio. The marketing materials for Squared, including the term sheet, pitch book and offering circular, all represented that the investment portfolio of CDO securities was selected by GSC, without disclosing the role played by Magnetar, a fact known by GSC.

3. J.P. Morgan Securities sold approximately \$150 million of the so-called "mezzanine" tranches of Squared's liabilities ("Notes") to a group of approximately 15 domestic and foreign institutional investors ("Mezzanine Investors"). All of the 10 Mezzanine Investors interviewed by the Commission staff indicated that they would have considered it important to their investment decision to have known that the equity investor in Squared took the short position for approximately half of the investment portfolio and played a significant role in the collateral selection process.

4. Squared, which priced on April 19, 2007 and closed on May 11, 2007, declared an event of default on January 18, 2008. By January 29, 2008, 50% of the CDO securities in the investment portfolio had been downgraded and 34% of the portfolio was on negative downgrade watch. As a result, the Mezzanine Investors lost most, if not all, of their principal. While J.P. Morgan Securities and its affiliates sustained losses of approximately \$880 million in connection with the entire super senior tranche, it also avoided potentially substantial losses when it closed the deal and removed the warehouse financing exposure from its books.

¹ The findings herein are made pursuant to Respondent's Offer of Settlement and are not binding on any other person or entity in this or any other proceeding.

Respondent

5. GSC, a registered investment adviser to various funds, was headquartered in Florham Park, New Jersey. GSC served as collateral manager for a number of CDOs, including Squared. As of December 31, 2006, GSC had closed nine structured finance CDO transactions, had more than \$12.9 billion in structured finance assets under management and over \$22 billion in total assets under management. GSC filed for Chapter 11 bankruptcy protection on August 31, 2010.

Other Relevant Person and Entity

6. Edward Steffelin (“Steffelin”), age 41, was a Managing Director at GSC’s offices in New York City and an associated person of GSC during the relevant period. Steffelin was in charge of the GSC team responsible for Squared. He obtained his Series 7 and 63 licenses in March 2010 and is currently a registered representative with a broker-dealer based in Scottsdale, Arizona.

7. J.P. Morgan Securities is the principal U.S. broker-dealer of J.P. Morgan Chase & Co., a global investment banking, securities and investment management firm headquartered in New York City. J.P. Morgan Securities structured and marketed Squared.

Facts

CDOs and CDO Squared Transactions Generally

8. CDOs are complex, structured investment vehicles generally backed by residential mortgage backed securities, commercial mortgage backed securities, or other types of asset-backed fixed income securities which are packaged and held by a special purpose vehicle (“SPV”) that issues notes entitling the holders to payment derived from the performance of the securities. A CDO portfolio may contain cash assets, such as the fixed income securities described above, and synthetic assets, such as CDSs² that reference the performance of fixed income securities. A “CDO squared” is a CDO whose portfolio contains securities issued by other CDOs or references the performance of securities issued by other CDOs.

9. The underwriter and structurer of a CDO squared typically provides a warehouse facility, pursuant to which it acquires and holds the assets selected by the collateral manager prior to the closing of the deal. The process of selecting portfolio assets colloquially is known as “ramping”, and the individual CDO securities or bonds are colloquially known as “names.” At closing, the SPV typically acquires the collateral on the terms negotiated by the underwriter and structurer, and pays the underwriter and structurer through the proceeds of the sale of notes to investors.

² CDSs are a type of bilateral contract in which a seller of protection agrees to pay a buyer of protection a specified amount of money if the issuer of the referenced bond defaults on its obligations. The counterparty CDS buyer, in return for that protection, periodically pays a specified fee, or spread, to the seller during the term of the CDS contract.

10. A CDO squared issues notes whose payments are made in waterfall fashion, with priority of payment determined by the risk profile of the investment tranche. Investors in the super senior, AAA tranche receive first priority of payment. The lower “mezzanine” tranches are junior in priority and, therefore, carry greater risk and lower payment priority than the super senior tranche. The unrated equity tranche carries the greatest risk, as it is the first to experience losses.

Squared CDO

11. Squared was a \$1.1 billion, largely synthetic CDO Squared. As such, its collateral portfolio consisted primarily of CDS assets that referenced the securities issued by other CDOs.

12. GSC and J.P. Morgan Securities executed the engagement letter for Squared on or about January 11, 2007. The engagement letter provided that J.P. Morgan would serve as arranger and placement agent, and would provide warehouse financing pursuant to a separate written agreement, and GSC would serve as portfolio manager. Steffelin signed the engagement letter on behalf of GSC.

Squared Collateral Selection Process: Phase One

13. The collateral selection and warehousing process for Squared began on or about January 12, 2007. Between January 12 and February 7, 2007, GSC selected for the warehouse 27 names with a notional value of \$436.4 million. During this phase, GSC selected this collateral and placed it in the J.P. Morgan Securities warehouse with little or no input from Magnetar.

14. Magnetar bought the CDS protection, or took the short position, on three of the selected CDO securities with a notional value of \$60 million. The short counterparties on the remaining 24 CDO securities were identified using a “bid wanted in competition” or “BWIC” process, in which a list of bonds is submitted to various brokers to solicit bids for protection on those bonds.

Squared Collateral Selection Process: Phase Two

15. On or about January 29, 2007, J.P. Morgan Securities executed a letter agreement with Magnetar obligating Magnetar to purchase the equity of Squared.

16. Shortly after executing the equity purchase agreement, Magnetar began to play a significant role in the process of selecting the remaining collateral for Squared. Between February 8 and 23, 2007, Magnetar took the short position on 18 of the 19 synthetic names that were selected for the Squared portfolio. Names for which Magnetar was not interested in taking the short position were neither included in the portfolio nor bid out to the market (using the customary BWIC process) to find other potential buyers of protection.

17. From early January through late February 2007, Steffelin engaged in a series of discussions with the Magnetar employee primarily responsible for the firm’s participation in the Squared transaction about possibly setting up a collateral manager for Magnetar.

18. Steffelin and Magnetar ultimately did not reach an agreement. However, such discussions with Magnetar at the same time he was ramping the portfolio for Squared posed a potential conflict of interest for Steffelin, who was permitting Magnetar to participate in the collateral selection process despite its having economic interests adverse to Squared's other investors.

19. Steffelin did not disclose this potential conflict of interest to J.P. Morgan Securities, the SPVs that issued the notes, or any of the Mezzanine Investors.

Squared Collateral Selection Process: Phase Three

20. On or about February 24, 2007, J.P. Morgan Securities closed the warehouse for Squared, meaning it stopped acquiring collateral for the portfolio. Between this time period and the deal closing, GSC, J.P. Morgan, and Magnetar discussed securities that might ultimately be included in the portfolio. On or about April 18, 2007, an agreement was reached among GSC, J.P. Morgan and Magnetar on the vast majority of the remaining names to be included in the Squared portfolio. The deal priced on April 19, 2007. None of the CDS names were bid out to the market, as Magnetar was pre-identified as the buyer.

21. The following chart summarizes the three phases of the warehousing and portfolio selection for Squared:

Phase	Total Notional Value (\$)	Total Number of Names	Magnetar Short Position (\$)	Number of Magnetar Names
I	436.4M	27	60M	3
II	365M	19	360M	18
III	293.9M	19	183.9M	12
Total	1.1B	65	603.9M	33

22. By the time Squared closed, Magnetar's \$8.9 million "long" position from purchasing the equity was dwarfed by its \$600 million "short" position as the purchaser of CDS protection.

23. Statistical analyses conducted in connection with the Commission staff's investigation indicate that Magnetar's involvement in the collateral selection process contributed, beginning in early 2008, to the negative performance of Squared's investment portfolio.

Disclosures Regarding the Role of GSC

24. During March and April 2007, J.P. Morgan Securities marketed the mezzanine tranches of Squared to potential investors. GSC participated in these efforts by meeting with potential investors and talking to them over the phone.

25. J.P. Morgan Securities' sales and marketing employees emphasized to investors the advantages of having GSC select and manage the portfolio. GSC was aware of this marketing emphasis.

26. Unbeknownst to the Mezzanine Investors, Phases II and III of the collateral selection process involved significant input from Magnetar, which engaged in back-and-forth negotiations with GSC and J.P. Morgan Securities, pursuant to which an agreement was reached on the portfolio.

27. The written marketing materials for Squared, including the pitch book, term sheet and offering circular, represented that GSC selected the investment portfolio. For example, J.P. Morgan Securities' April 2007 term sheet for the Squared CDO described GSC as the "Portfolio Selector."

28. Similarly, the J.P. Morgan Securities March 2007 pitch book for Squared, which provided an overview of GSC's senior management team, business strategy, expertise and credit selection process, represented that the portfolio would be selected and managed by GSC. GSC supplied this information for the pitch book, and reviewed and edited the document before it was provided to investors.

29. The May 2007 offering circular for Squared represented that the investment portfolio was selected by GSC in accordance with its "research, credit analysis and judgment."

30. GSC reviewed and edited the offering circular before it was provided to investors.

31. Although the offering circular disclosed that a noteholder may hold a short position with respect to the CDO securities or buy credit protection with respect to the CDO securities, and that a noteholder may act with respect to those positions "without regard to whether any such action might have an adverse effect on the Issuer, the Noteholders, related Reference Entity or any Reference Obligation," this disclosure did not indicate that a noteholder like Magnetar was involved in the portfolio selection process.

32. GSC also failed to disclose Magnetar's involvement in the collateral selection process to either of the SPVs that issued the Notes. Domestic and offshore SPVs were formed to issue the Notes in Squared. GSC entered into a Collateral Management Agreement with the offshore SPV, pursuant to which GSC was appointed as its investment adviser and agreed to select and manage the collateral. (As the Delaware SPV did not purchase any collateral, it was not a party to this agreement.) The SPVs were clients of GSC.

33. During the course of the Commission staff's investigation, the Chairman of the board of the offshore SPV and the sole director of the domestic SPV indicated that, had they been informed that: 1) a third party with economic interests adverse to that of the investors had played a significant role in the collateral selection process; or 2) the employee at the collateral manager principally responsible for the Squared transaction was talking about going into business with a third party that he was allowing to participate in the collateral selection process, they would have informed their respective legal counsel and asked them to determine whether these facts needed to be disclosed in the offering documents.

Squared's Mezzanine Investors

34. J.P. Morgan Securities sold Notes with a par value of \$150 million to the Mezzanine Investors, a group of approximately fifteen (15) institutional investors including seven located in the United States and eight located overseas (the Mezzanine Investors actually paid \$145.8 million due to modest pricing discounts). The seven domestic Mezzanine Investors in Squared were: Thrivent Financial for Lutherans, a Minneapolis, Minn.-based not-for-profit life insurance organization (\$10 million notional); General Motors Asset Management, a New York City-based asset manager for General Motors' pension plans (\$10 million notional); Security Benefit Corporation, a Topeka, Kansas-based provider of insurance and retirement products (\$12 million notional); Moneygram International, Inc., a Minneapolis, Minn.-based provider of global money transfer and bill payment services (\$15 million notional); Fifth Third Asset Management Inc., a Cincinnati, Ohio-based investment adviser and mutual fund company (\$4 million notional); Morgan Asset Management Inc., the Birmingham, Alabama-based asset management unit of broker-dealer Morgan & Keegan Co. (\$6 million notional); and Dillon Read Finance L.P., a New York City-based affiliate of a hedge fund unit within a major investment and commercial bank (\$20 million notional).

35. The eight foreign Mezzanine Investors were: two Taiwanese life insurance companies, Far Glory Life Insurance Company Ltd. (\$5 million notional) and Taiwan Life Insurance Company Ltd. (\$3 million notional); three banks, Paris-based Caisse D'Epargne (\$20 million notional), Tokyo-based Tokyo Star Bank (\$8 million notional) and Singapore-based United Overseas Bank (\$13 million notional); two asset managers, Hong Kong-based East Asia Asset Management Ltd. (\$1 million notional) and Tel Aviv-based Leader Capital Markets Ltd. (\$2 million notional); and a Sydney-based hedge fund, Basis Pac-Rim Opportunity Fund (\$10 million notional). The Mezzanine Investors lost most, if not all, of their principal when their Notes became nearly worthless less than one year after closing.

36. All of the ten Mezzanine Investors interviewed by the Commission's staff indicated that they would have considered it important to their investment decision to have known that the equity investor in Squared had taken the short position for approximately half of the investment portfolio and played a significant role in the collateral selection process.

GSC's Failure to Retain Adequate Books and Records

37. GSC failed to retain books and records regarding the process by which it purported to select the investment portfolio for Squared. Specifically, GSC did not retain the vast majority of email communications between GSC, J.P. Morgan Securities and/or Magnetar concerning the collateral selection process for Squared. Emails documenting internal GSC discussions of potential bonds for Squared also were not preserved in GSC's books and records.

38. GSC failed to maintain these email records in contravention of its email retention policy set forth in its "Policy and Procedures" manual. That policy states, in part, that the firm is required to retain written communications "related to any recommendation made or proposed to be made and any advice given or proposed to be given."

Violations

39. 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.” Section 206(2) of the Advisers Act imposes a fiduciary duty on investment advisers obligating them to disclose all material information, including conflicts of interest, to their clients. *SEC v. Capital Gains Research Bureau, Inc.*, 375 U.S. 180, 194-97 (1963). Proof of scienter is not required to establish a violation of Section 206(2), but rather may rest on a finding of simple negligence. *SEC v. Steadman*, 967 F.2d 636, 643 n.5 (D.C. Cir. 1992) (citing *Capital Gains*, 375 U.S. at 194-95.); *see also SEC v. Wash. Inv. Network*, 475 F.2d 392, 396 (D.C. Cir. 2007).

40. Sections 17(a)(2) and (3) of the Securities Act prohibit fraud in the offer or sale of any security or securities-based swap agreement. Scienter is not required to prove violations of Sections 17(a)(2) or (3). *Aaron v. SEC*, 446 U.S. 680, 697 (1980). Instead, violations of these sections may be established by showing negligent conduct. *SEC v. Hughes Capital Corp.*, 124 F.3d 449, 453-54 (3d Cir. 1997).

41. Rule 204-2(a)(7) promulgated under Section 204 of the Advisers Act requires SEC-registered investment advisers to retain all written communications related to any recommendation made or proposed to be made and any advice given or proposed to be given.

42. As a result of the negligent conduct described above, GSC violated Section 206(2) of the Advisers Act, Sections 17(a)(2) and (3) of the Securities Act, Section 204 of the Advisers Act and Rule 204-2(a)(7) thereunder.

Remedial Efforts

In determining to accept the offer, the Commission considered cooperation afforded the Commission staff by GSC.

IV.

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

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

A. Respondent GSC cease and desist from committing or causing any violations and any future violations of Section 17(a)(2) and (3) of the Securities Act and Sections 204 and 206(2) of the Advisers Act and Rule 204-2 promulgated thereunder.

By the Commission.

Elizabeth M. Murphy
Secretary