IN THE CIRCUIT COURT OF COOK COUNTY, ILLINOIS
COUNTY DEPARTMENT, CHANCERY DIVISION

12CH02535

THE PEOPLE OF THE STATE OF ILLINOIS,	)	
	)	
Plaintiff,	)	
	)	No.
	)	
v.	)	
	)	
THE MCGRAW-HILL COMPANIES, INC. and STANDARD & POOR'S FINANCIAL SERVICES LLC,	)	
	)	
Defendants.	)	

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COMPLAINT

The Plaintiff, THE PEOPLE OF THE STATE OF ILLINOIS, by LISA MADIGAN, Attorney General of the State of Illinois, brings this action against Defendants, The McGraw-Hill Companies, Inc., Standard & Poor's Financial Services LLC, and its business unit Standard & Poor's Ratings Services (referred to herein collectively as "S&P"), for violating the Illinois Consumer Fraud and Deceptive Business Practices Act, 815 ILCS 505/1-1 *et seq.*, and the Uniform Deceptive Trade Practices Act, 815 ILCS 510/1-1 *et seq.*

SUMMARY OF THE CASE

1. This lawsuit seeks redress for S&P's unfair, deceptive, and illegal business practice of systematically misrepresenting that its credit analysis of structured finance securities was objective, independent and not influenced by either S&P's or its clients' financial interests. These representations were untrue.

2. S&P represents that its analysis of structured finance securities is independent and objective and the result of the highest quality credit analytics that are available to S&P. Indeed, S&P's reputation for independence, objectivity and integrity is emphasized by S&P to the users of its ratings at nearly every turn.

3. As a senior S&P executive publicly stated in 2005: "Since any structured finance transaction involves complex structures and the transfer of complex credit risks, the key to a successful transaction is an independent and objective analysis of both the structure and the credit risk. And it is in this function that [S&P's] Structured Finance ratings have excelled."

4. S&P has further emphasized its representation of an independent and objective analysis in its publicly available Ratings Services Code of Conduct, in which S&P explicitly pledges that its ratings of structured finance securities are objective and uninfluenced by "the potential effect . . . [of the rating on S&P,] an issuer, an investor, or other market participant."

5. Despite this explicit representation, S&P failed to act independently and objectively when analyzing structured finance securities and thereby violated the Illinois Consumer Fraud Act and the Illinois Uniform Deceptive Trade Practices Act.

6. Starting in at least 2001, S&P allowed its desire for increased revenue and market share in the structured finance ratings market to influence the rating methodologies it developed for rating structured finance securities, as well as the ratings that were ultimately assigned to these investments. Similarly, revenue and market share concerns influenced the manner in which S&P monitored structured finance security ratings once they had been assigned.

7. In particular, by at least 2001, S&P's desire to increase revenue and market share by rating as many structured finance deals as possible led S&P to ignore the increasing risks of structured finance securities to cater to the preferences of large investment banks and other repeat issuers of structured finance securities that dominated S&P's revenue base.

8. Although S&P's analysis was designed to satisfy the demands of repeat issuers, S&P represented that its analysis and rating of structured finance securities was independent, objective and, as stated in its Code of Conduct, "not . . . affected by the existence of, or potential

for, a business relationship between [S&P] . . . and the Issuer . . . or any other party, or the non-existence of any such relationship." This representation by S&P was false.

9. By misrepresenting its objectivity when evaluating structured finance securities, S&P offered a service that was materially different from what it purported to provide to the marketplace, i.e., an independent and objective analysis of credit risk.

10. Since S&P allowed its compensation structure, desire for profits and fear of losing investment bank clients to taint the integrity of its supposedly independent credit analysis, S&P misrepresented the true nature of its services by advertising itself as objective and independent.

11. S&P's credit analyses have a significant impact on the consumer and financial markets in Illinois. S&P regularly transacts business in the State of Illinois and derives substantial revenue from its business within the State of Illinois. S&P rates structured finance securities issued by issuers located within Illinois. Additionally, S&P's ratings on structured finance securities are routinely viewed by investors and other participants in the financial markets located within the State of Illinois. Based on S&P's public representations, these individuals and entities depend on S&P to provide independent and objective assessments of the relative credit risk of structured finance securities, unaffected by S&P's or its clients interests.

12. The State of Illinois seeks disgorgement and civil penalties, as well as other injunctive and equitable relief to prevent these unfair, deceptive and illegal business practices from happening in the future.

PUBLIC INTEREST

13. The Illinois Attorney General believes this action to be in the public interest of the citizens of the State of Illinois and brings this lawsuit pursuant to Section 7 of the Illinois Consumer Fraud and Deceptive Business Practices Act, 815 ILCS 505/7(a).

JURISDICTION AND VENUE

14. This action is brought for and on behalf of THE PEOPLE OF THE STATE OF ILLINOIS by LISA MADIGAN, Attorney General of the State of Illinois, pursuant to the provisions of the Consumer Fraud and Deceptive Business Practices Act ("Consumer Fraud Act"), 815 ILCS 505/1 *et seq.*, and her common law authority as Attorney General to represent the People of the State of Illinois.

15. Venue for this action properly lies in Cook County, Illinois, pursuant to Section 2-101 and 2-102(a) of the Illinois Code of Civil Procedure, 735 ILCS 5/1-10 *et seq.*, in that Defendants are doing business in Cook County, Illinois.

PARTIES

16. Plaintiff, THE PEOPLE OF THE STATE OF ILLINOIS, by LISA MADIGAN, the Attorney General of the State of Illinois, is authorized to enforce the Consumer Fraud Act, 815 ILCS 505/7(a).

17. Defendant the McGraw-Hill Companies, Inc. ("McGraw-Hill") is a New York corporation with its principal place of business at 1221 Avenue of the Americas, New York, NY 10020. McGraw-Hill is registered with the Illinois Secretary of State to conduct business within the State of Illinois.

18. Defendant Standard & Poor's Financial Services LLC is a Delaware limited liability company and wholly owned subsidiary of defendant McGraw-Hill with a principal place of business at 55 Water Street, New York, NY 10041. Within Standard & Poor's Financial Services LLC is the business unit, Standard & Poor's Ratings Services, which operates as a credit rating agency that analyzes the credit risk of a broad range of securities, including structured finance securities, issued in domestic and international financial markets.

TRADE AND COMMERCE

19. Subsection 1(f) of the Consumer Fraud Act, 815 ILCS 505/1(f), defines "trade" and "commerce" as follows:

> The terms 'trade' and 'commerce' mean the advertising, offering for sale, sale, or distribution of any services and any property, tangible or intangible, real, personal, or mixed, and any other article, commodity, or thing of value wherever situated, and shall include any trade or commerce directly or indirectly affecting the people of this State.

20. Defendants were at all times relevant hereto engaged in trade and commerce in the State of Illinois by issuing credit ratings to structured finance securities arranged, issued, or underwritten by Illinois-based entities, and purchased by investors located in Illinois.

BACKGROUND

A. The Creation and Rating of Structured Finance Securities

a. Structured Finance and Structured Finance Securities

21. Structured finance generally refers to the process of securitizing the cash flow from an asset or pool of assets, typically loans or other debt instruments.

22. A structured finance security is the financial product that results from this securitization.

i. Residential Mortgage Backed Securities

23. In the last decade the largest dollar volume of structured finance securities was residential mortgage backed securities ("RMBS"). RMBS are securities issued against a pool of residential mortgages, where the mortgages serve as collateral for RMBS investors.

24. The process of creating an RMBS begins when an arranger, most often an investment bank, packages mortgage loans into a pool and transfers them to a trust that will issue securities collateralized by the pool. The trust purchases the loan pool and becomes entitled to

the principal and interest payments made by the borrowers, which are used to make monthly coupon payments to the investors in the RMBS.

25. To appeal to investors with different risk appetites, the trust issues different classes of securities, known as tranches, which offer a sliding scale of return rates based on the level of credit protection afforded to the tranche. Credit protection is designed to shield the securities within a tranche from the loss of interest and principal due to defaults of the loans in the overall pool. The degree of credit protection afforded any tranche of securities is known as credit enhancement.

26. The main sources of credit enhancement are subordination, over-collateralization, and excess spread. Subordination refers to the hierarchy of loss absorption among the tranches where any loss of interest and principal experienced by the trust from delinquencies and defaults in loans in the pool are allocated first to the lowest tranche until it loses all of its principal amount and then to the next lowest tranche up the capital structure. Consequently, the most senior tranche, and therefore the highest rated, would not incur any loss until all of the lower tranches have absorbed losses from the underlying loans.

27. Over-collateralization refers to the amount by which the principal balance of the mortgage pool exceeds the principal balance of the securities issued by the trust. This excess principal creates an additional equity tranche below the lowest debt tranche. The equity tranche absorbs losses up to its total value before any debt tranche is affected by defaults in the underlying collateral. While this "first loss" position imparts substantial risk, however, the equity tranche also offers the highest potential investment gains if the underlying collateral does not default.

28. Finally, excess spread refers to the difference between the interest rate on the underlying loans and the interest rate paid to the investors in the securities, which normally

results in the trust taking in more money in interest payments than it is required to pay out. Part of the excess spread pays administrative expenses of the trust such as loan servicing fees. The excess spread also can be used to build up reserves or pay off delinquent interest payments due to a debt tranche. Any amount that is not used to pay expenses or paid over to the debt tranches is retained by the equity tranche.

ii. Collateralized Debt Obligations

29. Another common structured finance security is a collateralized debt obligation ("CDO"). CDOs are securities backed by securitized debt or credit derivatives, where the securitized debt or credit derivatives serve as collateral for CDO investors.

30. There are generally two types of CDOs: cash and synthetic. Cash CDOs are CDOs in which the underlying assets are debt securities, such as junior tranches of a RMBS or another CDO.[1] A synthetic CDO is a CDO in which the underlying assets are credit derivatives that reference other debt securities. Synthetic CDOs often consist of credit default swaps ("CDS") that reference mortgages. A CDS is an insurance contract in which one party agrees to insure another party for the default of an underlying asset in exchange for premium payments. A CDS can be used to hedge credit risk or to replicate the economics of a debt instrument, such as a mortgage.

31. The process for creating a typical CDO is similar to that of a RMBS. Specifically, a sponsor creates a trust or other special purpose entity to hold assets and issue securities. Instead of the mortgage loans that are held in RMBS pools, a CDO trust is typically comprised of debt securities such as corporate or municipal bonds, junior tranches of RMBS, or credit derivatives, such as CDS or equity tranches of other CDOs. The trust then uses the

[1] Where the assets of a CDO consist of the junior tranches of other CDOs, the CDO is typically referred to as a CDO^2 investment.

interest and principal payments from the underlying debt securities to make interest and principal payments to investors in the CDO securities issued by the trust.

32. A CDO trust also issues different classes of securities divided into tranches that provide differing levels of credit enhancement to the securities it issues through the use of subordination, over-collateralization and excess spread. So long as the underlying assets continue to perform, the cash flow continues and the performance of each of the tranches of the CDO remains strong. Just as is the case with RMBS, the senior CDO tranches are paid first from the incoming cash flow generated from the collateral, followed by each subordinate tranche in the capital structure. Conversely, if the underlying assets begin to default, the cash flow diminishes and the investors at each CDO tranche level are subjected to risk starting from the bottom or equity tranches and proceeding upward.

b. The Need for a Credit Rating

33. The market for structured finance securities consists of the issuers (*i.e.*, sellers or sponsors), who create a trust to hold the underlying collateral and issue securities such as RMBS and CDOs, the buyers (*i.e.*, investors) that purchase these investments, and other market participants, such as government regulators, who rely on ratings information to evaluate the risk profile of regulated entities. Issuers of structured finance securities are financial companies such as banks, mortgage companies, finance companies and investment banks.

34. In order for an issuer to successfully market and sell a structured finance security such as an RMBS or a CDO to most buyers or investors, the security must receive a credit rating from a credit rating agency. A credit rating is a statement as to the likelihood that the borrower or issuer will meet its contractual, financial obligations as they become due.

35. Structured finance securities require credit ratings for two reasons. First, most institutional investors (such as pension funds and mutual funds) can only invest in securities that

have received a certain rating level from S&P or another credit rating agency recognized by the Securities and Exchange Commission ("SEC"). Therefore, issuers of structured finance securities need credit ratings in order to market and sell the securities to the broadest group of investors.

36. Second, and more importantly, structured finance securities are fundamentally different from other debt investments (*i.e.*, corporate and public bonds). For example, the issuing entity of a corporate bond has some independent existence and measurable value in and of itself that can usually be verified, at least in part, by reference to publicly available materials. This characteristic does not exist in the world of structured finance.

37. As a former senior managing director at a credit rating agency explained, "[s]omewhat unique to the structured finance [security] market is the opacity of the rated securities. In certain situations, the details of the underlying asset pool and often the structure of the transaction are not publicly available for external scrutiny. . . Moreover, the tools to analyze credit risk, even with transparent assets, are beyond the grasp of many investors."

38. In light of the constraints on institutional investors and the opaque nature and the cost of evaluating the risk of structured finance securities, issuers cannot effectively market structured finance securities without ratings from credit rating agencies. As a result, credit rating agencies play a central role in the market for structured finance securities.

B. The Rating of Structured Finance Securities

a. S&P's Credit Rating Scale

39. The results of S&P's credit analysis of structured finance securities are expressed in the form of a letter grade rating. According to its ratings definitions, S&P's letter grades are expressed in relative rank order. "AAA" is S&P's highest rating and indicates that the issuer has an "[e]xtremely strong capacity to meet [its] financial commitments." Ratings "AA," "A,"

"BBB," "BB," "B," "CCC," "CC," "C," and "D" are represented by S&P to have progressively less creditworthiness with each succeeding reduction in grade level.

40. S&P can also modify its ratings from "AA" to "CCC" by attaching a plus (+) or minus (-) sign to show the relative standing within the major rating categories.

41. Structured finance securities bearing an S&P rating of "BBB" or above are also described as "investment grade."

42. A higher S&P credit rating on a particular tranche of a structured finance security corresponds to a lower coupon rate that the issuer becomes obligated to pay the buyer / investor. Thus, a tranche rated "AAA" by S&P generally carries a lower coupon rate than a tranche rated "AA" by S&P because it is assumed that there is a lower level of credit risk to the investor. Similarly, a structured finance security rated "AA" by S&P generally carries a lower coupon rate than a structured finance security rated "A" by S&P, and so on down S&P's letter rating scale.

b. Market Concentration

43. There are few credit rating agencies that assign ratings on structured finance securities. Consequently, the market for rating structured finance securities is extremely concentrated. S&P, and its primary competitor, Moody's Investors Service, Inc. ("Moody's"), dominate the rating of these investments. For example, according to industry publication Asset-Backed Alert, S&P rated 97.5% of the CDOs issued in 2006.

44. Moreover, unlike the markets for most financial products, the market for structured finance securities is comprised of a relatively narrow group of sellers (*i.e.*, investment banks) that act as repeat issuers or sponsors of RMBS, CDOs and other asset-backed securities. Accordingly, there are a relatively small group of banks that hire S&P to rate their products on a regular basis.

c. The Issuer Pays Business Model

45. Credit rating agencies, including S&P, are compensated by the same entities that issue the structured finance securities that the rating agencies are tasked with evaluating. Specifically, in exchange for providing credit ratings on structured finance securities, rating agencies charge the issuer a fee based on the complexity and size of the structured finance security being rated. This compensation model is commonly referred to as the "Issuer Pays Business Model."

d. S&P Sacrificed its Principles of Independence and Objectivity to Obtain Market Share and Earn Profits.

46. In S&P's published guidelines for rating CDOs, it explains:

> In CDOs the goal of the structure is to allow an assignment of a rating higher than those of the sponsor (collateral manager or seller/servicer) and higher than the average rating of the underlying assets. This is not alchemy or turning straw into gold, but rather the implementation of structured finance to create different investment risk profiles, based on the structuring of credit support.

47. Although S&P claimed that structured finance securities were "not alchemy or turning straw into gold," S&P's credit analyses played a critical role in ensuring that structured finance securities were not simply masking risk.

48. S&P, however, failed to play this critical role and instead changed its credit analytics to help it obtain market share and earn profits.

49. Despite changing its credit analytics to cater to issuer preferences, S&P continued to hold itself out as independent and objective and misrepresented the factors it considered when evaluating structured finance securities, which prevented market participants from properly evaluating S&P's ratings of structured finance securities.

50. Sections C and D below document how S&P deceived investors and sacrificed its principles to enhance or maintain its ratings market share and earn substantial profits.

C. S&P Represents Itself to the Public as an Independent and Objective Evaluator of Structured Finance Securities

a. **S&P's Pledge to Safeguard the Integrity of its Rating Process**

51. S&P represented to investors and other participants in the financial markets, including those in Illinois, that its credit ratings, including those of structured finance securities, were independent, objective and free from outside influence. S&P repeatedly, consistently, and publicly emphasized its independence and objectivity to investors and other market participants in a variety of public statements and in its annual reports. S&P's Code of Conduct, which is consistent with the principles established in the International Organization of Securities Commissions Code of Conduct Fundamentals for Credit Rating Agencies ("IOSCO Code"), likewise advertised S&P's "mission to provide high quality, objective, independent, and rigorous analytical information to the marketplace."

52. S&P emphasized the company's integrity through independence, assuring consumers that "[m]ost notably, [S&P] is known as an independent provider of credit ratings." In a document then available on its website, "The Fundamentals of Structured Finance Ratings," S&P acknowledged that the "issuer pays" model may compromise its analysis but reassured investors by claiming, "[w]e are intensely aware that our entire franchise rests on our reputation for independence and integrity. Therefore, giving in to 'market capture' would reduce the very value of the rating, and is not in the interest of the rating agency."

53. Harold McGraw III, the Chairman, President and Chief Executive Officer of McGraw-Hill, described S&P in the company's 2002 Annual Report as "the world's leading provider of independent opinions and analysis on the debt and equity markets," and noted that "securitization, disintermediation and privatization create a growing demand for our independent ratings and analysis."

54. In McGraw-Hill's 2003 Annual Report, Mr. McGraw further emphasized that "[S&P] enjoys a preeminent position in the world's financial architecture" and the company's

"ongoing commitment to improving transparency facilitates the global capital-formation process." Similarly, Mr. McGraw noted that S&P is responding to the new challenges created by the structured finance market "by building on its market leadership as the world's foremost provider of independent credit ratings and risk evaluation."

55. In McGraw-Hill's 2004 Annual Report, the company reiterated that "[f]or more than a century, The McGraw-Hill Companies has been opening opportunity in the markets it serves by providing essential information and insight. The Corporation is aligned around three powerful and enduring forces driving economic growth worldwide: the need for capital, the need for knowledge and the need for information transparency." To that end, McGraw-Hill further stated that "[S&P] provides investors with the independent benchmarks they need to feel more confident about their investment and financial decisions."

56. S&P's vow of independence, objectivity and integrity were codified in October of 2005, when it adopted a Code of Professional Conduct ("S&P's Code" or the "Code") for its ratings practices. In a 2006 report explaining its implementation of the Code, S&P noted that: (a) "[S&P] recognizes its role in the global capital markets and is committed to providing ratings that are objective, independent and credible;" (b) "It is a central tenet of [S&P] that its ratings decisions not be influenced by the fact that S&P receives fees from issuers;" (c) "Ratings are monitored on an ongoing basis in accordance with S&P's policies unless the rating is a point in time confidential rating without surveillance;" and (d) "[S&P's] Code reflects further alignment of its policies and procedures with the [International Organization of Securities Commissions] ("IOSCO") Code of Conduct."

57. The S&P Code also assures consumers, shareholders, investors and regulators that S&P "endeavors to conduct the rating and surveillance processes in a manner that is transparent and credible and that also maintains the integrity and independence of such processes in order to

avoid any compromise by conflicts of interest, abuse of confidential information, or other undue influences." Echoing such a pledge, S&P's Code also notes that "[S&P] fully supports the essential purpose of the IOSCO Code, which is to promote investor protection by safeguarding the integrity of the rating process. [S&P] believes that the Code is consistent with the IOSCO Code and appropriately implements IOSCO's Statements of Principles Regarding the Activities of Credit Rating Agencies."

58. One of the key principles set forth in the IOSCO Code (first published in December of 2004) was the need for credit rating agencies such as S&P to maintain independence from the issuers who pay for the ratings.

59. In particular, the IOSCO Code sets forth the principle that "the essential purpose of the Code Fundamentals is to promote investor protection by safeguarding the integrity of the rating process. IOSCO members recognize that credit ratings, despite their numerous other uses, exist primarily to help investors assess the credit risks they face when making certain kinds of investments. Maintaining the independence of credit rating agencies vis-à-vis the issuers they rate is vital to achieving this goal. Provisions of the Code Fundamentals dealing with credit rating obligations to issuers are designed to improve the quality of credit ratings and their usefulness to investors."

60. The IOSCO Code also emphasizes that "[r]ating analyses of low quality or produced through a process of questionable integrity are of little use to market participants," and that "[w]here conflicts of interest or a lack of independence is common at a credit rating agency and hidden from investors, overall investor confidence in the transparency and integrity of a market can be harmed."

61. With these principles as a guide, since October of 2005, S&P has made several representations in its Code about the manner in which S&P maintains its independence and

avoids conflicts of interest with issuers. The most important of these representations are found in sections 1.12, 2.1 – 2.4, and 1.9 of the Code, which currently remain in effect as purported limitations on the factors that S&P considers when rating structured finance securities.

62. Specifically, Section 1.12 of S&P's Code states: "[S&P] and its employees shall deal fairly and honestly with issuers, investors, other market participants, and the public."

63. Section 2.1 of S&P's Code states: "[S&P] shall not forbear or refrain from taking a Rating Action, if appropriate, based on the potential effect (economic, political, or otherwise) of the Rating Action on [S&P], an issuer, an investor, or other market participant."

64. Section 2.2 of S&P's Code states: "[S&P] and its Analysts shall use care and analytic judgment to maintain both the substance and appearance of independence and objectivity."

65. Section 2.3 of S&P's Code states: "The determination of a rating by a rating committee shall be based only on factors known to the rating committee that are believed by it to be relevant to the credit analysis."

66. Section 2.4 of S&P's Code states: "Ratings assigned by [S&P] to an issuer or issue shall not be affected by the existence of, or potential for, a business relationship between [S&P] (or any Non-Ratings Business) and the Issuer (or its affiliates), or any other party, or the non-existence of any such relationship."

67. Section 1.9 of S&P's Code states: "[S&P] shall allocate adequate personnel and financial resources to monitoring and updating its ratings. . . . [O]nce a rating is assigned [S&P] shall monitor on an ongoing basis and update the rating by: (a) regularly reviewing the issuer's creditworthiness; (b) initiating review of the status of the rating upon becoming aware of any information that might reasonably be expected to result in a Rating Action (including withdrawal

of a rating), consistent with the applicable rating criteria and methodology; and (c) updating on a timely basis the rating, as appropriate, based on the results of such review."

68. An updated version of S&P's Code is available on its web site and the requirements of Sections 1.12, 2.1 through 2.4, and 1.9 have continued to be referenced in several public statements by S&P since the Code's adoption in October of 2005.

b. S&P Reassures the Public of its Role as an "Independent Expert"

69. McGraw-Hill's Annual Reports only reinforce S&P's public role as an "independent expert." In its 2006 Annual Report picked up on the same themes and once again reiterated its long history of independence and objectivity. Specifically, McGraw-Hill stated that "[m]any investors know [S&P] for its respected role as an independent provider of credit ratings. . . As financial markets grow more complex, the independent analysis, critical thinking, opinions, news and data offered by [S&P] are an integral part of the global financial infrastructure."

70. Similarly, in its 2007 Annual Report, McGraw-Hill emphasized that: "[s]ince 1916, markets across the globe have relied on the independent analysis and integrity of [S&P's] credit ratings," and further stated that "S&P is highly valued by investors and financial decision-makers everywhere for its analytical independence, its market expertise and its incisive thought leadership."

71. Similarly, Mr. McGraw stated in the company's 2008 Annual Report that "[i]t is important to note that S&P has effectively served the global capital markets with high quality, independent and transparent credit ratings for many decades" and highlighted that "[t]o ensure the continued integrity and relevance of its ratings business, [S&P] . . . has undertaken a series of actions which further enhance transparency and the independence of its ratings process."

72. In sworn testimony before the Senate Committee on Banking, Housing and Urban Affairs in April 2007, S&P's then Managing Director of RMBS, Susan Barnes, also testified at

length regarding S&P's commitment to "ongoing" monitoring of the accuracy and integrity of its ratings. For instance, Ms. Barnes stated that "[a]fter a rating is assigned, S&P monitors or 'surveils' the ratings to adjust for any developments that would impact the original rating. The purpose of this surveillance process is to ensure that the rating continues to reflect our credit opinion based on our assumption of the future performance of the transaction."

73. In her testimony before Congress, Ms. Barnes underscored that S&P's credit ratings are "grounded in the cornerstone principles of independence, transparency, credibility, and quality. These principles have driven our long-standing track record of analytical excellence and objective commentary." In October of 2008, the President of S&P's Financial Services LLC reiterated these themes in his testimony before the House Committee on Oversight and Government Reform: "[t]he key question for any approach, whether it be investor or issuer paid, is then whether the rating agency takes appropriate steps to preserve its independence. For S&P, that independence is a core principle of our business."

74. These themes were reiterated by Deven Sharma, the President of Standard & Poor's Financial Services LLC, in October 2008 testimony before the House Committee on Oversight and Government Reform. Mr. Sharma testified that "[t]he real question is not whether there are potential conflicts of interest in the 'issuer pays' model, but whether they can be effectively managed. . . . S&P maintains rigorous policies and procedures around the integrity of our analytical processes through a number of checks and balances. . . . Taken together, we believe these measures provide robust safeguards against the potential conflict of interest inherent in the 'issuer pays' model." Mr. Sharma further explained that "[t]he key question for any approach, whether it be investor or issuer paid, is then whether the rating agency takes appropriate steps to preserve its independence. For S&P, that independence is a core principle of our business."

75. In sum, the statements made by S&P in its Annual Reports and its testimony before Congress depict a pattern and practice of public announcements intended to repeatedly emphasize several basic representations by S&P to buyers / investors and other market participants. First, S&P represents that its analyses of structured finance securities have been, and continue to be, independent, objective and free from consideration of S&P's desire for revenue or winning additional business from issuers.

76. Second, recognizing that S&P holds a position of trust in the marketplace, S&P represents that it deals fairly and honestly with the public, including the buyers / investors of the structured finance securities that it rates.

77. Third, S&P represents that it agrees with and has implemented the principles set forth in the IOSCO Code of Conduct by maintaining independence, objectivity and integrity of its ratings of structured finance securities.

78. Fourth, S&P represents that it understands the Issuer Pays business model creates conflicts of interest, but that these conflicts have been adequately managed by the company as demonstrated by the principles set forth in S&P's Code so as to ensure that its credit ratings are purely a function of credit analytics. Investors and other market participants depend on S&P to properly manage this conflict and reasonably interpret S&P's representations to understand that S&P does so.

79. Fifth and finally, S&P represents that it dedicates the resources necessary to and does in fact conduct timely and thorough surveillance on its ratings of structured finance securities to ensure that the rating assigned by S&P continues to reflect S&P's assessment of the credit risk associated with the obligation.

D. S&P's Evaluation of Structured Finance Securities was not Independent and Objective

80. Rather than maintaining independence and objectivity when analyzing structured finance securities as its public statements promised, S&P was focused on pleasing the relatively small group of repeat issuers that pay its lucrative fees, thereby maintaining its already high market share and its revenue. As a result, S&P's credit analytics when rating structured finance securities were influenced by the very business and revenue considerations that its public statements consistently and explicitly disavow and its Code of Conduct prohibits.

81. In the past several years, evidence that S&P sacrificed its independence and objectivity to please issuers of structured finance securities emerged through congressional hearings and internal S&P correspondence. As described in more detail below, the evidence reveals that S&P was heavily motivated by business considerations in analyzing structured finance securities, so that its risk analysis was not objective and underestimated the true risks of the underlying securities.

a. **S&P's Analysis of Structured Finance Securities was Designed to Cater to Issuer Preferences and not to Provide Independent and Objective Risk Analysis.**

82. Evidence from congressional hearings reveals that S&P sacrificed its independence and objectivity in a number of specific ways, including: 1) relaxing its rating criteria when evaluating structured finance securities to reduce the amount of credit enhancement issuers needed for higher ratings; 2) considering business impact and not the accuracy of its credit analysis in evaluating changes to its rating methodology; 3) tweaking the application of its rating models and altering its rating methodology in individual deals to suit the demands of repeat issuers; and 4) failing to sufficiently monitor the performance of rated structured finance securities after they were issued. The examples in subsections ***i*** through ***iv*** below are not meant to provide an exhaustive account of how S&P's risk analysis was comprised, but merely illustrate some of S&P's deceptive practices.

i. S&P Relaxed its Rating Criteria When Evaluating Structured Finance Securities to Reduce the Amount of Credit Enhancement Issuers Needed for Higher Ratings

83. In order to obtain market share, S&P relaxed its rating criteria so issuers of structured finance securities could achieve higher ratings with less credit enhancement. S&P relaxed its criteria in a number of ways, including but not limited to: 1) using outdated models to rate RMBS and CDOs; 2) feeding bad or outdated data into its statistical modeling software; and 3) making ill-conceived assumptions about the risks involved in structured finance transactions, including underestimating the correlation risk of mortgage assets in a structured finance security.

LEVELS

84. In rating RMBS, S&P primarily relied on a proprietary statistical software program that S&P developed with industry input. Loan Evaluation and Estimate of Loss System or LEVELS was designed to model the performance of assets in a RMBS portfolio over time to determine the level of credit enhancement required for RMBS tranches. LEVELS simulates the performance of a portfolio of mortgages based on historical loan performance data.

85. The first version of LEVELS was implemented by S&P in 1996 and used a database that aggregated loan performance data going back five or more years for approximately 500,000 residential loans across the United States. Upon implementing LEVELS and publicizing its use to market participants, S&P's original stated intention was to refine and improve the model by annually adding additional loan performance data to its database. This plan was a function of the fact that the predictive quality of its LEVELS model was only as accurate as the quality of the historical data underlying its predictions.

86. Consistent with this principle, S&P updated LEVELS in early 1999 by adding loan performance data going back six to eight years for approximately 900,000 loans. As acknowledged by a former senior S&P executive responsible for rating RMBS, these updates

were critical to the LEVELS' success because of the proliferation of new riskier and subprime mortgage products for which the older default/payment data provided little guidance.

87. Beginning in 2001, however, as the number of RMBS transactions in the United States increased and, therefore, the number of opportunities for S&P to earn lucrative fees for rating structured finance securities also greatly increased, S&P's upper level management stopped refining S&P's LEVELS model by adding new loan data. S&P adopted this new approach despite the fact that its senior managers in the RMBS group repeatedly emphasized the importance of keeping the model up to date given the constantly changing nature of the residential mortgages issuers sought to securitize.

88. For example, at the insistence of the managing director responsible for rating RMBS, S&P's LEVELS development team continued to collect data on historical loan performance. Based on this work, in 2001 S&P developed a beta update to LEVELS based on significant performance data for 2.5 million loans. S&P upper level management, however, chose not to release and implement this update.

89. Similarly, in early 2004, S&P's RMBS unit completed another beta update of LEVELS based on performance data from approximately 9.5 million loans, including the full spectrum of new mortgage products such as those in the area of sub-prime lending, which was the fastest growing segment of residential lending. Despite the urgings of the managing director in charge of rating RMBS, S&P did not release and implement this comprehensive update for rating RMBS upon its completion in 2004.

90. Furthermore, as one former senior S&P managing director testified before Congress, although S&P still maintained a trove of additional residential loan data, as of October of 2008, it still had not implemented any meaningful updates to its LEVELS model based on the much more comprehensive database developed by its analysts.

91. S&P's conscious decision between at least 2001 and 2008 to use a version of LEVELS with outdated historical data version to rate RMBS was motivated, as evidenced by internal communications and contrary to the representations in S&P's Code, by S&P's desire to cater to issuer preferences and preserve market share, earning much more revenue for the company.

92. For example, in an internal email March 23, 2005, an S&P managing director in the Global Structured Finance Group wrote the following to several senior and managing directors, including Susan Barnes, then managing director of the RMBS at S&P, regarding LEVELS v. 6.0: "While I agree with number 1, I'm puzzled. When we first reviewed 6.0 results **a year ago** we saw the sub-prime and Alt-A numbers going up and that was a major point of contention which led to all the model tweaking we've done since. Version 6.0 could've been released months ago and resources assigned elsewhere if we didn't have to massage the sub-prime and Alt-A numbers to preserve market share."

93. In the words of one former senior S&P managing director in charge of rating RMBS, a primary factor in S&P's break down in ratings standards and lack of interest in keeping the LEVELS model current was that "the RMBS group enjoyed the largest ratings market share among the three major rating agencies (often 92% or better), and improving the model would not add to S&P's revenues."

94. Rather than run the risk of disrupting its already dominant and highly profitable business of rating RMBS, S&P simply kept using a model that was outdated because it satisfied market demand in a way an updated model, based on a larger and more accurate data set, would not.

CDO EVALUATOR

95. In analyzing and rating CDOs, S&P used a similar proprietary software program, CDO Evaluator. Like LEVELS, CDO Evaluator simulates the performance of a pool of securities to determine the default rates for the various tranches in a CDO. Default rate, as used in the context of a CDO, refers to a fixed percentage of defaults in a pool. For example, a default rate of 24% means that 24% of the securities in the pool default. S&P analysts used CDO Evaluator to determine the percentage of defaults (or default rate) a particular tranche should be able to withstand in order to receive a certain rating.

96. The primary issue with S&P's use of CDO Evaluator to determine default rates for tranches in a CDO is that the inputs (the data used to determine the probability distribution of default rates) are the ratings of the underlying securities themselves.

97. These inputs are particularly problematic in the case of CDOs composed entirely of RMBS tranches previously rated by S&P because the ratings will underestimate the risk of the securities due to S&P's failure to properly maintain and update LEVELS.

98. As a result, the problems described above with respect to S&P's failure to update LEVELS are compounded when S&P evaluates CDOs of RMBS, because the ratings of the tranches of the CDO are based on S&P's biased downward evaluation of the risk of the underlying securities.

99. Moreover, as illustrated in subsection *iv* below, when S&P analysts raised this concern and requested to look at RMBS loan level data, they were discouraged and ignored by S&P management.

100. The risk error of CDO Evaluator is further compounded with CDO^2 transactions where the underlying assets are equity tranches of CDOs composed of equity tranches of S&P rated RMBS, or with synthetic CDOs that reference S&P rated RMBS or derivative RMBS securities.

101. In an internal email dated December 15, 2006, an associate director of S&P structured finance group wrote the following to a senior director at S&P, noting the complexity of modeling default risk of CDO^2 transactions and suggesting that S&P was issuing ratings on CDOs without adequate answers to many of these modeling problems:

> "When the required subordination for the BBB tranche was determined, we modeled the recoveries of the assets given a BBB scenario (indicating the severity of loss in a BBB economic environment given the position of the asset in the capital structure). If we ran the recovery model with the AAA recoveries, it stands to reason that the tranche would fail . . . since there would be lower recoveries and presumably a higher degree of defaults. Essentially, I'm wondering whether my initial feeling that a drill down approach on synthetics would not work is false. BUT are there any knock-on effects if the synthetic itself had synthetics in its portfolio? **Rating agencies continue to create and [sic] even bigger monster – the CDO market. Let's hope we are all wealthy and retired by the time this house of cards falters.**" Emphasis added.

102. As this email illustrates, the inputs S&P was feeding into CDO Evaluator failed to adequately model the risk of CDO assets.

103. Yet S&P continued to rely on the ratings of CDO assets in rating CDOs to satisfy market demand.

Correlation Risk

104. S&P not only used outdated models with deliberately bad inputs in analyzing structured finance securities, but it also made unrealistic assumptions about correlation risk to preserve market share.

105. In evaluating the default risk of assets in a structured finance security, S&P analysts examine the risk characteristics of each asset and the correlation risk between the assets. Correlation risk measures how assets in a structured finance security perform together. For example, in rating RMBS, a correlation risk of 0% indicates that there is no correlation between the risk of two loans in the pool defaulting. Put differently, a correlation risk of 0% means each loan can be measured in isolation and the default of a single loan can be viewed as an aberration that does not change the underlying riskiness of the pool.

106. In analyzing RMBS and CDOs, S&P used very low correlation risk assumptions to reduce the level of credit enhancement required from issuers. That S&P's correlation assumptions deliberately underestimated risk to maintain market share was well known within S&P and the broader structured finance community.

107. For example, in an email dated March 20, 2006, a senior managing director of Aladdin Capital Management, LLC wrote the following to a senior director at S&P: "I mentioned to you a possible error in the new Evaluator 3.0 assumptions: Two companies in the same Region belonging to two *different* local Sectors are assumed to be correlated (by 5%), while if they belong to the *same* local Sector then they are *un*correlated. I think you probably didn't mean that."

108. In response, an S&P director noted in an internal email dated May 17, 2006, that while there may be a problem with S&P's correlation assumptions, the issue would not be addressed until "the next time [S&P] change[s] correlation assumptions."

109. Despite acknowledging that it was using faulty correlation risk assumptions, S&P continued to evaluate and rate CDOs with these inaccurate assumptions.

ii. In Evaluating Changes to its Ratings Methodology, S&P was Motivated by Business Considerations and Not the Accuracy of its Ratings.

110. Internal emails from S&P reveal that S&P employees occasionally suggested changes to S&P's ratings methodology to improve the accuracy of the ratings. In each instance, however, internal emails reveal that S&P focused on the business impact of changing its methodology in determining whether or not to pursue the change. An internal email dated May 24, 2004 encapsulates the way S&P generally approached changes to its rating methodology: "We just lost a huge Mizuho [Bank] RMBS deal to Moody's due to a huge difference in the required credit support level . . . What we found from the arranger was that our support level was

at least 10% higher than Moody's . . . the only way to compete is to have a paradigm shift in thinking. . .."

111. As further demonstrated by the emails quoted below, loss of S&P's market share was an important consideration when evaluating a change to its ratings methodology.

112. For example, on November 4, 2004, an S&P employee forwarded a proposal for S&P to assign separate ratings to the principal and interest portions of credit-linked notes, the underlying assets of synthetic CDOs, in order to better model the risk of these securities. In response, in an internal email dated November 9, 2004, an S&P managing director wrote, "I am trying to ascertain whether we can determine at this point if we will suffer any loss of business because of our decision and if so, how much? We should have an effective way of measuring the impact of our decisions over time." Rather than evaluate whether the change would improve the accuracy of their credit analytics, S&P employees exhibited more concern for preserving market share.

113. In another example, in an internal email dated May 23, 2007, a credit analyst at S&P wrote to senior directors at S&P that S&P should stress "the actual spread to something lower, when modeling cash flows for static deals – on the assumption that if there is adverse selection when assets default, your spread may go down. . . ." Put more plainly, the S&P employee was suggesting that assets in static[2] CDOs might suffer from adverse selection, where the issuer relied on bad or inaccurate assumptions in picking portfolio assets, and the correlation risk between assets might be higher than S&P's models suggested.

114. In response, in an internal email dated May 24, 2007, an S&P senior director noted that S&P's published criteria for evaluating CDOs actually provided that analysts may want to test for adverse selection to compensate for weak correlation assumptions. However,

[2] A static CDO is a CDO is which the assets are not actively managed but remain static throughout the life of the CDO.

S&P did not implement this recommendation. The director wrote, "I would recommend we do something [u]nless we have too many deals in US where this could hurt," demonstrating that, while S&P was aware that it did not model correlation risk properly, it would not change its correlation assumptions due to the business impact such changes may have.

115. In rare instances where S&P actually contemplated or made changes to its ratings methodology, the changes were either illusory or minor.

116. For example, in an internal email dated March 4, 2004, a managing director at S&P wrote the following regarding a change to S&P's correlation assumptions to mollify industry criticism:

> "I would like to discuss how we plan on ultimately 'spinning' our revised correlation assumptions . . . combined with the fact that we plan on eliminating our stress factors . . . as our current proposal stands . . . I just want you all to be aware that the article also made it quite clear that a change in correlation assumptions . . . without a corresponding change in subordination levels (i.e. "higher") . . . would imply we did something to 'neutralize' the shift to a more stringent set of correlation assumptions."

117. In another example, with respect to changes to S&P's RMBS ratings methodology, an S&P managing director wrote the following to assuage concerns raised by an issuer: "[T]o say that these changes will leave us 5 notches back of Moody's sounds like a gross over statement, especially since we have been a notch or two more liberal then [sic] they have been (causing the split rating issues) for over the last year or two. The simulations that we did on the impact of our changes, more often then [sic] not we believes [sic] will bring our requirements close to theirs or in certain situations slightly higher. We certainly did[n't] intend to do anything to bump us off a significant amount of deals."

Updates to CDO Evaluator

118. That S&P was primarily motivated by business considerations when evaluating ratings changes is most apparent from internal emails regarding the release of CDO Evaluator 3.0, an update to S&P's CDO rating software.

119. Numerous internal emails reveal that S&P was concerned about the business impact of the update and considered grandfathering in deals to avoid adverse market reaction.

120. For example, in 2005, an S&P managing director wrote the following regarding Evaluator 3.0: "This has proven to be a complex update and review, and many issues have arisen and continue to arise. The overarching issue at this point is what to do with currently rated transactions if we do release a new version of Evaluator. Some believe for both logistical and market reasons that the existing deals should mainly be 'grand fathered'. Others believe that we should run all deals using the new Evaluator. The problem with running all deals using E3 is twofold: we don't have the model or resource capacity to do so, nor do we believe that even if we did have the capability, **it would be the responsible thing to do to the market."** Emphasis added.

121. Similarly, another S&P employee wrote the following regarding whether S&P would downgrade existing deals based on their new model: "My best guess is for existing rated deals, if E.2.4.3 does not differ from the final version of E3 by a couple of notches, no rating action will be taken. If more, we will have intensive scrutiny and depending on the circumstances upgrade or downgrade. Needless to say, we are minimizing the number in the latter category."

122. In response, an S&P managing director emphasized, "[t]he trick is of course to minimize impact on deals."

123. The same managing director later wrote the following in an internal email regarding S&P's rollout of Evaluator 3.0: "Lord help our fucking scam . . . this has to be the

stupidest place I have worked at. Marc Steinberg is sending us a cash CDo [sic] of ABS portfolio to check as we speak."

iii. S&P Tweaked the Application of its Rating Models and Altered its Rating Methodology in Individual Deals to Suit the Demands of Repeat Issuers

124. Although S&P's credit analytics were designed to minimize the amount of credit enhancement issuers needed for higher ratings, issuers often failed to provide sufficient credit enhancement to meet S&P's already relaxed standards. Instead of demanding additional credit support in these cases, S&P altered its rating methodology and tweaked the application of its rating models to accommodate issuers.

125. For example, in 2001, S&P was asked to provide a credit estimate by a leading investment bank and frequent S&P customer on a deal called Pinstripe I CDO, a CDO that was collateralized by RMBS. A credit estimate is not an official rating, but a private analysis made by S&P for a fee regarding how it would likely rate the transaction. S&P had not previously rated the RMBS underlying the Pinstripe I CDO and, therefore, did not have independent access to the underlying loan level data. The managing director responsible for performing the credit estimate stated that to conduct an appropriate analysis his team would need to obtain the loan level data and then run that data through S&P's LEVELS model. In response to the managing director's request for access to the loan level data to carry out a proper credit estimate, the S&P managing director was chastised by the co-head of S&P's CDO group and member of its Executive Committee, as follows:

> Any request for loan level tapes is TOTALLY UNREASONABLE!!! Most investors don't have it and can't provide it. Nevertheless we MUST produce a credit estimate . . . .
>
> It is your responsibility to provide those credit estimates and your responsibility to devise some method for doing so. Please provide the credit estimates requested! (Emphasis in original.)

126. In short, rather than directing the managing director to adhere to S&P's internal policy by actually obtaining the appropriate data and carrying out the necessary analysis (albeit using the LEVELS model that already had become out of date), upper level S&P management instructed him to ignore the "robust safeguards" S&P had in place and estimate the transaction's credit risk without access to even the most basic information about the deal. In the view of the managing director, he was essentially being asked to provide a guess.

127. Despite the managing director's objections and refusal to provide a credit estimate without having rated the underlying RMBS or gaining access to the loan level data, S&P went forward with grading the transaction and assigned its highest credit estimate of AAA to a significant portion of the Pinstripe I CDO's securities. S&P disregarded the safeguards that its internal policies were designed to ensure and the recommendation of one of its most senior managers, because it wanted to meet the demands of one of its best customers and it did not want to forego revenue that otherwise would be captured by one of its competitors.

128. In another example in 2004, after S&P released LEVELS version 5.6, an S&P employee reported that the Federal Home Loan Bank of Indianapolis asked S&P if they could use LEVELS version 5.5 to analyze loans in a RMBS because "some of their commitments which were structured to achieve a "0" loss coverage at 'AA' when using 5.5 are now showing a loss coverage > 0 under 5.6." In response, a managing director at S&P wrote, "Yes, we can [allow] this if required. IT can resurrect 5.5 and send the banks a 'key' to unlock them." In other words, rather than require additional credit enhancement from the issuer, S&P accommodated the issuer by having its IT department "resurrect" an out-dated version of LEVELS to help the issuer achieve the rating it desired with no credit enhancement.

129. In a further example, in an internal email dated February 8, 2006, an S&P employee described the following changes he made to improve the performance of a RMBS in

LEVELS: "I changed the first payment date for all loans that were seasoned 5 years or greater back to their original date so they would receive credit in LEVELS (approx 17.4% of total pool balance). The net effect was not as great as expected."

130. In response, an S&P senior director wrote, "I don't think this is enough to satisfy them. What's the next step?" Not only did S&P use outdated models to reduce the amount of credit enhancement structured finance issuers needed to provide, but S&P fraudulently modified the actual economics of the underlying assets in order to accommodate issuers.

131. In a final example, in an internal email dated April 26, 2006, a senior research assistant wrote the following regarding the results of stress tests on a CDO for Madaket Funding: "[T]he Class D tranche is failing in one scenario by 48 basis points . . . [The banker] is requesting that this run be omitted." In response, one senior director wrote, "I am not a proponent of run waivers, but given that it is passing under E3 & beta cash flow assumptions, I would tend to be more forgiving," and another director wrote, "I'm OK with the results."

132. In sum, when all of S&P's tricks to help issuers satisfy its relaxed criteria failed, S&P ignored evidence of increased risk and blessed transactions with higher ratings.

iv. S&P Failed to Sufficiently Monitor the Performance of Rated RMBS and CDOs After They Were Issued

133. S&P's focus on business considerations such as revenue enhancement and maintaining its market share also influenced the manner in which it monitored or conducted surveillance on the structured finance securities that it had already rated.

134. Prior to 2007, S&P performed only a sporadic and cursory review of its RMBS ratings and did not use the best surveillance tools that were at its disposal. This reality was in sharp contrast to the public representations of S&P's senior executives, including the managing director of RMBS, highlighting that the company maintained a robust surveillance process with

substantial resources at its disposal that allowed S&P to timely and thoroughly monitor the performance of previously rated RMBS.

135. In particular, S&P did not dedicate the necessary resources to effectively conduct surveillance on previously rated RMBS and failed to use its LEVELs model as part of the monitoring process of these obligations. As noted by a senior S&P managing director in Congressional testimony:

> [T]here are two sides to the rating. You have an initial rating when the bonds are sold, and then you have the surveillance. And at some point in the mid-1990s, the management in [S&P] decided to make surveillance a profit center instead of an adjunct critical key part of keeping investors informed as to how their investments were performing after they bought bonds. And as a result, they didn't have the staff or the information. They didn't even run the ratings model in the surveillance area which would have allowed them to have basically re-rated every deal S&P had rated to that time and see exactly what was going on and whether the support was there for those triple-A bonds.
>
> The [internal] reason [S&P management] gave for not doing it was because they were concerned that the ratings would get volatile and people would start to feel like all triple-As aren't the same. And it was a much more pragmatic business decision than really focusing on how to protect the franchise and the reputation by doing the right thing for the investors.

136. That S&P did not devote sufficient resources to surveillance, and that this was done for business reasons, is confirmed by numerous internal emails.

137. For example, an S&P managing director wrote the following regarding S&P's surveillance: "In various asset classes, the way surveillance is done is different from how a new deal is done . . .the two major reasons why we have taken this approach is (i) lack of sufficient personnel resources and (ii) not having the same models/information available for surveillance to relook at an existing deal with the new assumptions (i.e. no cash flow models for a number of assets). The third reason is concerns of how disruptive wholesale rating changes, based on a criteria changes can be to the market."

138. In another example, the head of S&P's European structured finance group wrote the following in an internal email: "[J]ust sat on a panel [with Moody's] who fielded a question on what happens to old transactions when there is a change to rating methodologies. The official Moody's line is that there is no "grandfathering" and that old transactions are reviewed using the new criteria. However, the truth is that we do not have the resources to review thousands of transactions, so we focus on those that we feel are more at risk."

139. As these emails demonstrate, there was very little profit in diligently monitoring the performance of previously rated RMBS because S&P had already been paid its fee and issuers continued to want only AAA ratings. Indeed, proper surveillance could actually lead to S&P earning less revenue because there was a real business risk that as the volatility of S&P's ratings increased investors would perceive S&P's ratings as less accurate, thus leading issuers to stop using S&P to rate structured finance securities.

140. Put simply, S&P failed to dedicate the appropriate resources to responsibly conduct surveillance, did not implement the more up to date version of LEVELS developed by its analysts, and did not use its LEVELS model to continually monitor its ratings of RMBS because doing so would have revealed that many of the structured finance securities that it had previously rated AAA were not deserving of such a high rating.

141. As a result, much of the credit risk contained in RMBS that received S&P's highest ratings remained hidden from the marketplace for much longer than it would have if S&P had treated surveillance as the "robust safeguard" that its public statements promised.

142. Once again, S&P's internal business decisions – motivated primarily by its self-interested desire to achieve or maintain revenue and market share goals – directly contradicted S&P's Code of Conduct and its public representations regarding its robust surveillance, as well as maintaining independence and objectivity in its ratings of structured finance securities.

b. S&P's Ratings did not Capture the True Risks of the Underlying Securities

143. In congressional testimony, a former managing director of S&P provided the following stark testimony about the business environment at S&P during the last ten years:

> Well, profits were what drove it starting in about 2001 at [S&P]. It was the growth in the market and the growth – profits were running the show. In a nutshell, that was the simple answer. And the business managers that were in charge just wanted to get as much of the [revenue] as they saw like this, growing out in the street, into their coffers . . . .
>
> I believe that [S&P] at this time, there was a raging debate between the business managers and the analysts. The analysts were in the trenches. We saw the transactions coming in. We could see the shifts that were taking place in the collateral. And we were asking for more staff and more investment in being able to build the databases and the models that would allow us to track what was going on. The corporation, on the other hand was interested in trying to maximize the money that was being sent up to McGraw-Hill, and the requests were routinely denied. So, by 2005 . . . we did have two very excellent models that were developed but not implemented. And it's my opinion that had we built the databases and been allowed to run those models and continually populated that base and do the analysis on a monthly quarterly basis, we could have identified the problems as they occurred."

144. Numerous internal emails and conversations demonstrate that S&P was dramatically underestimating risk and was aware there could be broad macroeconomic consequences from S&P's abandonment of independence and objectivity in ratings.

145. Moreover, during the first half of 2007, S&P continued to issue AAA ratings for a large number of RMBS and CDO securities despite clear information that the underlying assets were failing. S&P would subsequently downgrade most of these securities in the second half of 2007 and throughout 2008, providing strong evidence that S&P deliberately issued inflated ratings for securities it was going to downgrade.

i. Internal Emails

146. The following internal emails evidence the problems with the RMBS securities rating market and S&P's underestimating risks.

147. In an email dated June 27, 2005, a real estate professional wrote Susan Barnes, then managing director of S&P's RMBS group, the following:

> "I am extremely afraid of the seeds of destruction the financial markets have planted. I have contacted the OTS, FDIC and others and my concerns are not addressed. I have been a mortgage broker for the past 13 years and I have never seen such lack of attention to loan risk. I am confident our present housing bubble is not from supply and demand of housing, but from money supply. In my professional opinion the biggest perpetrator is Washington Mutual. 1) No income documentation loans; 2) Option ARMS (negative amortization). On over-leveraged collateral. . . . 5) 100% financing loans. I have seen instances where WAM approved buyers for purchase loans; where the fully indexed interest only payments represented 100% of borrower's gross monthly income. We need to put a stop to this madness!!"

148. In another example, in response to an October 19, 2006, Wall Street Journal article title "More Home Loans Go Sour --- Though New Data Show Rising Delinquencies, Lenders Continue to Loosen Mortgage Standards," a managing director in S&P's structured finance group wrote the following in an internal email dated October 20, 2006: "Pretty grim news as we suspected – note also the 'mailing in the keys and walking away' epidemic has begun – I think things are going to get mighty ugly next year!"

149. In internal email from February 27, 2007, regarding loan level surveillance of RMBS, an S&P managing director wrote, "I'm just thinking if they are assuming 100% of foreclosures go REO [real estate owned – lender takes back possession of] and we know . . . that 40% foreclosures on average cure and go back to performing it seems odd that S&P would still use the incorrect assumptions in running cashflows – I would scratch my head as an investor." In response, an S&P employee responded, "Agree. Also remember, our data is the aggregate and most of the deals allegedly have better (cough, cough) subprime loans. Therefore, would the cure rate for the "better loans" be greater? Hummm. Something to dr/th-ink about or both."

150. In an email dated March 5, 2007, an S&P director wrote the following with the subject line <u>2006 Deals May Be Worst Performing in Recent History</u>: "The number of total and serious delinquencies for the 2006 vintage is consistently higher than the more recent vintages . . . [A]fter one year of performance delinquencies for the 2006 vintage were approximately 13%,

14%, 59%, 94%, 95%, and 41% higher than those for the 2000-2005 vintages, respectively. In addition, serious delinquencies in the 2006 transactions have increased approximately 11%, 22%, 73%, 105%, 113%, and 43% faster than those in the 2000-2005 vintages, respectively."

151. As a final example, an Instant Messaging conversation between S&P employees in April 2007, a few months before S&P would start massive downgrades, makes the point quite starkly:

> Thursday, April 05, 2007 3:58:42 PM EDT Shah, Rahul Dilip (Structured Finance - New York): btw - that deal is ridiculous
> Thursday, April 05, 20073:59:05 PM EDT Mooney, Shannon: i know right ... model def does not capture half of the rish [sic]
> Thursday, April 05,20073:59:08 PM EDT Mooney, Shannon: risk
> Thursday, April 05, 2007 3:59:09 PM EDT Shah, Rahul Dilip (Structured Finance - New York): we should not be rating it
> Thursday, April 05, 2007 3:59: 17 PM EDT Mooney, Shannon: we rate every deal
> Thursday, April 05, 2007 3:59:30 PM EDT Mooney, Shannon: it could be structured by cows and we would rate it
> Thursday, April 05, 2007 3:59:54 PM EDT Shah, Rahul Dilip (Structured Finance - New York): but there's a lot of risk associated with it - I personally don't feel comfy signing off as a committee member.

ii. S&P Continued to Issue Inflated Ratings on the Eve of Massive Downgrades

152. During the first half of 2007, S&P continued to provide AAA ratings for RMBS and CDOs, despite clear evidence both internally and externally that the underlying assets were defaulting at an alarming rate.

153. As noted in a recent Senate subcommittee report, "[i]n the first week of July 2007 alone, S&P issued over 1,500 new RMBS ratings, a number that almost equaled the average number of RMBS ratings it issued in each of the preceding three months."

154. S&P's decision to continue to use its outdated credit analytics to rate these securities is particularly troubling in light of the fact that S&P began massive downgrades during the second half of 2007 and throughout 2008. As further noted in the Senate subcommittee

report, "[o]n July 10 [2007], S&P placed on credit watch, the ratings of 612 subprime RMBS with an original value of $7.35 billion, and two days later downgraded 498 securities."

155. In other words, S&P continued to issue investment grade ratings for RMBS and CDOs up until days before it began massive downgrades of these same securities.

156. S&P's conduct with respect to two CDOs highlights how S&P's drive for profits led it to feed bad ratings information into the market during 2007.

Delphinus CDO

157. Delphinus CDO 2007-1 was a $1.6 billion hybrid CDO created by Magnetar Capital, LLC, an Illinois-based hedge fund, and underwritten by the Japanese bank Mizuho.

158. The Delphinus CDO was one of a number of CDOs put together by Magnetar Capital, which consisted of assets specifically picked by Magnetar because of their high risk of default. In July and August of 2007, S&P gave AAA ratings to six tranches of the Delphinus CDO, but as noted in the Senate subcommittee report, "began downgrading its securities by the end of the year, and by the end of 2008, had fully downgraded its AAA securities to junk status."

159. In other words, in July and August 2007, after S&P already had begun mass downgrades of RMBS and CDOs, S&P gave its highest rating, AAA, to six tranches of a CDO it would downgrade to junk status only months later.

Vertical CDO

160. Vertical ABS CDO 2007-1 was a CDO issued by UBS. Internal emails from March and April 2007 reveal that S&P analysts were having trouble obtaining sufficient information from UBS to rate the transaction.

161. For example, in an internal email dated March 30, 2007, an S&P analyst wrote the following: "Sarah and I have been working with James Yao from UBS but we have not been

getting cooperation from him. He has told me that I am jeopardizing the deal. . . . This is the third time that he refuses to model the cashflow according to the Indenture and Criteria."

162. Similarly, in an April 5, 2007, an S&P manager wrote: "There seems to be a general lack of interest [from UBS] to work WITH us, incorporate our comments, or modeling to our criteria. Based on their collective difficult experience so far, our analysts estimate a smooth closing is unlikely."

163. The same day, another S&P analyst wrote the following regarding the performance of the CDO: "Just wanted to let you know that this deal is closing and going Effective [sic] next Tuesday, but our rated Equity tranche (BBB) is failing in our cashflow modeling. Sarah tried a lot of ways to have the model passed. Unfortunately we are still failing by 1bp [basis point], without any stress runs and without modeling certain fees (anticipated to be minimal). In addition, we already incorporated the actual ramped up portfolio, and not a hypothetical one, for this exercise."

164. The next day, the analyst noted that "[w]e found a mistake in the waterfall modeling that was more punitive than necessary," and that the model was now passing.

165. On April 10, 2007, S&P gave investment grade ratings to all but one of the nine Vertical CDO tranches.

166. Four months later, in August 2007, "all but the top three tranches were put on credit watch," and two months after that in October, Moody's downgraded all but one of the Vertical's tranches to junk status. The CDO was subsequently liquidated in 2008.

167. Both of the Vertical and Delphinus CDOs illustrate that S&P was not merely careless in analyzing structured finance securities; rather, S&P's conduct was deceptive and misleading.

APPLICABLE STATUTES

168. Section 2 of the Consumer Fraud and Deceptive Business Practices Act provides, in relevant part:

> **§ 2: Unlawful practices; construction with Federal Trade Commission Act**
>
> Unfair methods of competition and unfair or deceptive acts or practices, including but not limited to the use or employment of any deception fraud, false pretense, false promise, misrepresentation or the concealment, suppression or omission of any material fact, with intent that others rely upon the concealment, suppression or omission of such material fact, or the use or employment of any practice described in Section 2 of the "Uniform Deceptive Trade Practices Act", approved August 5, 1965 [815 ILCS 510/2], in the conduct of any trade or commerce are hereby declared unlawful whether any person has in fact been misled, deceived or damaged thereby. In construing this section consideration shall be given to the interpretations of the Federal Trade Commission and the federal courts relating to Section 5(a) of the Federal Trade Commission Act.

815 ILCS505/2.

169. Section 2(a) of Uniform Deceptive Trade Practices Act provides, in relevant part:

> **§ 2: Deceptive Trade Practices**
>
> (a) A person engages in a deceptive trade practice when, in the course of his or her business, vocation, or occupation, the person:
>
> . . .
>
> (5) represents that goods or services have sponsorship, approval, characteristics, ingredients, uses, benefits, or quantities that they do not have or that a person has a sponsorship, approval, status, affiliation, or connection that he or she does not have;
>
> . . .
>
> (7) represents that goods or services are of a particular standard, quality, or grade or that goods are a particular style or model, if they are of another;
>
> . . .

(12) engages in any other conduct which similarly creates a likelihood of confusion or misunderstanding.

. . .

815 ILCS 510/2(a)(5),(7) and (12).

VIOLATIONS

COUNT I

CONSUMER FRAUD AND DECEPTIVE BUSINESS PRACTICES ACT

170. While engaged in trade or commerce, Defendants committed unfair and/or deceptive acts or practices, and engaged in unfair methods of competition declared unwful under Section 2 of the Consumer Fraud Act, 815 ILCS 505/2, by:

a. Repeatedly emphasizing the following misleading and deceptive information in public statements:

I. that S&P's analysis and rating of structured finance securities is independent, objective, and free from consideration of S&P's desire for revenue or additional business from issuers;

II. that S&P understands that it holds a position of trust in the marketplace and, as such, deals fairly and honestly with the public, including the buyers / investors of the structured finance securities that it rates;

III. that S&P understands that the Issuer Pays business model creates conflicts of interest but that these conflicts have been adequately managed and neutralized by the company as demonstrated by the principles set forth in S&P's Code of Conduct;

IV. that S&P agrees with and has implemented the principles set forth in the IOSCO Code of Conduct pertaining to its obligation as a credit

rating agency to maintain the independence, objectivity and integrity of its ratings of structured finance securities; and

V. that S&P conducts timely and thorough surveillance on its ratings of structured finance securities to ensure that the rating assigned by S&P continues to reflect S&P's assessment of the credit risk associated with the obligation.

b. Making the following misrepresentations in its Code of Conduct:

I. Section 1.12: "[S&P] and its employees shall deal fairly and honestly with issuers, investors, other market participants, and the public."

II. Section 2.1: "[S&P] shall not forbear or refrain from taking a Rating Action, if appropriate, based on the potential effect (economic, political, or otherwise) of the Rating Action on [S&P], an issuer, an investor, or other market participant."

III. Section 2.2: "[S&P] and its Analysts shall use care and analytic judgment to maintain both the substance and appearance of independence and objectivity."

IV. Section 2.3: "The determination of a rating by a rating committee shall be based only on factors known to the rating committee that are believed by it to be relevant to the credit analysis."

V. Section 2.4: "Ratings assigned by [S&P] to an issuer or issue shall not be affected by the existence of, or potential for, a business relationship between [S&P] (or any Non-Ratings Business) and the Issuer (or its affiliates), or any other party, or the non-existence of any such relationship."

VI. Section 1.9: "[S&P] shall allocate adequate personnel and financial resources to monitoring and updating its ratings . . . [O]nce a rating is assigned [S&P] it shall monitor on an ongoing basis and update the rating by: (a) regularly reviewing the issuer's creditworthiness; (b) initiating review of the status of the rating upon becoming aware of any information that might reasonably be expected to result in a Rating Action (including withdrawal of a rating), consistent with the applicable rating criteria and methodology; and (c) updating on a timely basis the rating, as appropriate, based on the results of such review."

c. Representing that S&P was independent and objective, when in fact:

I. S&P's analysis and ratings of structured finance securities were influenced by its desire to please its clients, increase market share, and enhance revenue for the company;

II. S&P did not deal fairly and honestly with buyers / investors of structured finance securities or other market participants;

III. S&P allowed business and revenue considerations to influence the rating methodologies it developed to rate structured finance securities;

IV. S&P's surveillance of its ratings on RMBS was influenced by business concerns such as revenue enhancement and maintaining market share;

V. S&P did not operate its business in conformance with either its own Code of Conduct or the principles set forth in the IOSCO Code;

VI. S&P's structured finance ratings were based in part on the preferences of the narrow group of repeat issuers of structured finance securities that dominated S&P's revenues;

VII. S&P's structured finance ratings were based in part on a desire to promote S&P's own economic interests; and

VIII. S&P deliberately issued false ratings of structured finance securities in order to please issuers.

COUNT II

UNIFORM DECEPTIVE TRADE PRACTICES ACT

171. While engaged in trade or commerce, Defendant violated Section 2 of the Uniform Deceptive Trade Practices Act, 815 ILCS 510/2(a)(5), (7) and (12) by:

a. Falsely representing, in public statements, that:

I. S&P's analysis and rating of structured finance securities is independent, objective, and free from considerations of S&P's desire for revenue or additional business from issuers;

II. S&P conducts timely and thorough surveillance on its ratings of structured finance securities to ensure that the rating assigned by S&P continues to reflect S&P's assessment of the credit risk associated with the obligation;

b. Making the following misrepresentations in its Code of Conduct:

I. Section 2.1: "[S&P] shall not forbear or refrain from taking a Rating Action, if appropriate, based on the potential effect (economic, political, or otherwise) of the Rating Action on [S&P], an issuer, an investor, or other market participant."

II. Section 2.3: "The determination of a rating by a rating committee shall be based only on factors known to the rating committee that are believed by it to be relevant to the credit analysis."

III. Section 2.4: "Ratings assigned by [S&P] to an issuer or issue shall not be affected by the existence of, or potential for, a business relationship between [S&P] (or any Non-Ratings Business) and the Issuer (or its affiliates), or any other party, or the non-existence of any such relationship."

IV. Section 1.9: "[S&P] shall allocate adequate personnel and financial resources to monitoring and updating its ratings . . . [O]nce a rating is assigned [S&P] shall monitor on an ongoing basis and update the rating by: (a) regularly reviewing the issuer's creditworthiness; (b) initiating review of the status of the rating upon becoming aware of any information that might reasonably be expected to result in a Rating Action (including withdrawal of a rating), consistent with the applicable rating criteria and methodology; and (c) updating on a timely basis the rating, as appropriate, based on the results of such review."

REMEDIES

172. Section 7 of the Consumer Fraud and Deceptive Business Practices Act, 815 ILCS 505/7, provides:

> (a) Whenever the Attorney General has reason to believe that any person is using, has used, or is about to use any method, act or practice declared by the Act to be unlawful, and that proceedings would be in the public interest, he may bring an action in the name of the State against such person to restrain by preliminary or permanent injunction the use of such

method, act or practice. The Court, in its discretion, may exercise all powers necessary, including but not limited to: injunction, revocation, forfeiture or suspension of any license, charter, franchise, certificate or other evidence of authority of any person to do business in this State; appointment of a receiver; dissolution of domestic corporations or association suspension or termination of the right of foreign corporations or associations to do business in this State; and restitution.

(b) In addition to the remedies provided herein, the Attorney General may request and this Court may impose a civil penalty in a sum not to exceed $50,000 against any person found by the Court to have engaged in any method, act or practice declared unlawful under this Act. In the event the court finds the method, act or practice to have been entered into with intent to defraud, the court has the authority to impose a civil penalty in a sum not to exceed $50,000 per violation.

PRAYER FOR RELIEF

WHEREFORE, the Plaintiff prays that this Honorable Court enter an Order:

A. Finding that Defendants have engaged in trade or commerce within the meaning of Section 2 of the Consumer Fraud Act;

B. Finding that the Defendants have violated Section 2 of the Consumer Fraud Act, 815 ILCS 505/2, by, including but not limited to, the unlawful acts and practices alleged herein;

C. Finding that Defendants' conduct as described above constituted unfair and deceptive methods, acts, and practices within the meaning of Section 2 of the Uniform Deceptive Trade Practices Act;

D. Preliminarily and permanently enjoining Defendants and their employees, officers, directors, agents, successors, assigns, affiliates, merged or acquired predecessors, parent or controlling entities, subsidiaries, and any and all persons acting in concert of participation with Defendants, from continuing the unlawful methods, acts, and practices described above;

E. Assessing a civil penalty of $50,000.00 if the Court finds the Defendants have engaged in methods, acts or practices declared unlawful by the Act without the intent to defraud; if the Court finds Defendants have engaged in methods, acts or practices declared unlawful by the Act with the intent to defraud, then assessing a statutory civil penalty of $50,000.00 per violation, all as provided in Section 7 of the Consumer Fraud Act, 815 ILCS 505/7;

F. Disgorging all revenues, profits, and gains achieved in whole or in part through the unfair acts or practices complained of herein;

G. Requiring the Defendants to pay all costs for the prosecution and investigation of this action, as provided by Section 10 of the Consumer Fraud Act, 815 ILCS 505/10; and

H. Providing such other relief as justice and equity may require.

Respectfully Submitted,

THE PEOPLE OF THE STATE OF
ILLINOIS, by LISA MADIGAN
ATTORNEY GENERAL OF ILLINOIS

BY: _____
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Consumer Protection Division, Chief

_____
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