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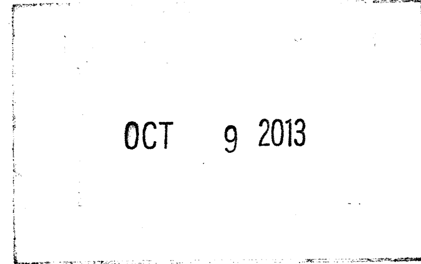


SUPERIOR COURT OF NEW JERSEY
CHANCERY DIVISION, GENERAL
EQUITY: ESSEX COUNTY
DOCKET NO. ESX-C-________________

JOHN J. HOFFMAN, Acting Attorney General of the State of New Jersey, and ERIC T. KANEFSKY, Director of the New Jersey Division of Consumer Affairs,

Plaintiffs,

v.

MCGRAW HILL FINANCIAL, INC. and STANDARD & POOR'S FINANCIAL SERVICES, LLC,

Defendants.

Civil Action

COMPLAINT

Plaintiffs John J. Hoffman, Acting Attorney General of the State of New Jersey ("Attorney General"), with offices located at 124 Halsey Street, Fifth Floor, Newark, New Jersey 07101, and Eric T. Kanefsky, Director of the New Jersey Division of Consumer Affairs

("Director"), with offices located at 124 Halsey Street, Seventh Floor, Newark, New Jersey 07101 (collectively, "Plaintiffs"), by way of Complaint state:

PRELIMINARY STATEMENT

1. The Attorney General and Director bring this action pursuant to the New Jersey Consumer Fraud Act, N.J.S.A. 56:8-1 et seq. ("CFA"), to redress years of unconscionable commercial practices, misrepresentations, and knowing omissions of material fact by Defendants McGraw Hill Financial, Inc. and Standard & Poor's Financial Services, LLC (collectively, "S&P") that they were independent and objective in analyzing credit ratings for structured finance securities.

2. S&P has represented and continues to represent to consumers in the State of New Jersey ("New Jersey") that its analysis of structured finance securities is independent, objective, and the result of the highest quality credit analytics that are available to S&P. It has made these representations on its web site, in its annual reports, in Congressional testimony, and in numerous other public statements. Those representations were false.

3. In contrast to S&P's public representations about its independence and objectivity, the truth was far different. As demonstrated in this Complaint, S&P failed to disclose that it was allowing its desire for revenue and market share to influence and undermine the integrity of the analytical models that it used to evaluate the risk of and to issue ratings on structured finance securities. S&P further omitted to disclose that these business considerations also relaxed the process by which S&P monitored the performance of structured finance securities that it had already rated. S&P favored the interests of its investment banking clients, which issued these structured finance securities, over the interests of New Jersey's consumers.

S&P thus engaged in unconscionable commercial practices by allowing this inherent conflict of interest to corrupt its analytics and compromise its integrity.

4. The reason S&P allowed the interests of its investment banking clients to undermine its independence and objectivity was simple. The investment banking clients paid S&P's fees under what is known as the "issuer pays" model. These fees were a significant and increasing source of revenue for S&P, and thus the threat of losing market share to competitors such as Moody's Investors Service or Fitch Ratings caused S&P to utilize out-of-date and incomplete creditworthiness modeling analytics, and to devote insufficient resources and support to its surveillance of the securities it had already rated.

5. A credit rating by S&P purports to represent S&P's independent qualitative and quantitative analysis of the issuer's ability to meet its financial obligations or, in the case of structured finance securities, whether the underlying assets are likely to experience delinquency and default. The independent and objective methodology behind these ratings is of critical importance to consumers.

6. This action does not challenge S&P's judgment or opinion regarding which rating to apply to any specific structured finance security. Nor is this action brought for the purpose of demonstrating that any particular rating was incorrect. Instead, Plaintiffs maintain that S&P violated the CFA by misrepresenting that it was at all times independent and objective. Plaintiffs also maintain that S&P violated the CFA by failing to disclose that S&P's desire to maximize its revenues and market share caused it to utilize issuer-friendly analytical models, as well as to provide insufficient monitoring of the instruments that it had already rated.

7. S&P's conduct, as described herein, constitutes multiple violations of the CFA, as well as the Regulations Governing General Advertising, N.J.A.C. 13:45A-9.1 et seq.

("Advertising Regulations"). Accordingly, Plaintiffs seek, among other things, disgorgement, restitution, civil penalties, and injunctive and equitable relief to redress and halt these deceptive practices, which have adversely impacted New Jersey's consumers.

PARTIES AND JURISDICTION

8. The Attorney General is charged with the responsibility of enforcing the CFA and all the regulations promulgated thereunder, N.J.A.C. 13:45A-1.1 et seq. ("CFA Regulations"), including the Advertising Regulations. The Director is charged with the responsibility of administering the CFA and the CFA Regulations on behalf of the Attorney General.

9. By this action, Plaintiffs seek injunctive and other relief for violations of the CFA. Plaintiffs bring this action pursuant to their authority under the CFA, specifically N.J.S.A. 56:8-8, 8-11, 8-13, and/or 8-19.

10. Defendant McGraw Hill Financial, Inc. ("McGraw Hill"), formerly The McGraw-Hill Companies, Inc. before May 1, 2013, is a publicly traded New York corporation with its principal place of business at 1221 Avenue of the Americas, New York, New York 10020. McGraw Hill is registered to conduct business within New Jersey, and maintains a business address at 148 Princeton-Hightstown Road, Hightstown, New Jersey 08520.

11. Defendant Standard & Poor's Financial Services LLC ("S&P Financial") is a Delaware limited liability company and wholly owned subsidiary of McGraw Hill, with its principal place of business at 55 Water Street, New York, New York 10041. Standard & Poor's Ratings Services is a business unit or division of S&P Financial. S&P Financial is the successor entity to a unit that previously operated within an unincorporated division of McGraw Hill. S&P Financial is registered to conduct business within New Jersey.

12. Venue is proper in Essex County, pursuant to R. 4:3-2, because this is a county in which the cause of action arose, and Defendants McGraw Hill and/or S&P Financial do business here.

GENERAL ALLEGATIONS COMMON TO ALL COUNTS

A. S&P's Ratings of the Structured Finance Market

13. S&P plays a dominant role in the marketplace with respect to the analysis of structured finance securities.

14. Structured finance securities are asset-backed securities ("ABS"), a financial product whose value is derived from the stream of revenue flowing from a pool of underlying assets. These securities are in turn sold to investors who rely upon the revenue stream generated from the underlying asset pool for repayment of the investors' principal and collection of interest.

15. Among the common types of structured finance securities rated by S&P are residential mortgage backed securities ("RMBS"), which are secured by a pool of residential mortgages that often include subprime mortgages.

16. RMBSs are created when an issuer, usually an investment bank, packages mortgage loans into a pool and transfers them to a trust that issues securities collateralized by the pool. The trust purchases the loan pool and becomes entitled to the interest and principal payments made by the mortgagors, which are then used to make monthly distribution to the RMBS investors.

17. The trust, in an effort to attract investors seeking various degrees of risk, creates different classes of RMBSs known as tranches. The tranches offer a sliding scale of payment priorities based on the level of risk and credit protection provided to each tranche.

18. Credit protection is designed to shield the securities within a tranche from the loss of interest and principal due to defaults of mortgage loans in the overall pool. The amount of credit protection afforded to a tranche is called a credit enhancement.

19. Subordination is a type of credit enhancement where the issuer will create a hierarchy among the different tranches. The lowest tranches are the first to absorb any losses of principal and interest payments due to defaults and delinquencies. These are allocated to the lowest tranche until that tranche loses its entire principal amount, and then to the next lowest tranche up the hierarchy. Accordingly, the lower tranches usually receive lower credit ratings than the senior tranches, which enjoy greater protection from default losses by virtue of the cushion provided by the lower tranches and the overcollateralization.

20. A collateralized debt obligation ("CDO") is another structured finance security or ABS rated by S&P, and is the most common structured finance security collateralized by other securities.

21. A CDO is formed when an issuer creates a trust or other special purpose entity to hold assets and issue securities. Instead of mortgage loans held in the RMBS pool, a CDO trust is typically comprised of multiple debt securities such as RMBS and other CDOs. The trust then uses the interest and principal payments from the underlying debt securities to make payments to investors of the securities issued by the CDO trust.

22. Like a RMBS, a CDO trust also issues different classes of securities divided into tranches that provide different levels of credit protection through the use of subordination and other forms of credit enhancement.

23. After an ABS is created by an issuer, the ABS is then sent to S&P for analytical review.

24. S&P uses its analytical models to determine how much credit enhancement a given tranche would need to receive a particular credit rating. If S&P determines that the issuer's proposed capital structure does not allow for sufficient credit enhancement to receive a "AAA" or other investment grade rating, the issuer must adjust the capital structure if it wishes to receive such a rating. This could require the issuer to include additional mortgages or collateral in the capital structure, thus increasing the issuer's cost and decreasing its profit margins. The smaller the credit enhancement, the more profitable the security is to the issuer.

25. S&P charges the issuer a fee in exchange for assigning and publishing a credit rating grade measuring the creditworthiness of the ABS. Because S&P is selected and paid by the same entities that issue the security that S&P analyzes and rates, the fee arrangement is referred to as the "issuer pays" model.

26. The market for analyzing structured finance securities is very lucrative. S&P charges three or four times as much to analyze a structured finance security as it does to rate a corporate bond. In 2006, S&P's revenues rose approximately 15% to $12.7 billion, with approximately one-half of that growth derived from increased fees from structured finance ratings. Indeed, industry publications estimate that in both 2006 and 2007, as much as 40% of S&P's revenue was derived from its analysis of structured finance securities.

27. The market for structured finance securities is also dominated by a narrow group of sellers, consisting of the major investment banks that issue RMBSs, CDOs, and other ABSs on a regular basis. S&P has allowed the market dominance of those sellers to influence it to provide unjustifiably favorable ratings.

28. According to the industry publication Asset-Backed Alert, S&P rated 97.5% of CDOs issued in 2006. As of 2009, S&P had rated and was monitoring ratings of approximately 198,000 structured finance securities.

29. As the volume of RMBS and CDO offerings increased, so did the opportunity for S&P to derive significant fees for issuing such favorable ratings on these securities. For S&P to capitalize on these revenue driven opportunities, it channeled its efforts on pleasing this relatively small group of investment banks and financial institutions that issued structured finance securities and were repeat customers of S&P, thus allowing S&P to avoid the risk of losing the business of these issuers in the future.

30. Credit agencies such as S&P distinguish between different grades of creditworthiness. Creditworthiness refers to the likelihood that the issuer of a particular security will meet its financial obligations as they become due or, in the case of structured finance securities, that the underlying assets will experience delinquencies and defaults.

31. S&P's credit ratings use a scale of letter grades from AAA to D: AAA, AA, A, BBB, BB, B, CCC, CC, C, and D. "AAA" is the highest grade and indicates the lowest risk of default. "D" is the lowest grade and indicates the highest risk of default or that a default has already occurred. Ratings from AA to CCC may be modified by the addition of a plus (+) or minus (-) sign.

32. An S&P credit rating of BBB- and above is "investment grade," while a lower S&P rating is non-investment or "speculative grade."

33. S&P not only rates but also monitors the ongoing creditworthiness of an ABS through surveillance after it has rated it.

34. The ratings issued, published, and monitored by S&P for ABSs are crucial to consumers because structured finance securities are extremely complex in nature, and there is limited information available to the investing public about the underlying loans used to create RMBSs and CDOs.

35. Additionally, investors in ABSs include pension and retirement funds, and other institutional investors, that are subject to regulations or other requirements that they only invest in investment grade securities with a rating of BBB- or above.

36. Consumer evaluation of and interest in an issuer's ABS, and the marketability and profitability of that ABS, is directly impacted by the credit rating grade assigned to it by S&P.

B. S&P's Representations about the Independence of Its Credit Ratings

37. The publicized independence and objectivity of S&P's credit ratings of securities is essential to the credibility of the ratings to consumers.

38. Since at least 2004, S&P represented to the public that its credit ratings are independent and free of outside influence on numerous occasions.

39. Specifically, in S&P's 2004 "Code of Practices and Procedures" ("Practices and Procedures") S&P stated that it "endeavors to conduct the ratings and surveillance process in a manner that is transparent and credible and that also ensures that the integrity and independence of such processes are not compromised by conflicts of interest, abuse of confidential information, or other undue influences."

40. Elsewhere in the same Practices and Procedures, S&P claimed that its "mission has always remained the same – to provide high-quality, objective, independent, and rigorous analytical information to the market place" and that "in all analytic processes, [S&P] must preserve the objectivity integrity and independence of its ratings. In particular, the fact that

[S&P] receives a fee from the issuer must not be a factor in the decision to rate an issuer or in the analysis and the rating opinion."

41. In October of 2005, S&P instituted a publicly available "Code of Professional Conduct" ("Code"). S&P's Code also contains sections dedicated to the manner in which S&P maintains the independence and objectivity of its analysis and avoids conflicts of interest with issuers. The Code and its representations, including Sections 1.9, 1.12, and 2.1 through 2.4, currently remain in effect as purported limitations on the factors that S&P considers when rating structured finance securities.

42. Section 1.9 of S&P's Code states: "[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."

43. 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."

44. 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."

45. 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."

46. 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."

47. 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."

48. The Code of Professional Conduct is available on S&P's web site, and S&P has referenced the foregoing and other tenets of S&P's Code in numerous public statements.

49. For example, in a 2006 report about the Code's implementation, S&P trumpeted the independence and objectivity of its ratings practices, and also acknowledged its substantial role in the financial markets, declaring:

a. "[S&P] recognizes its role in the global capital markets and is committed to providing ratings that are objective, independent and credible";

b. "[I]t is a central tenet of [S&P] that its ratings decisions not be influenced by the fact that S&P receives fees from issuers"; and

c. "Ratings are monitored on an ongoing basis in accordance with [S&P's] policies unless a rating is a point in time confidential rating without surveillance."

50. The report explains that S&P's Code of Professional Conduct sought to "further align" policies and procedures with the International Organization of Securities Commissions ("IOSCO") Code of Conduct of Conduct Fundamentals for Credit Rating Agencies ("IOSCO Code"), noting 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."

51. First published in December of 2004, the IOSCO Code describes the need for credit rating agencies like S&P to maintain independence from the issuers who pay for the ratings, explaining: "[T]he 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."

52. Furthermore, 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."

53. In 2006, McGraw Hill's Annual Report continued to highlight S&P's 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."

54. Similarly, in its 2007 Annual Report, McGraw Hill emphasized that: "Since

1916, markets across the globe have relied on the independent analysis and integrity of [S&P's] credit ratings . . . . S&P is highly valued by investors and financial decision-makers everywhere for its analytical independence, its market expertise and its incisive thought leadership."

55. Furthermore, in April 2007, S&P's then Managing Director of RMBSs, Susan Barnes, testified before the United States Senate Committee on Banking, Housing and Urban Affairs regarding S&P's commitment to "ongoing" monitoring of the accuracy and integrity of its ratings: "After 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."

56. Ms. Barnes also stressed 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."

57. In its 2008 Annual Report, McGraw Hill reiterated 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 underscored 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."

58. In October of 2008, Deven Sharma, the then President of S&P Financial testified before the United States House Committee on Oversight and Government Reform 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."

59. 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."

60. As demonstrated below, however, the representations made by S&P in its codes, web site, public filings, public statements by its officers and executives, and other public statements were false and misrepresented the following to consumers in New Jersey.

a. First, that S&P's analysis of structured finance securities has been, and continues to be, independent, objective and free from consideration of S&P's desire for revenue or winning additional business from issuers.

b. Second, recognizing that S&P holds a dominant position of trust in the marketplace, that S&P deals fairly and honestly with the public, including New Jersey's consumers.

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

d. Fourth, that S&P understands that 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. S&P also understands that consumers depend on S&P to properly manage this conflict and reasonably interpret S&P's representations to understand that S&P does so.

e. Fifth, that S&P dedicates the resources necessary and does in fact conduct timely and thorough surveillance on its analysis 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.

61. The above representations made by S&P were material to consumers. None of them were true. These representations were not mere commercial puffery. They were representations of fact about the way in which S&P conducted its structured finance ratings business and the standards by which it purported to abide.

C. <u>S&P Ratings Were Guided by the Desire to Increase Revenues, Not Analytics</u>

62. Rather than maintain its independence and objectivity when rating structured finance securities, S&P opted to cater to a small group of repeat issuers who pay S&P to rate their securities. As a result, when S&P rated structured finance securities, S&P allowed its credit analytics to be unduly influenced by the very market share and revenue considerations that its public statements consistently and explicitly disavowed.

63. S&P catered to these specific issuers by participating in a process known as "ratings shopping."

64. "Ratings shopping" refers to the practice of an issuer offering its business to the rating agency requiring the least amount of credit enhancement necessary to achieve the issuer's desired rating.

65. In describing the effect of ratings shopping, a former S&P executive has been quoted as follows: "The discussion tends to proceed in this sort of way. 'Look, I know that you aren't comfortable with such and such assumption but apparently Moody's are even lower and if that is the only thing standing between rating this deal and not rating this deal, are we really hung

up on this assumption?' You don't have infinite information. Nothing is perfect. So the line in the sand shifts and shifts, and can shift quite a bit."

66. Between at least 2004 and 2007, when the markets for RMBSs and CDOs were particularly active, S&P experienced this pressure on a daily basis and the pressure did in fact influence S&P's analysis, the ratings that S&P assigned to structured finance securities, the recommendations that S&P's analysts made to their superiors, and the feedback that S&P provided to repeat issuers.

67. S&P did not disclose in a public statement that these outside influences affected S&P's analysis of structured finance securities. To the contrary, S&P represented quite the opposite by repeatedly stating that its analyses were not influenced by its business relationships.

68. S&P's desire for more revenue unduly influenced its decision to make adjustments to the assumptions built into its analytical models used to rate RMBSs and CDOs, or, alternatively, to refrain from updating its analytical models based on the best information available to S&P in order to preserve the use of analytical models that were appealing to repeat issuers.

69. By at least 2001, S&P's focus on monitoring and growing its market share and generating additional revenue dominated the attention of S&P's senior management. This compulsion to maximize revenue influenced the analytical models that S&P developed and implemented for rating RMBSs and other structured finance securities.

70. S&P believed that the only way for it to successfully compete for an issuer's structured finance business was to adjust its analytical models so that S&P's levels of proposed credit enhancement reflected the issuer's expectations. As a result, S&P focused on meeting the

demands of the repeat issuers that paid its fees, rather than providing an objective credit analysis that was not influenced by the financial interests of either S&P or its issuer clients.

71. S&P's adjustment to its analytical models based on revenue and market share concerns began as early as 2001.

72. For example, beginning in approximately 1996, S&P used an analytical model it developed called "LEVELS," for "Loan Evaluation and Estimate of Loss System," which used a database that aggregated loan performance going back five or more years for approximately 500,000 residential loans across the United States. The LEVELS model was S&P's analytical model for evaluating RMBSs.

73. S&P's LEVELS model used a statistically based methodology to estimate the default and loss experience of residential home loans and loan pools based in part on historical loan performance data. Put simply, based on how other loans have performed over time, S&P's LEVELS model estimates the default probability and expected loss for a particular pool of loans and structure proposed by an issuer of an RMBS.

74. Upon implementing LEVELS and publicizing its use to market participants, S&P represented to the public that it would refine and improve the model annually by 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.

75. 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.

76. As acknowledged by a former senior S&P executive responsible for rating RMBSs, these updates were critical to the LEVELS model's success because each new version

was built with more current data on both traditional and new mortgage products, particularly with respect to the growing, riskier subprime mortgage market for which the older default and payment data provided little guidance.

77. Beginning in 2001, S&P's upper level management stopped the process of adding new loan data to refine S&P's LEVELS model.

78. S&P adopted this new approach even though its senior managers in the residential mortgage backed securities group repeatedly emphasized the importance of keeping the analytical model up to date given the constantly changing nature of the residential mortgages issuers sought to securitize. For example, at the insistence of the managing director responsible for rating RMBSs, S&P's LEVELS development team continued to collect data on historical loan performance. Based on this work, in 2001 S&P developed a new version of its LEVELS model based on significant and more current performance data for 2.5 million loans. Although this would have made the LEVELS evaluations far more current and meaningful, S&P upper level management, however, opted not to release and implement this update.

79. Similarly, in early 2004, S&P's residential mortgage backed securities unit completed another update of the LEVELS model based on performance data from approximately 9.5 million loans covering the full spectrum of new mortgage products, particularly those in the area of subprime lending, which was the fastest growing segment of residential lending. Despite the urgings of the managing director in charge of rating RMBSs, S&P did not implement this more comprehensive model for rating RMBSs upon its completion in 2004 to avoid negatively impacting S&P's revenues and market share.

80. Furthermore, one former senior S&P managing director testified before Congress that, although S&P still maintained a trove of additional and more accurate residential loan data,

it still had not implemented any meaningful updates to its LEVELS model as of October 1988 based on the much more comprehensive and current database developed by its analysts. Thus, LEVELS continued to evaluate RMBS (which included subprime and other less traditional mortgages that had become far more prevalent during the housing boom) based upon outdated data that largely predated the era of subprime and other more aggressive mortgage lending such as Alt-A loans.

81. S&P's decision between at least 2001 and 2008 to use an outdated version of its LEVELS model for analyzing RMBSs, and to ignore the potential risk of default and delinquency in the loan pools underlying RMBSs, was motivated by S&P's desire to continue to assign its "AAA" ratings with minimal credit enhancement, which issuers coveted, thus preserving S&P's market share and earning much more revenue for the company.

82. 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."

83. Rather than run the risk of disrupting its already dominant and highly profitable business of rating RMBSs, S&P simply kept using an outdated model because the model already provided the "AAA" ratings with minimal levels of credit enhancement that S&P's most important customers desired.

84. Indeed, this reality was acknowledged in 2005 by a frustrated member of the S&P team responsible for the LEVELS model when he stated: "[LEVELS] Version 6.0 could have been released months ago and resources assigned elsewhere if we didn't have to massage the

subprime and Alt-A numbers to preserve market share." In the same email chain, another S&P employee said, "We have known for some time (based on pool level data and LEVELS 6.0 testing) that . . . . Subprime: B and BB levels need to be raised . . . . ALT A: B, BB and BBB levels need to be raised (we have had a disproportionate number of downgrades)."

85. Another aggravated S&P director wrote to a coworker in an email, "Remember the dream of being able to defend the model with sound empirical research? The sort of activity a true quant[itative] . . . should be doing perhaps? If we are just going to make it up in order to rate deals, then quants are of precious little value."

86. As succinctly noted by another S&P analyst to senior S&P executives, S&P's consideration of market share and revenue when conducting its analysis had dire consequences both for S&P and the financial markets as a whole: "Screwing with the criteria to 'get the deal' is putting the entire S&P franchise at risk – it's a bad idea."

87. Furthermore, a former senior S&P executive stated that, between at least 2001 and 2008, when analyzing RMBSs, S&P's internal business strategy valued revenues over ratings quality, while at the same time promising independence and objectivity in its public statements:

> 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.

88. The analysis of the underlying assets such as RMBS was an essential factor in S&P's CDO ratings.

89. S&P CDO analysts needed to know if the ratings of RMBS assets underlying the CDOs they were rating were being considered for possible downgrade by the S&P analysts covering them because a downgrade of these ratings would mean that the CDO posed a greater credit risk, which in turn would lead to an overstated credit rating of the CDO if the risk was not addressed by some sort of credit enhancement.

90. S&P CDO analysts, however, typically were not told that S&P RMBS surveillance was considering downgrading RMBS tranches underlying the CDOs they were rating unless S&P had already placed the RMBS tranches on a public list known as Credit Watch Negative, which publicly identified RMBS tranches being considered for possible downgrade.

91. S&P's decision to sacrifice the independence and accuracy of its ratings for business considerations was not limited to RMBSs. It occurred with respect to S&P's ratings of CDOs as well, as demonstrated below.

92. In August of 2004, one of S&P's managing directors informed her colleagues as follows: "We are meeting with your group this week to discuss adjusting criteria for rating CDOs of real estate assets . . . because of the ongoing threat of losing deals . . . . [B]onds below 'AAA' are pricing wider which impacts the weighted average pricing on the deals. Ultimately issuers will react by taking the path of least resistance and making sure Moody's is on the deals.

Thereafter, it's only a matter of time before their rating is also mandated for the primary deals as well."

93. The head of S&P's CDO unit and a member of its Executive Committee endorsed lessening the standards by responding:

> Ok with me to revise criteria . . . .
>
> I 'predict' that Moody's will not be able to make any significant issue out of this. They have attacked us on the basis of criteria before in a number of asset classes (e.g. RMBS) to no avail in the past. This will blow over too with no lasting impact. To the extent that spreads on [commercial mortgage backed securities] collateral without Moody's ratings continue to trade wider than those with it is something the CDO group cannot do much about at this point in time. We maintain a higher market penetration than Moody's in CDOs across all types. [The Structured Finance Leadership Team] is aware of the competitive threats that Moody's is taking in CDOs and has authorized us to take certain actions.

94. Similarly, as succinctly stated in S&P's 2005 CDO Strategic Plan: "Ratings criteria and associated credit support levels for the rated tranches in any CDO transaction are another key revenue driver. Criteria is one of the key competitive elements among the main rating agencies globally and regionally . . . . [H]aving criteria and analytical tools that enable us to rate the transactions and meet the needs of the players in the market will ensure that S&P will continue to be the one agency rating the largest share of transactions."

95. S&P demonstrated that market share was more important to it than issuing accurate ratings in 2005, when the release of S&P's revised CDO Evaluator v3.0 ("E3") model was specifically delayed due to negative feedback from S&P's CDO issuer clients. In the words of senior leaders in S&P's structured finance department: "Due to the not insignificant impact on lowly rated (BBB and down) synthetic reference pools . . . we have toned down and slowed down our roll out of E3 to the market, pending further measures to deal with such negative results . . . . Bear Stearns pointed out that the potential business opportunities we would miss by

effectively having to walk away from such high yield structures would NOT be compensated for by any increase in rating volume for highly rated collateral pools."

96. S&P was concerned about the business impact of the update and considered grandfathering in deals to avoid adverse market reaction.

97. By way of example, in a 2005 email sent by an S&P managing director regarding the CDO Evaluator updates, the S&P managing director wrote:

> 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.

98. 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 [CDO Evaluator v.]2.4.3 does not differ from the final version of E3 by a couple 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."

99. In response, an S&P managing director emphasized, "The trick is of course to minimize impact on deals." The same managing director later wrote the following in an internal email regarding S&P's rollout of Evaluator 3.0: "Lord help our [expletive] scam . . . this has to be the stupidest place I have worked at."

100. Failing to utilize the CDO Evaluator updates directly contradicted S&P's previous assertions that it ensured issued ratings continued to neglect S&P's assessment of credit risk.

101. The recognition that the integrity of S&P's ratings was being compromised for the sake of business was not limited to S&P's management; S&P analysts were also aware that their CDO analysis was not comprehensive. On or about April 5, 2007, two S&P CDO analysts conversed via instant messenger discussing whether S&P's CDO ratings model was properly assessing credit risks:

> [Analyst 1]: btw - that deal is ridiculous
>
> [Analyst 2]: i know right . . . model def[initely] does not capture half of the . . . risk
>
> [Analyst 1]: we should not be rating it
>
> [Analyst 2]: we rate every deal . . . it could be structured by cows and we would rate it
>
> [Analyst 1]: but there's a lot of risk associated with it - I personally don't feel comfy signing off as a committee member.

102. Also in April of 2007, S&P privately acknowledged the full extent that its desire for increased revenue and market share had played, and was continuing to play, in its analysis of CDOs as part of a presentation made to the senior leaders of S&P's structured finance group. In particular, in a slide titled, "A Better Mousetrap," S&P summarized its past analytical approach as follows: "To come up with [probability of default]s and asset correlations in [CDO Evaluator v.]2.4.3, we look at our raw data and come up with a statistical best fit. When this does not meet our business needs, we have to change our parameters ex-post to accommodate." The correlating diagram is called, "The Old way: One Way Street."

103. This private acknowledgment directly contradicts all of S&P's representations to the public with respect to the factors it considers when analyzing CDOs and other structured finance securities. But S&P's admissions went even further.

104. The "Better Mousetrap" that S&P was developing called for S&P to first start with a set of assumptions that were best for its ratings business and then try to fit those assumptions into the available data. In the words of the analysts making the presentation: "So we came up with a new methodology emphasizing on flexibility. We decide on a number of business friendly [probability of default] matrices first" and then decide whether that "set is reasonable." If the selected matrices were not "reasonable" for some reason, S&P simply tried a different set of issuer-friendly matrices and started the process anew.

105. Illustrated under the name, "The New way: Two Way Street," this proposal for how S&P should conduct its analysis going forward was met with approval from S&P's structured finance leadership.

106. S&P continued to trumpet its ratings and methods even in the wake of the mass downgrades that occurred in July 2007 leading up to the subprime mortgage crisis. On August 14, 2007, S&P published an article improvidently titled, "Structured Investment Vehicle Ratings are Weathering the Current Market Disruptions," that discussed the tests S&P used to rate structured investment vehicles (SIVs) and the factors that are considered when S&P issues a rating. The article also praised SIVs for their "sustained performance during both calm and volatile markets."

107. Those S&P employees who resisted S&P management's drive to adjust S&P's analysis in order to maximize revenue were ignored within the company and marginalized. In the words of frustrated S&P analysts shocked by S&P's new extremely lax correlation assumptions for CDOs made up of parts of other CDOs: "I am interested to see if any career consequences occur. Does company care about deal volume or sound credit standards? Some people try to hold line (like you) on arb and don't get recognition – or get held back."

108. The undisclosed influences of market share and increased revenue outlined above did not just drive S&P's analysis in the years leading up to the financial crisis, but persisted during its onset and beyond.

109. S&P's desire for increased revenue and maintenance of its high market share also led S&P to make several adjustments (or ignore necessary adjustments) to the analytical model used by S&P to rate RMBSs and CDOs to make them more business friendly and appealing to issuers. As a result, S&P issued ratings that were not objectively warranted.

D. S&P's Surveillance Group Was Ignored and Designed to Fail

110. S&P's focus on business considerations also influenced the manner in which it monitored the structured finance securities that it had already rated.

111. Prior to 2008, 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 RMBSs. These statements falsely represented 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. The truth was far different.

112. S&P did not dedicate the necessary resources to conduct effective surveillance on previously rated RMBSs, and failed to use its analytical models 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.

113. As this candid statement demonstrates, S&P knew that there was very little profit in diligently monitoring the performance of previously rated RMBSs because S&P had already been paid its fee and issuers continued to want only AAA ratings. Indeed, proper surveillance would have led to S&P earning less revenue because it could be perceived as calling S&P's initial analysis into question.

114. Accordingly, S&P failed to properly fund and dedicate the appropriate number of personnel to surveillance, and did not use the best tools that it had available to conduct surveillance on previously rated RMBSs. This failure by S&P reached a breaking point in late 2006 and early 2007. In the words of one of the leaders of S&P's surveillance team: "[W]hat can we do now? My group is under serious pressure to respond to the burgeoning poor performance of sub-prime deals . . . . [W]e are really falling behind. We need to talk about getting more resources in general. I am seeing evidence that I really need to add to staff to keep up with what is going on with sub prime and mortgage performance in general, NOW."

115. In response to the suggestion that additional resources may be available by August of 2007, the same surveillance executive noted in early February of 2007 as follows: "Let's talk about anything that we might be able to do in the interim. I talked to [a senior S&P executive] yesterday and he thinks that the ratings are not going to hold through 2007. He asked me to begin discussing taking rating actions earlier on the poor performing deals . . . . We do not

have the resources to support what we are doing now. A new process, without the right support, would be overwhelming."

116. Influenced by its desire for increased revenue and market share, S&P also ignored the recommendations of its surveillance group and delayed the downgrade of impaired RMBSs in order to further its own financial interests, as well as the financial interests of its issuer clients. Specifically, despite the meager resources allocated to it, by January of 2007, S&P's surveillance group concluded that it needed to intensify review of 2006 vintage subprime RMBSs and begin taking large scale negative rating action. In February of 2007, S&P's surveillance team made formal recommendations to that effect to S&P senior management.

117. S&P senior management overruled the recommendations of S&P's surveillance group. S&P's delay in taking action on its surveillance group's recommendations was directly influenced by its desire to continue earning lucrative fees by rating CDOs and not upsetting its investment banking clients.

118. As an S&P employee noted on July 5, 2007, when S&P was in crisis mode in the days immediately preceding S&P's mass downgrades of impaired RMBSs: "The fact is, there was a lot of internal pressure in S&P to downgrade lots of deals earlier on before this thing started blowing up. But the leadership was concerned of p*ssing off too many clients and jumping the gun ahead of Fitch and Moody's." Indeed, on July 8, 2007, as the task of assigning blame began within S&P, S&P's surveillance leadership noted: "[W]e were ahead of the curve with our original recommendations in February. We had a process in place, but we were told it was too stressful."

119. Moreover, on or about June 11, 2007, S&P's surveillance group determined that, on average, tranches of subprime RMBSs rated BBB and lower had greater than 100% severe

delinquencies versus available credit support, which meant that the ratings of these RMBS tranches were, on average, almost certainly to be lowered. Despite this determination, after June 11, 2007, S&P continued to assign and confirm ratings for CDOs exposed to significant amounts of subprime RMBS tranches rated BBB and below. In sum, S&P took these RMBS ratings at face value as inputs for its analytical model and did nothing to account for the fact that many of the underlying RMBS tranches would almost certainly be downgraded. S&P engaged in this conduct in part because it wanted to maximize its revenue and continue to please its CDO issuer clients.

120. This conduct is yet another example of how S&P's internal business decisions – motivated by its desire to achieve or maintain revenue and market share goals – corrupted its analytic judgment and directly contradicted S&P's Code and other public representations about maintaining independence and objectivity in its analysis of structured finance securities.

COUNT I

MISREPRESENTATIONS AND KNOWING OMISSIONS OF MATERIAL FACT BY DEFENDANTS IN VIOLATION OF THE CFA

121. Plaintiffs repeat and reallege the allegations contained in paragraphs 1 through 120 above as if more fully set forth herein.

122. The CFA prohibits:

> The act, use or employment by any person of any unconscionable commercial practice, deception, fraud, false pretense, false promise, misrepresentation, or the knowing[ ] concealment, suppression, or omission of any material fact with intent that others rely upon such concealment, suppression or omission, in connection with the sale or advertisement of any merchandise . . . .
>
> [N.J.S.A. 56:8-2.]

123. The CFA defines "merchandise" as including "any objects, wares, goods, commodities, services or anything offered, directly or indirectly to the public for sale." N.J.S.A. 56:8-1(c). The "services" provided by S & P in providing purportedly independent and objective ratings of structured finance securities, and the ratings themselves, were "merchandise" within the meaning of the CFA.

124. In issuing credit ratings that were not independent and objective, S&P has engaged in misrepresentations and knowing omissions of material fact.

125. S&P's has made misrepresentations including, but not limited to:

a. That S&P and its business models were independent, objective and free of influence from those paying for the ratings;

b. That S&P dealt fairly and honestly with the public, including the consumers of New Jersey;

c. That S&P operated its business in conformance with the IOSCO Code;

d. That S&P adequately managed conflicts of interests created by the "issuer pays" business model to ensure that its credit ratings are purely a function of credit analytics; and

e. That S&P allocated sufficient resources to its surveillance activities in order to ensure that the ratings assigned by S&P continue to reflect S&P's assessment of the credit risk associated with the obligations.

126. S&P engaged in knowing omissions of material fact including, but not limited to:

a. That S&P had a conflict of interest when rating RMBS and CDOs that corrupted its ratings; and

b. That S&P was influenced by its desire to please repeat, issuer clients, increase market share, and enhance revenue.

127. Each misrepresentation and/or knowing omission of material fact by S&P constitutes a separate violation under the CFA, N.J.S.A. 56:8-2.

COUNT II

UNCONSCIONABLE COMMERCIAL PRACTICES BY DEFENDANTS IN VIOLATION OF THE CFA

128. Plaintiffs repeat and reallege the allegations contained in paragraphs 1 through 127 above as if more fully set forth herein.

129. S&P's affirmative misrepresentations about its ratings services and deception of the structured finance markets, its failure to disclose material facts to market participants, and its sacrificing of its independence and objectivity for business considerations, as alleged herein, constituted unconscionable commercial practices that were pervasive throughout S&P's RMBS and CDO ratings business.

130. Each unconscionable commercial practice by S&P constitutes a separate violation under the CFA, N.J.S.A. 56:8-2.

COUNT III

MISREPRESENTATIONS AND KNOWING OMISSIONS OF MATERIAL FACT BY DEFENDANTS IN VIOLATION OF THE ADVERTISING REGULATIONS

131. Plaintiffs repeat and reallege the allegations contained in paragraphs 1 through 130 above as if more fully set forth herein.

132. The Advertising Regulations, among other things, govern general advertising practices.

133. Specifically, the Advertising Regulations provide, in relevant part:

> (a) Without limiting the application of N.J.S.A. 56:8-1 et seq., the following practices shall be unlawful with respect to all advertisements:
>
> . . . .
>
> 9. The making of false or misleading representations of facts concerning the reasons for, existence or amounts of price reductions, the nature of an offering or the quantity of advertised merchandise available for sale.
>
> [N.J.A.C. 13:45A-9.2(a)(9).]

134. S&P violated the Advertising Regulations by making false and misleading representations of fact through its web site and other public statements, including, but not limited to:

a. That S&P and its business models were independent, objective and free of influence from those paying for the ratings;

b. That S&P dealt fairly and honestly with the public, including the consumers of New Jersey;

c. That S&P operated its business in conformance with the IOSCO Code;

d. That S&P adequately managed conflicts of interests created by the "issuer pays" business model to ensure that its credit ratings are purely a function of credit analytics; and

e. That S&P allocated sufficient resources to its surveillance activities in order to ensure that the ratings assigned by S&P continue to reflect S&P's assessment of the credit risk associated with the obligations.

135. Each violation of the Advertising Regulations by S&P constitutes a per se violation of the CFA.

PRAYER FOR RELIEF

WHEREFORE, based upon the foregoing allegations, Plaintiffs respectfully request that the Court enter judgment against S&P as follows:

a. Finding that the acts and omissions of Defendants constitute multiple instances of unlawful practices in violation of the CFA, N.J.S.A. 56:8-1 et seq., and the regulations promulgated thereunder, specifically the Advertising Regulations, N.J.A.C. 13:45A-9.1 et seq.;

b. Permanently enjoining Defendants and their owners, officers, directors, shareholders, founders, managers, agents, servants, employees, representatives, independent contractors and all other persons or entities directly under their control, from engaging in, continuing to engage in, or doing any acts or practices in violation of the CFA, N.J.S.A. 56:8-1 et seq., and the regulations promulgated thereunder, specifically the Advertising Regulations, N.J.A.C. 13:45A-9.1 et seq., including, but not limited to, the acts and practices alleged in this Complaint;

c. Ordering Defendants to submit to an accounting to determine the amount of improper fees and revenue paid to S&P as a result of any acts or practices in violation of the CFA, N.J.S.A. 56:8-1 et seq., and the Advertising Regulations, N.J.A.C. 13:45A-9.1 et seq., including, but not limited to, the acts and practices alleged in this Complaint;

d. Ordering Defendants to disgorge all funds and property (real and personal) acquired and/or retained as a result of any acts or practices in violation of the CFA, N.J.S.A. 56:8-1 et seq., and the Advertising Regulations,

N.J.A.C. 13:45A-9.1 et seq., including, but not limited to, the acts and practices alleged in this Complaint;

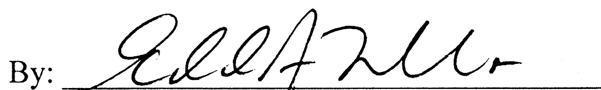
e. Directing Defendants, jointly and severally, to restore to any affected person, whether or not named in this Complaint, any money or real or personal property acquired by means of any alleged practice herein to be unlawful and found to be unlawful, as authorized by the CFA, N.J.S.A. 56:8-8;

f. Assessing the maximum statutory civil penalties against Defendants, jointly and severally, for each and every violation of the CFA, in accordance with N.J.S.A. 56:8-13;

g. Directing the assessment of costs and fees, including attorneys' fees, against Defendants, jointly and severally, for the use of the State of New Jersey, as authorized by the CFA, N.J.S.A. 56:8-11 and 56:8-19; and

h. Granting such other relief as the interests of justice may require.

JOHN J. HOFFMAN
ACTING ATTORNEY GENERAL OF NEW JERSEY
Attorney for Plaintiffs

By: 

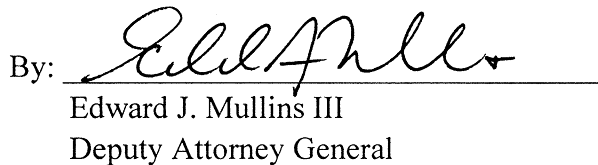
Brian F. McDonough
Assistant Attorney General
Edward J. Mullins III
Deputy Attorney General
Steven Scutti
Krima D. Shah
Special Deputy Attorneys General

Dated: October 9, 2013

RULE 4:5-1 CERTIFICATION

I certify, to the best of my information and belief, that the matter in controversy in this action involving the aforementioned violations of the Consumer Fraud Act, is not the subject of any other action pending in any other court of this State. I further certify, to the best of my information and belief, that the matter in controversy in this action is not the subject of a pending arbitration proceeding in this State, nor is any other action or arbitration proceeding contemplated.

JOHN J. HOFFMAN
ACTING ATTORNEY GENERAL OF NEW JERSEY
Attorney for Plaintiffs

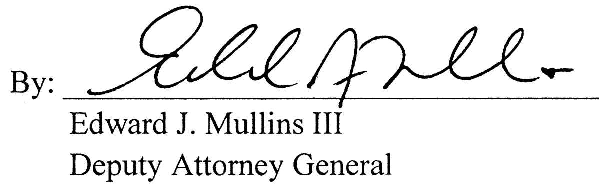
By: 
Edward J. Mullins III
Deputy Attorney General

Dated: October 9, 2013

RULE 1:38-7(c) CERTIFICATION OF COMPLIANCE

I certify that confidential personal identifiers have been redacted from documents now submitted to the court, and will be redacted from all documents submitted in the future in accordance with R. 1:38-7(b).

JOHN J. HOFFMAN
ACTING ATTORNEY GENERAL OF NEW JERSEY
Attorney for Plaintiffs

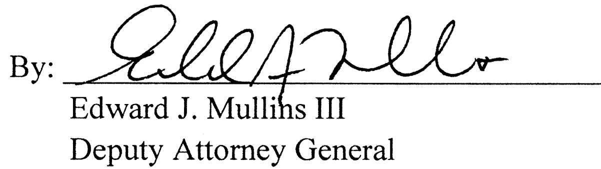
By: 
Edward J. Mullins III
Deputy Attorney General

Dated: October 9, 2013

DESIGNATION OF TRIAL COUNSEL

Pursuant to R. 4:25-4, Assistant Attorney General Brian F. McDonough and Deputy Attorney General Edward J. Mullins III are hereby designated as trial counsel for the Plaintiffs in this action.

JOHN J. HOFFMAN
ACTING ATTORNEY GENERAL OF NEW JERSEY
Attorney for Plaintiffs

By: 
Edward J. Mullins III
Deputy Attorney General

Dated: October 9, 2013