RETURN DATE: AUGUST 19, 2008

STATE OF CONNECTICUT	:	SUPERIOR COURT
Plaintiff,	:	JUDICIAL DISTRICT OF HARTFORD AT HARTFORD
v.	:	
MOODY'S CORPORATION	:	
Defendant.	:	JULY 30, 2008

COMPLAINT

I. SUMMARY OF THE CASE

1. This lawsuit seeks redress for Moody's Corporation's ("Moody's") unfair, deceptive, and illegal business practice of systematically and intentionally giving lower credit ratings to the bonds issued by states, municipalities, and other public entities as compared to corporate and other forms of debt with similar or even worse rates of default.

2. This systematic underrating of bonds issued by states, municipalities, and other public entities has harmed these public bond issuers by forcing them to either purchase bond insurance to improve their credit rating or to pay higher interest costs on their lower rated bonds. These costs are ultimately borne by taxpayers and would be unnecessary if Moody's fairly rated public bonds on the same scale as corporate and other bonds and published those fair ratings in a non-deceptive manner.

3. Since 1999, Moody's own credit studies have repeatedly concluded that many common types of public bonds almost never default. For example, a 1999 Moody's study found that public bond defaults are "extremely rare" and that "general obligation bonds and essential service revenue bonds have been particularly safe investments" because "no Moody's rated issuer defaulted on any of these securities [from 1970-2000]." These findings

were confirmed by a 2002 Moody's study which found that the 10-year default rates for <u>all</u> Moody's rated municipal bonds were more than <u>30 times less</u> than for Moody's Aaa-rated corporate bonds. Based on these facts, Moody's concluded that "if municipalities were rated on the corporate scale, Moody's would likely assign Aaa ratings to the vast majority of general obligation debt issued by fiscally sound, large municipal issuers…." Moody's own conclusions were matched by similar studies done by the other two major credit rating agencies, S&P and Fitch. Moody's was fully aware of the S&P and Fitch studies.

4. Despite its own conclusions that public bonds were underrated and that many classes of public bonds essentially never default, Moody's intentionally chose not to give public bonds the higher credit ratings they deserved. Instead, Moody's continues to use a different and far more difficult rating scale for public bonds, as compared to corporate bonds, in order to justify its continued lower credit ratings on public bonds.

5. As part of this unfair practice, Moody's continues to use the very same letter grades ("Aaa," Aa," "A") to rate both public and corporate bonds in order to obscure the true credit quality of public bonds. Thus, when a bond buyer purchases similarly rated corporate and public bonds, the buyer sees only deceptively identical letter symbols that Moody's knows actually purport to represent entirely different levels of credit risk and to measure entirely different things.

6. Moody's chose to unfairly underrate public bonds and to deceptively label its credit ratings not because it disbelieved its own data, but because it wanted to protect the marketability of its own credit ratings and to please sophisticated investors. Moreover, Moody's acted with the full knowledge that its underrating of public bonds would increase the demand for and cost of bond insurance that Moody's own studies demonstrated was typically

unnecessary and even harmful to a public bond's credit quality. Moody's was not concerned about what it knew to be more accurate and fair ratings, it was concerned about whether use of those fair and accurate ratings would be good for its bottom line.

7. Moody's unfair, deceptive and illegal business practices have cost the State of Connecticut and every Connecticut city, town and school district millions of dollars in inflated interest payments and unnecessary bond insurance premiums. All of these costs are ultimately borne by Connecticut taxpayers.

8. For example, from 2002 through 2008, the City of New Haven issued nine general obligation bonds backed by the full faith and credit of the City of New Haven. From 2002-2006, the City of East Hartford issued five general obligation bonds backed by the full faith and credit of the City of East Hartford. Moody's gave each of New Haven's bonds an "A3" credit rating and each of East Hartford's bonds an "A1" credit rating. As a result of Moody's deliberate underrating of public bonds, New Haven taxpayers paid a total of $2.2 million in unnecessary bond insurance premiums to receive a higher "Aaa" rating from Moody's. East Hartford taxpayers paid over $150,000 for their "Aaa" bond insurer credit rating. What Moody's did not tell the citizens of New Haven or East Hartford, however, was that they were actually paying for a "Aaa" rating from a bond insurer that Moody's own credit studies concluded was far more likely to default than was either New Haven or East Hartford.

9. Similarly, between 2003 and 2006, the Town of Bethany issued two general obligation bonds backed by the full faith and credit of the Town of Bethany. Moody's gave each of Bethany's bonds an "A1" rating. As a result of Moody's deliberate underrating of public bonds, Bethany taxpayers paid a total of over $33,000 in bond insurance premiums to receive the "Aaa" rating from Moody's. What Moody's did not tell the citizens of Bethany,

however, was that Moody's own credit studies concluded that Bethany's bonds already had an essentially zero probability of defaulting and thus bond insurance was unnecessary.

10. Inflated interest costs and unnecessary bond insurance premiums would not be required of the State of Connecticut and the many Connecticut cities, towns, school districts and other public entities that hire Moody's, if Moody's would fairly and honestly rate the credit risk of these public entities on the same scale as corporate and other bonds and publish those fair ratings to bond buyers in a non-deceptive manner.

11. In pursuing these unfair, deceptive and illegal business practices, Moody's violated the Connecticut Unfair Trade Practices Act. Pursuant to Conn. Gen. Stat. § 42-110m, the Connecticut Attorney General, in the name of the State of Connecticut, seeks restitution, disgorgement, and civil penalties for the injuries suffered by the State of Connecticut and all issuers of public debt in Connecticut, as well as other injunctive and equitable relief to prevent these unfair, deceptive and illegal business practices from continuing.

II. PARTIES

12. Plaintiff State of Connecticut, represented by Richard Blumenthal, Attorney General of the State of Connecticut, brings this action in its sovereign enforcement capacity pursuant to Conn. Gen. Stat. § 42-110m at the request of Jerry Farrell, Jr., Commissioner of the Department of Consumer Protection for the State of Connecticut.

13. Moody's is divided into two business units, Moody's Investors Service and Moody's Analytics. Moody's Investors Service is the credit rating agency portion of Moody's and publishes credit ratings on a broad range of bonds issued in domestic and international financial markets. In 2007, Moody's reported total revenue of approximately

$2.3 billion worldwide and employed approximately 3,600 people. Moody's rates a very large portion of all the bonds issued in the U.S. public bond market.

14. Moody's is incorporated under the laws of the state of Delaware and maintains an office and principal place of business at 7 World Trade Center at 250 Greenwich Street, New York, New York.

15. Moody's regularly transacts business in the State of Connecticut and derives substantial revenue from its business within the State of Connecticut. From 1998 through 2008, Moody's provided over 345 credit ratings to at least 85 Connecticut cities and towns. Moody's also rates the many public bonds issued by the State of Connecticut.

16. In 2007, Moody's took in approximately $221 million for its rating of public bonds. In the first quarter of 2008, Moody's took in approximately $56 million in revenue for its rating of public bonds.

III. THE MUNICIPAL BOND MARKET

17. The municipal bond market consists of the issuers who issue public bonds and the buyers who purchase public bonds. Issuers of public bonds are states, like Connecticut, as well as large cities, small towns, school districts, sewer districts, housing authorities, airport authorities and many other publicly chartered or public purpose entities. Buyers of public bonds are banks or other lenders that buy a bond when it is first issued, as well as many individual and institutional investors that trade or sell public bonds in the secondary bond market.

18. A public bond is simply a loan to a public entity. Public entities issue bonds to raise funds to pay for a variety of essential government functions like construction or improvement of schools, roads, sewer and water systems, airports, and other public projects

and financial needs. Just like other loans, the cost of paying back the principal and interest on a public bond is paid for by the public entity that issued the bond. That means states, municipalities, school districts, sewer districts and other public entities pay back the principal and interest on the bond in accordance with a schedule set out in the bond. These costs are ultimately borne by taxpayers in the form of taxes and fees.

19. Once a bond is issued, it may be held by the buyer (usually a bank or other lender) who made the original loan, or the bond may be sold into the secondary market. Both the original buyer and any subsequent buyers in the secondary market, buy and sell public bonds depending in material part on the risk that the issuer will not pay back the bond.

20. A buyer of a bond will charge a higher interest rate on the bond the more likely it is that the bond issuer will not pay back the loan. A higher interest rate compensates the buyer for the higher risk it undertakes in making a more risky loan.

21. A critical and material part of a buyer's assessment of the risk associated with a bond, and therefore the interest rate the buyer will charge the issuer for the loan, is the bond's credit rating. Moody's is well aware of this fact. For example, a 1999 Moody's report on its ratings methodology represents that "Moody's ratings are intended to provide [bond buyers] with a framework for comparing the credit quality of debt securities." There are many bond buyers in Connecticut, including, *inter alia*, banks, insurance companies, hedge funds and individuals.

22. The credit rating market is extremely concentrated. The three major credit rating agencies, Moody's, Standard & Poor's ("S&P"), and Fitch, Inc. ("Fitch"), together issue credit ratings on essentially 100% of the public bonds issued in the United States.

23. Failure to receive a credit rating from one or more of the three major credit rating agencies typically leads to a public bond receiving either a very high interest rate or not being bought at all. Therefore, most public bond issuers are forced to seek a credit rating from one or more of the three major credit rating agencies in order to issue their public bonds at some reasonable interest rate.

24. Moody's is well aware that public bonds are extremely secure investments. Indeed, a June 2002 Moody's study stated that for "the period covering 1970-2000, the one year, issuer-weighted average default rate for all Moody's rated municipal issuers – regardless of their rating level – [was] just .01% versus 1.30% for all corporate issuers." In other words, as early as 2002 Moody's own documents established that municipal bonds are 130 times less likely to default on average during their first year than their corporate bond counterparts.

25. Public bonds rarely default because of the fundamental nature of governments. Governments typically have broad taxing power that ensures that they can meet their bond payments. Governments are not subject to economic competition as businesses are. Governments do not go out of business and frequently are legally prohibited from filing for bankruptcy. Moreover, many cites, towns, and other public entities effectively are supported by higher levels of government that can and do provide necessary funding to prevent any defaults. These facts are known to Moody's and are reflected in Moody's credit studies.

26. From 1998 to 2008, the State of Connecticut issued multiple bonds totaling over $15 billion. From 1998 to 2008, over one hundred Connecticut cities and towns issued over $8 billion in bonds to pay for the types of necessary government projects identified above.

27. Despite never having defaulted on any bond obligation, the State of Connecticut has been rated in the "Aa" range by Moody's for many years. Most Connecticut municipalities have also been rated by Moody's in the "Aa" and "A" range, even though no Connecticut municipalities have defaulted on a bond obligation and would likely be rated "Aaa" if judged on the same scale as corporate bonds with equal probabilities of default.

28. Approximately 50% of the buyers in the public bond markets are individual investors and consumers. In many cases, individual buyers are less sophisticated than institutional buyers like investment banks or mutual fund companies. Institutional buyers frequently have the resources to do their own credit analysis on a bond. Individual buyers frequently do not have either the resources or expertise to do their own credit analysis on a bond.

29. Individual public bond buyers rely heavily on the credit ratings provided by Moody's and the other credit rating agencies when making a decision to purchase a public bond. Indeed, Moody's credit rating of a public bond is a significant and material factor in any bond buyer's decision whether to buy a public bond and what price to pay for that bond. Moody's is aware of public bond buyers' use and reliance on Moody's credit ratings.

IV. MOODY'S ROLE IN THE MUNICIPAL BOND MARKET

30. Moody's represents that its credit ratings provide a fair and honest assessment of five basic factors in determining its public bond credit ratings: economy, finances, debt, governance/management strategies, and the bond's structure. Moody's represents that "each of these factors is evaluated individually and for its effect on the other factors in the context of the municipality's ability to repay its debt."

31. To provide its credit ratings, Moody's charges the issuer a fee based on the size and complexity of the bond being issued. In return for the fee paid by the issuer, Moody's provides the issuer with a letter grade credit rating and makes that letter grade credit rating available to the public on its website.

32. Moody's represents to public bond issuers that its public bond credit ratings will be based on an analysis of facts. Before Moody's issues a credit rating, it meets with a public issuer to gather information on the issuer's financial status. Moody's discusses any questions it might have with employees of the issuer and allows the issuer to ask Moody's analysts questions. Moody's issues ratings through a credit committee that discusses the individual merits of an issuer's credit profile and reaches a consensus on an appropriate rating. Moody's provides an appeals process if the issuer believes Moody's credit rating is wrong.

33. Moody's credit ratings, like the other major credit rating agencies, have long been expressed in the form of a letter grade. According to its ratings definitions, Moody's letter grades are expressed in relative rank order, with a bond rated "Aaa" by Moody's having the "strongest creditworthiness," and a bond rated "Aa" by Moody's demonstrating "very strong creditworthiness." Bonds rated "A," "Baa," "Ba," "B," "Caa," "Ca," and "C" are represented by Moody's to have progressively less creditworthiness with each succeeding reduction in grade level.

34. Moody's also appends numerical modifiers of "1," "2," and "3" to each generic rating category from "Aa" through "Caa." The modifier "1" indicates that the issuer or obligation ranks in the higher end of Moody's generic rating category, while the modifier

"2" indicates a mid-range ranking and the modifier "3" indicates a ranking in the lower end of that generic rating category.

35. Through its relative letter ranking system, Moody's intentionally, but deceptively, represents that bonds rated "Aaa" have less chance of nonpayment than bonds rated "Aa," that bonds rated "Aa" have less chance of nonpayment than bonds rated "A," and so on down Moody's rating scale.

36. A public bond issuer will often obtain ratings from two or three of the different credit rating agencies. The ratings of the credit agencies generally correlate with each other, such that a bond rated "Aaa" by Moody's will typically carry an identical or very similar rating by S&P and Fitch.

37. A bond's letter grade credit rating has a significant impact on the interest rate the issuer pays the buyer in order to sell the bond to the buyer. Thus, a bond rated "Aaa" by Moody's generally carries a lower interest rate than a bond rated "Aa" by Moody's. A bond rated "Aa" by Moody's generally carries a lower interest rate than a bond rated "A" by Moody's, and so on down Moody's letter rating scale. This means that a state, city, town, school district or other public issuer that issues a bond rated "A" by Moody's will pay a higher interest rate and higher debt service costs than the same or similar bond rated "Aaa" by Moody's.

38. To avoid the higher cost of a higher interest rate, public issuers rated below "AAA" by Moody's can improve the rating their bonds receive by purchasing insurance from one of the major bond insurance companies, such as MBIA or Ambac. States, including Connecticut, and other public issuers, including Connecticut cities and towns, are forced to buy bond insurance because Moody's uses the same alphanumeric symbols to rate public and

corporate credit risk and therefore Moody's intentionally and knowingly creates the misrepresentation that bond insurers' credit ratings are comparable to public issuers' credit ratings. Approximately one half of the public bonds issued are issued with bond insurance.

39. Bond insurers guarantee the repayment of the bond in the rare event that a state, town, or school district defaults on its bonds. Because until very recently most major bond insurers were given "Aaa" credit ratings by Moody's, the practical effect of a public issuer purchasing bond insurance was to transfer the bond insurer's "Aaa" credit rating to the public issuer's bond. Thus, if a public issuer received an "A" credit rating from Moody's, that issuer might purchase bond insurance and thereby improve the credit rating of its bond to "Aaa." This increase would allow the public issuer's bond to receive the lower interest rate associated with a "Aaa" credit rating, but with the added cost of the bond insurance premium. Moody's is aware of this process and the essential part its credit ratings play in the process.

40. Because of the direct effect of Moody's credit rating on the interest rate charged on public bonds, it is critical that bond insurers receive a "Aaa" rating from Moody's. In fact, a July 2006 Moody's report concluded that "because ratings are so important to the [bond insurance] industry's value proposition, a highly-rated financial guarantor will likely take whatever actions are feasible to preserve its rating during times of stress." If a bond insurer's credit rating drops below "Aaa," many public bond issuers would receive little or no benefit from purchasing bond insurance because the bond insurer's credit rating would be little or no better than the issuer's own credit rating. Bond insurers' use of their credit ratings to sell their insurance helps perpetuate and elevate the importance of Moody's credit ratings in the bond market.

41. What Moody's did not tell many public bond issuers or buyers, however, was that Moody's knew the bond insurer's true credit risk was already no better, or, in many cases, much worse than the public issuer purchasing bond insurance.

42. Moody's rates bond insurers such as MBIA or Ambac using the same alphanumeric symbols that Moody's uses to rate public bonds. When applied to a bond insurer, however, these symbols actually mean something vastly different because bond insurers are rated on Moody's much more lenient corporate scale, not Moody's more stringent "municipal" scale used for public issuers. Thus, when a public issuer with an "A" rating from Moody's purchased bond insurance from an insurer with a deceptive and seemingly better "Aaa" rating from Moody's, the public issuer was actually purchasing a credit rating that Moody's knew from its own studies was as much as <u>15 times</u> more likely to default on the bond.

43. Making matters more harmful and unfair still to public bond issuers is how Moody's calculated the credit risk associated with bond insurers. A key component of a bond insurer's credit rating is Moody's assessment of the bond insurer's ability to pay claims on defaulted bonds. A key component in assessing a bond insurer's ability to pay claims is Moody's assumption of how often public bonds will default, thus requiring a payment by the bond insurer.

44. When assuming how often public bonds will default to assess a bond insurer's ability to pay claims, Moody's chooses to recognize its public bond default study findings by assuming that public bonds would default at rates as much as three times less than similarly rated corporate bonds. This Moody's practice has the direct effect of increasing the amount of insurance that a bond insurer can issue (because less money needs to be reserved when

claims are unlikely to be made) while at the same time propping-up the bond insurer's critical "Aaa" Moody's credit rating.

45. By contrast, when deciding what credit ratings to give public bond issuers, Moody's intentionally and unfairly ignored its own public bond default study findings by not increasing public bond issuer credit ratings based on their demonstrated lack of defaults. Instead, Moody's chose to rate public bond issuers on a different, more stringent rating scale, while at the same time using the same letter symbols as used for corporate bonds. The direct effect of this Moody's policy, as Moody's well knew, was to artificially depress public bond ratings, artificially increase bond insurer ratings, and thereby artificially increase the market for bond insurance. As one executive for a leading bond insurer wrote in an internal email in 2006, "Moody's is **already** giving us capital treatment for Munis AS IF they [the public issuer] were given the higher corporate rating – that's the good news," but if Moody's were to "actually make the rating change, premiums may suffer – that's the bad news." (emphasis in original).

46. Put simply, Moody's intentionally and unfairly gave the benefit of public bond issuers' good credit history to the bond insurers knowing full well that the bond insurers were going to turn around and effectively sell that good credit history back to the public bond issuers for the price of the insurance premium. As one industry analyst complained to Moody's in December of 2007, "the insurers [are] largely an expensive vehicle for translating muni ratings onto the corporate scale; were munis not already Aaa-level risks, the insurers would never be allowed to keep their own Aaas with such minimal capital levels."

V. MOODY'S UNFAIRLY UNDERRATES PUBLIC BONDS AND DECEPTIVELY LABELS ITS PUBLIC BOND RATINGS

47. For nearly a decade, Moody's has known that public bonds have much lower default rates than corporate bonds with similar ratings. Moody's also knows that its public bond ratings are on a different, more stringent scale and purport to measure a different metric than Moody's corporate bond ratings. Despite these facts, Moody's continues to unfairly and deceptively issue public bond ratings using the exact same letter symbols as Moody's corporate bonds. Moody's deliberately engages in this unfair and deceptive business practice to obscure the true credit quality of public bond issuers. As one Moody's executive conceded in an August 31, 2006 email: "I think there is clearly a mismatch between the default data and people's perception of the risk associated with municipal credits." Moody's also deliberately engages in this unfair and deceptive business practice to please some investors and market participants, such as bond insurers, and to maintain the importance, and therefore marketability, of Moody's own credit ratings.

48. In August of 1999, Moody's published a report entitled "The Evolving Meaning of Moody's Bond Ratings," which stated that "compared to the corporate bond default experience, post-War municipal bond defaults have been extremely rare and recoveries in the event of default have been quite high." The Moody's 1999 report also concluded that, "[s]eparate rating systems with different implied expected loss levels may increasingly lead to suboptimal investment decisions in the future by market participants investing in multiple asset classes, and the risks of rating and regulatory arbitrage are rising." In other words, Moody's recognized that a dual rating scale would confuse bond buyers and lead them to make different purchasing decisions than they otherwise would make.

49. In the fall of 1999, Fitch published a default study of public debt which concluded that public bonds default far less often than corporate bonds with similar or higher credit ratings. Moody's was aware of the Fitch study.

50. In or about 2000, Moody's began a study of the default rates of over 82,000 Moody's rated public bonds issued by nearly 29,000 separate public bond issuers from 1970 through 2000.

51. In July of 2001, S&P published a public bond default study which found that public bonds default at much lower rates than corporate bonds of similar or higher credit ratings. S&P published at least six subsequent default studies on public bonds from April 2004 through May of 2008. Each of these S&P studies reached the same conclusion as S&P's July 2001 study. Moody's was aware of all of the S&P studies.

52. In June of 2002, Moody's published the "highlight" results from its own default study that Moody's began in 2000. Moody's found that for "the period covering 1970-2000, the one year, issuer-weighted average default rate for all Moody's rated municipal issuers – regardless of their rating level – is just .01% versus 1.30% for all corporate issuers." In other words, for the study period, Moody's found that public bonds were on average <u>130 times less</u> likely to default than corporate bonds during the first year after issuance. The Moody's study also found that the default rate for "Aa" rated public bonds was approximately <u>5 times less</u> than "Aa" rated corporate bonds five, ten and 15 years after the bonds were issued.

53. Despite knowing these facts, Moody's did not upgrade its public bond ratings. Instead, according to Moody's June 2002 "highlight" document, Moody's "decided to retain its existing municipal rating scale for tax-backed and essential revenue backed bonds – by far

the largest segments of the municipal market in terms of number and dollar volume of ratings."

54. In November of 2002, Moody's published the final version of its public bond default study. The Moody's study concluded that "the 1, 5, and 10-year cumulative default rates for <u>all</u> Moody's rated municipal bond issuers have been .0043%, .0233%, and .0420%, respectively compared to .0000%, .1237%, and .6750% for <u>Aaa-rated</u> corporate bonds during the same time period" (emphasis in original). In other words, Moody's concluded that public bonds as a group, even when including public bonds with low credit ratings, have lower default rates on average than the highest, "Aaa" rated corporate bonds. Moody's also found that "[general obligation] bonds and essential service revenue bonds have been particularly safe investments" because "no Moody's rated issuer defaulted on any of these securities during the sample period."

55. Finally, when comparing public bond ratings to corporate ratings, Moody's November 2002 study reported that "if municipalities were rated on the corporate scale, Moody's would likely assign Aaa ratings to the vast majority of general obligation debt issued by fiscally sound, large municipal issuers," and that "Aaa ratings would likely be assigned to the bulk of the senior obligations issued by large, fiscally sound municipal providers of essential services." Despite these unmistakable conclusions, Moody's intentionally maintained its lower rating scale for public bonds and continued giving public bonds the same letter ratings as corporate bonds, even though Moody's November 2002 report acknowledged that "municipal rating symbols have different meanings" as compared to corporate bond rating symbols.

56. Moody's purports that its corporate bond ratings measure a bond's "expected loss" which Moody's states is the sum of the probability that a corporate bond will default, multiplied by the amount, or size, of the loss on the corporate bond once a default occurs. By contrast, Moody's so-called "municipal scale" credit rating is purported to measure, according to Moody's, an entirely different metric. Moody's represents that its public bond ratings are intended to measure a bond's "distance to distress," i.e., how likely it is that a public bond issuer will need some kind of support from another entity, such as a higher level of government, or voter approved tax hikes, in order to avoid a default.

57. Despite this acknowledged difference in the meaning of the ratings on its municipal and corporate rating scales, Moody's refused to provide different rating symbols for its corporate and public bond ratings. This decision is in marked contrast to Moody's overall practice of using different symbols to distinguish between ratings that have different meanings. Indeed, Moody's publishes six different ratings symbols to rate different types of bonds and market participants in order to alert consumers of Moody's ratings that the rating in question means something different than its standard rating symbols of "Aaa," "Aa," "A," etc.

58. For example, Moody's attaches a subscript to its national scale long term ratings to differentiate it from its standard global rating scale and to signify the country that is involved in the bond issuance (i.e., Aaa.br for Brazil or Aaa.tw for Taiwan.) Similarly, Moody's differentiates its bank financial strength ratings from its global scale by using only five letter symbols, ranging from "A" to "E."

59. By contrast, despite the fact that the symbols purport to represent entirely different assessments of credit risk, Moody's municipal ratings, corporate ratings, structured

finance ratings, and insurance financial strength ratings all utilize the identical alphanumeric symbols of "Aaa," "Aa," "A," etc.

60. Additionally, Moody's opaque description of what its public bond rating actually measures has added to the confusion and deception created by its public bond credit ratings being expressed with the same alphanumeric symbols as its corporate bond ratings. Moody's has used the following key terms to describe what its public bond credit rating measures: "creditworthiness," "credit risk," "ability to repay debt," "default probability," "intrinsic financial strength of an entity," "investment quality," "intrinsic ability and willingness of an entity to pay its debt service," and, most recently, "distance to distress." Moody's represents that none these terms change what Moody's public bond rating scale actually measures. None of the above terms, however, have any clear meaning on their own.

61. Moody's changing and opaque description of what its public bond ratings purportedly measure, coupled with its decision to maintain the same rating symbols across both its public and corporate bond rating scales, confuses and misleads public bond issuers and buyers. Because Moody's public and corporate bond ratings are identical on their face, consumers of Moody's ratings quite reasonably assume they mean the same thing.

62. In April of 2003, Moody's published a "special comment" announcing that – for an additional fee – Moody's would offer corporate scale ratings on a very limited number of public bonds. Moody's offered these so-called "Corporate Equivalent Ratings" under such extremely restrictive criteria that from 2003 through 2007, Moody's issued only seven of these ratings.

63. In June 2003, Fitch published an update of its 1999 default study. Fitch's 2003 study again concluded that public bonds default far less than corporate bonds. Moody's was aware of the Fitch study.

64. In February of 2005, Moody's produced a draft copy of a second public bond default study focusing on public "enterprise" bonds which are used to fund such projects as airports, hospitals, housing projects, transportation projects, and universities. Although such public enterprise bonds were thought to be more risky and therefore comparable to corporate bonds, the Moody's study concluded that public enterprise bonds are as much as <u>4 times less</u> likely to default than Moody's highest rated "Aaa" corporate bonds. This Moody's study was never made public.

65. In September of 2005, Moody's own employees recognized that it was confusing to consumers to give the same rating symbol to bonds rated on different scales and with different meanings. To alleviate this problem, a top Moody's public bond analyst requested that Moody's provide a "flag," much like Moody's does on other credit ratings it issues, that would differentiate between the two rating scales:

> Moody's rates transactions on either the Municipal Scale or the Corporate Scale using the same alphanumeric scale (Aaa-C). Within the tax-exempt market there are transactions rated based on entities rated on the corporate scale (insured deals, bank-supported deals ....) Currently there is not a way to identify in our systems – either internally or externally – which scale a particular rating is on.
>
> ....
>
> To provide transparency on this issue, the [Public Finance Group] is recommending that a field be added to our systems that will identify transactions rated on the municipal scale. This "flag" would travel with the Moody's rating on the related transaction and be displayed on our products....
>
> ...

> The clear identification of Moody's ratings that have been rated on the municipal scale is critical. Without a "flag", users of our ratings may not know what scale a rating is on and this could understate credit risk if the user thought the rating was on the municipal scale when it was based on the corporate scale ….

66. Moody's overruled its employees' recommendations and refused to provide the necessary funding to implement a "flag" to differentiate between public bond and corporate bond ratings. Moody's continued to issue ratings on public bonds with the same letter grades as corporate bonds even though the bonds were rated on different scales and the rating symbols represented entirely different measurements.

67. In the beginning of 2006, Moody's began internal deliberations over whether it should offer corporate scale ratings for all public bonds. Moody's drafted a request for comment asking for comments on "should Moody's … assign corporate equivalent ratings to U.S. municipal obligations in all sectors …." Moody's sent this draft request for comment to prominent bond insurers. Moody's did not send its draft request for comment to other market participants or to any public bond issuers.

68. Bond insurers immediately recognized that a Moody's decision to rate public debt on the same scale as corporate debt would severely harm their business. Wrote one bond insurer executive "[d]id we know this was coming – at first blush this looks pretty serious to me … won't higher ratings just serve to contract spreads. This is cutting at the heart of our industry given that investors buy on rating. While we in the industry might agree with the default/loss conclusion (this is in part the basis of our success and ability to leverage as high as we are), to lay it out there like this could be very detrimental." An executive at the same bond insurer agreed: "… we know that hardly anybody reads the Moody's special reports so it didn't matter. However, if they actually assign the higher ratings, that's a totally different story …"

69. To prevent Moody's from offering public bond ratings equal to corporate bond ratings, several bond insurers agreed to organize a coordinated industry response to Moody's draft proposal through the bond insurer's industry association, the Association of Financial Guarantee Insurers (AFGI). Wrote one bond insurer executive "I have contacted AFGI to see if we can draft an industry response[.] I think this is important to all, particularly if the wider applicability of this mapping leads to contracted spreads in the muni market."

70. On May 10, 2006, the top executives of two leading bond insurers met with Moody's top public finance analysts to express the bond insurance industry's concerns over Moody's proposal to assign credit ratings to public bonds on a corporate scale. After the meeting, one bond insurer executive wrote "Mtg. went well … we were preaching to choir."

71. In June 2006, Moody's publicly released its request for comment on assigning corporate scale ratings to public bonds. The public version of Moody's request for comment dropped any reference to assigning "corporate equivalent ratings to U.S. municipal obligations in all sectors" and instead sought comment only on offering corporate equivalent ratings to taxable public bonds sold in the United States – a relatively small portion of the public bond market. Also added to the Moody's request for comment was the possibility of eliminating the assignment of corporate equivalent ratings altogether. All of these changes in Moody's request for comment were made at the request of the bond insurers.

72. Section 2.1 of the June 2005 Moody's Code of Professional Conduct, states that "Moody's will not forbear or refrain from taking a Credit Rating action based on the potential effect (economic, political, or otherwise) of the action on Moody's, an Issuer, an investor, or other market participant." Section 2.3 of Moody's Code of Conduct states that

"[t]he determination of a Credit Rating will be influenced only by factors relevant to the credit assessment."

73. Moody's final June 2006 request for comment restated Moody's long held conclusion that "[s]ince 1970, defaults of municipal bonds have been rare. Even the riskiest municipal sectors have extremely low default rates for investment grade credits – lower on average than Aaa-rated corporate bonds." The Moody's request for comment also noted that "[m]unicipalities in severe financial distress usually receive some form of extraordinary support from another entity prior to a payment default. The Gulf Coast communities most severely affected by Hurricane Katrina provide a recent illustration of the occurrence of extraordinary support. Many of these municipalities are likely to avoid default because they have received, or will receive, extraordinary assistance from federal or state levels of government."

74. During the summer and fall of 2006, Moody's again considered adding a "flag" to its public bond ratings because of the inherent confusion among bond buyers and issuers created by using the same letter grade credit rating on public and corporate bonds. For example, on July 13, 2006, one Moody's executive commented "[i]n the feedback we've received so far on the muni scale proposal, one of the recurring themes is concern about confusion between the municipal and corporate scale ratings. . . . I think we need to revisit the concept of adding a field to moodys.com indicating which ratings are on the municipal scale."

75. Moody's again overruled its employees' recommendations and refused to provide the necessary funding to provide a "flag" on Moody's public bond ratings. One of the reasons Moody's chose not to implement the "flag" project was the fact that many public

bond buyers' investment guidelines reference Moody's public bond ratings without the "flag" and Moody's "didn't want to have them re-open their prospectuses because for the most part we now have a favored status in investment requirements."

76. In March of 2007, Moody's formally announced its intention to give corporate scale credit ratings to public bonds, but only to a relatively limited class of taxable public bonds. In announcing its intention to provide these additional ratings, Moody's said that "[t]o minimize the potential for confusion between Moody's U.S. municipal scale ratings and [corporate] scale ratings, we intend to implement a "U.S. municipal scale flag" that we will attach to all ratings on the municipal scale. With such a flag in place, market participants will be able to assume that any rating that does not display the flag is rated on the [corporate] scale."

77. Further acknowledging the confusion as to exactly which kinds of bonds were rated on which of Moody's very different rating scales, Moody's went on to state that some "[t]ax-exempt [public] bonds [] have historically been rated on the [corporate] scale, including bonds supported by financial guarantors, letter of credit banks and other corporate guarantors, as well as certain housing, student loan and tobacco settlement bonds" and so will not display the municipal scale flag. But then again, Moody's noted that "[o]ur short term municipal ratings … are already calibrated to the [corporate] scale" and so these apparently public issuer ratings will not display the municipal flag.

78. To date, Moody's has never attached a "flag" to its bond ratings to distinguish which of its public or corporate bond ratings are on which scale and measure which metric. Instead, Moody's continues to unfairly underrate public bonds that it knows have much lower credit risk than similarly or even higher rated corporate bonds, and label public and corporate

bonds with the same letter credit rating grades despite the fact that the letter grades are purported by Moody's to convey entirely different information.

79. Finally, Moody's March of 2007 formal announcement stated that corporate scale ratings would not be extended to general obligation tax exempt public bonds, thus ensuring that these public bonds would continue to be underrated by Moody's. Moody's made this decision for the following reason: "Because many municipal investors and issuers place a high value on the fine gradations of risk provided by the municipal rating scale, Moody's will continue to use this scale for our core U.S. municipal ratings." Moody's never told public bond issuers or buyers that its credit ratings were based in part on Moody's desire to avoided ratings "compression," to prop-up the bond insurance industry, or to cater to sophisticated bond investors wanting to trade on Moody's created, false differences in a public bond issuer's creditworthiness.

VI. CAUSES OF ACTION

First Count: Breach of the Connecticut Unfair Trade Practices Act (Conn. Gen. Stat. § 42-110a et seq.)

1-79. Paragraphs 1 through 79 of the Complaint are hereby repeated and realleged as Paragraphs 1 through 79 of this First Count as if fully set forth herein.

80. At all times relevant to this Complaint, Moody's was engaged in the trade or commerce of providing credit ratings within the State of Connecticut.

81. By engaging in the acts and practices alleged herein, Moody's made or caused to be made to Connecticut consumers, directly or indirectly, explicitly or by implication, representations which are material, reasonably interpreted, false and likely to mislead, including, but not limited to, the following:

a. that corporate and public bonds with the same letter credit rating symbol had similar levels of credit risk;

b. that corporate and public bonds with the same letter credit rating symbology measured the same metric;

c. that bond insurers rated "Aaa" by Moody's were a better credit risk than public bond issuers with lower Moody's credit ratings; and

d. that public bonds with the same letter credit rating symbol had similar levels of credit risk.

82. By engaging in the acts and practices alleged herein, Moody's made omissions to Connecticut consumers that Fitch had a duty to disclose by virtue of Moody's contractual obligations to Connecticut consumers and its other representations to Connecticut consumers, including, but not limited to, the following:

a. that corporate and public bonds with the same letter credit rating symbols did not have similar levels of credit risk;

b. that bond insurers rated "Aaa" by Moody's were typically not a better credit risk than public bond issuers with lower Moody's credit ratings;

c. that public bonds with the same letter credit rating symbol did not have the same level of credit risk when the public bond was insured;

d. that not all public bond credit ratings were on the same scale and measured the same metric;

e. that Moody's public bond ratings were based in part on a desire to avoid ratings compression;

f. that Moody's public bond ratings were based in part on the preferences of investors and other market participants, like bond insurers; and

g. that Moody's public bond ratings were based in part on a desire to promote Moody's economic interests.

83. Moody's acts and practices regarding Connecticut consumers as alleged herein are unfair, oppressive or unscrupulous and violated the public policy of the State of Connecticut, including, but not limited to the public policy against:

a. misrepresenting the nature and extent of your services in business;

b. labeling products and services in a deceptive and misleading manner;

c. abusing and unfairly profiting from a dominant position in the market; and

d. wasting taxpayer resources.

84. Moody's acts and practices as alleged herein have directly and proximately caused substantial injury to consumers within the State of Connecticut.

85. Moody's knew or should have known that their conduct alleged herein violated Conn. Gen. Stat. § 42-110b.

86. Moody's acts or practices alleged herein constitute unfair or deceptive acts or practices in violation of Conn. Gen. Stat. § 42-110b.

PRAYER FOR RELIEF

WHEREFORE, the State of Connecticut requests the following relief:

1. A finding that by the acts alleged herein, Moody's engaged in unfair and deceptive acts and practices in the course of engaging in the trade or commerce of a credit rating agency within the State of Connecticut in violation of the Connecticut Unfair Trade Practices Act;

2. An injunction pursuant to Conn. Gen. Stat. § 42-110m enjoining Moody's from engaging in any acts that violate the Connecticut Unfair Trade Practices Act, including, but not limited to, the unfair and deceptive acts and practices alleged herein;

3. An order pursuant to Conn. Gen. Stat. § 42-110m requiring that Moody's submit to an accounting to determine:

    a. the amount of improper fees and revenue paid to Moody's as a result of its unfair and deceptive acts and practices;

    b. the amount Moody's unfair and deceptive acts and practices improperly increased borrowing costs for issuers of public debt in Connecticut;

4. An order pursuant to Conn. Gen. Stat. § 42-110o directing Moody's to pay a civil penalty of $5,000 for each and every willful violation of the Connecticut Unfair Trade Practices Act;

5. An order pursuant to Conn. Gen. Stat. § 42-110m directing Moody's to pay restitution to the State of Connecticut, its municipalities, and other public entities;

6. An order pursuant to Conn. Gen. Stat. § 42-110m directing Moody's to disgorge all revenues, profits, and gains achieved in whole or in part through the unfair acts or practices complained of herein;

7. An order pursuant to Conn. Gen. Stat. § 42-110m directing Moody's to pay reasonable attorneys' fees to the State of Connecticut;

8. Costs of suit; and

9. Such other relief as this Court deems just and equitable.

Plaintiff State of Connecticut hereby demands a trial by jury on all issues and causes of action so triable.

Dated at Hartford, Connecticut, this 30th day of July, 2008.

PLAINTIFF
STATE OF CONNECTICUT

By: ______________________
RICHARD BLUMENTHAL
ATTORNEY GENERAL

By: George O'Connell
Michael E. Cole
Chief, Antitrust Department
Matthew J. Budzik
Gary Becker
George W. O'Connell
Assistant Attorneys General
Antitrust Department
55 Elm Street, P.O. Box 120
Hartford, CT 06141-0120
Tel: (860) 808-5040
Fax: (860) 808-5033

RETURN DATE: AUGUST 19, 2008

STATE OF CONNECTICUT	:	SUPERIOR COURT
Plaintiff,	:	JUDICIAL DISTRICT OF HARTFORD AT HARTFORD
v.	:	
MOODY'S CORPORATION	:	
Defendant.	:	JULY 30, 2008

AMOUNT IN DEMAND

The amount, legal interest or property in demand is $15,000.00 or more, exclusive of interest and costs.

PLAINTIFF
STATE OF CONNECTICUT

RICHARD BLUMENTHAL
ATTORNEY GENERAL

BY: George O'Connell

Michael E. Cole
Chief, Antitrust Department
Matthew J. Budzik
Gary M. Becker
George W. O'Connell
Assistant Attorneys General
Antitrust Department
55 Elm Street, P.O. Box 120
Hartford, CT 06141-0120
Tel: (860) 808-5040
Fax: (860) 808-5033