RETURN DATE: MARCH 30, 2010

STATE OF CONNECTICUT	:	SUPERIOR COURT
	:	
	:	JUDICIAL DISTRICT OF HARTFORD
Plaintiff,	:	
	:	AT HARTFORD
v.	:	
	:	
MOODY'S CORPORATION and MOODY'S INVESTORS SERVICE, INC.	: :	
	:	MARCH 10, 2010
Defendants.	:	

COMPLAINT

I. SUMMARY OF THE CASE

1. This lawsuit seeks redress for Moody's Corporation's and Moody's Investors Service, Inc.'s (referred to herein collectively as "Moody's") unfair, deceptive, and illegal business practice of systematically and intentionally misrepresenting that the ratings it assigned to structured finance securities were objective, independent and not influenced by either Moody's or its clients' financial interests. These representations were untrue and Moody's knew it.

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

3. As Moody's CEO, Raymond McDaniel stated in 2005, "Moody's is committed to reinforcing among all relevant stakeholders – debt issuers, the investment community, employees, governmental authorities and shareholders – a sense of trust in the accuracy, independence and reliability of Moody's products and services, and our stewardship of the business."

4. This principle has been further emphasized by Moody's in its publicly available Code of Conduct in which Moody's explicitly pledges that its ratings on structured finance securities are objective and uninfluenced by "the potential effect . . . [of the rating] on Moody's, an issuer, an investor, or other market participants."

5. Despite this intentional and explicit representation, Moody's failed to live up to its statements of independence and objectivity when rating structured finance securities and thereby violated the trust that it successfully cultivated with the marketplace. Moreover, Moody's knew its false representations of independence and objectivity were especially misleading and harmful to participants in the structured finance securities market because structured finance securities are particularly complex and their creditworthiness is difficult, if not impossible, to evaluate even for the most sophisticated financial entities.

6. Starting in at least 2004, Moody's knowingly allowed its desire for increased revenue and market share in the structured finance ratings market to influence the rating methodologies it developed for rating structured finance securities, as well as the ratings that were ultimately assigned to these investments.

7. In particular, by at least 2004 Moody's desire to maximize revenue and market share by rating as many structured finance deals as possible led Moody's to cater to the preferences of large investment banks and other repeat issuers of structured finance securities that dominated Moody's revenue base, rather than focusing on what Moody's said it was doing, which was providing independent and objective credit analysis.

8. Thus, when formulating its rating methodologies for structured finance securities, Moody's intentionally developed a rating methodology that mirrored what its competitors were using, but which Moody's knew did not capture all the credit risk that Moody's knew existed. Moody's engaged in this conduct because it enabled Moody's to continue to assign the high ratings that Moody's frequent customers desired, thus enabling Moody's to maximize its revenue and preserve its already high market share for rating structured finance securities.

9. The reason for Moody's breach of its own standards was further explained by Moody's CEO, Raymond McDaniel, in a presentation that he made to his Board of Directors in October of 2007 when he admitted: "Analysts and MDs [managing directors] are continually pitched by bankers, issuers, investors . . . whose views can color credit judgment . . . (we drink the kool-aid). Coupled with strong internal emphasis on market share and margin focus, this does constitute a risk to ratings quality."

10. As privately acknowledged by Mr. McDaniel in October of 2007, Moody's acted with the full knowledge that it was allowing the financial interests of itself and the dominant issuers that paid Moody's the majority of its fees to influence its ratings of structured finance

securities, and that Moody's was not living up to its public representations of independence and objectivity.

11. For purposes of clarity, this lawsuit does not challenge Moody's judgment regarding which rating methodology to use, or how to apply it, when rating any specific structured finance security. Similarly, the State's lawsuit is not brought for the purpose of demonstrating that any particular rating on a structured finance security was incorrect (*i.e.*, too high or too low.)

12. Rather, the State's lawsuit takes issue with the fact that Moody's represented that its ratings on structured finance securities were independent, objective and, as stated in its Code of Conduct, "not . . . affected by the existence of, or potential for, a business relationship between [Moody's] . . . and the Issuer . . . or any other party, or the non-existence of any such relationship." This representation by Moody's was false and Moody's knew it.

13. By intentionally and knowingly misrepresenting and / or omitting factors it considered when rating structured finance securities, Moody's offered a product and / or service that was materially different from what it purported to provide to the marketplace.

14. Moody's conduct as described herein constitutes a deceptive, unfair and illegal business practice in violation of 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, as well as other injunctive and equitable

relief to prevent these unfair, deceptive and illegal business practices from happening in the future.

II. PARTIES

15. 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 and at the request of Jerry Farrell, Jr, Commissioner of the Department of Consumer Protection for the State of Connecticut.

16. Defendant Moody's Corporation is a Delaware corporation with its principal place of business at 7 World Trade Center at 250 Greenwich Street, New York, New York 10007. Moody's Corporation is divided into two divisions, Moody's Investors Service, Inc. and Moody's Analytics. In 2008, Moody's reported total revenue of approximately $1.7 billion worldwide and employed approximately 3,900 people.

17. Defendant Moody's Investors Service, Inc. is a Delaware corporation with its principal place of business located at 7 World Trade Center at 250 Greenwich Street, New York, New York 10007. Moody's Investors Service, Inc. is a division and subsidiary of Moody's Corporation and operates as a credit rating agency that assigns credit ratings on a broad range of securities, including structured finance securities, issued in domestic and international financial markets. As of 2008, Moody's Investors Service, Inc. had rated and currently monitored ratings on approximately 109,000 structured finance obligations.

18. Moody's holds a dominant position in the credit rating agency market, particularly with respect to the market for rating structured finance securities. According to Moody's own documents, Moody's routinely rates over 90% of the structured finance securities issued into the global capital markets. In 2006, of Moody's total ratings revenue of approximately $1.6 billion, over $800 million of the revenue originated from Moody's rating of structured finance securities.

19. Moody's regularly transacts business in the State of Connecticut and derives substantial revenue from its business within the State of Connecticut. Moody's rates structured finance securities issued by issuers located within Connecticut. Additionally, Moody's ratings on structured finance securities are routinely viewed and relied on by investors and other participants in the financial markets located within the State of Connecticut. Based on Moody's public representations, these individuals and entities depend on Moody's to provide independent and objective assessments of the relative credit risk of structured finance securities, unaffected by Moody's or its clients' financial interests.

III. BACKGROUND

A. The Creation and Rating of Structured Finance Securities

1. What is a Structured Finance Security?

20. Broadly stated, structured finance securities are Asset-Backed Securities ("ABS"), which are financial products whose value is derived from a stream of revenue flowing from a pool of underlying assets. These assets are sold to buyers / investors who rely upon the revenue

stream generated from the underlying asset pool for the repayment of their principal and interest. Many different types of assets can serve as collateral for ABS. Some of the most common types of assets used to support an ABS are residential and commercial mortgages.

21. The largest type of structured finance securities are securities backed by residential mortgages ("RMBS"). For example, during 2006, approximately $2.5 trillion in mortgages were originated in the United States. Approximately 80% of those mortgages were securitized into RMBS. Additionally, approximately 25% of all RMBS issued were backed by subprime mortgages. Between 2002 and 2005 the annual volume of mortgage securities sold to private investors tripled to $1.2 trillion and the subprime portion of these obligations rose to approximately $456 billion.

22. Structured finance securities can also be backed by a variety of other types of assets, such as commercial mortgages ("CMBS"), student loans, and credit card balances.

23. Collections or "pools" of asset backed securities such as RMBS can themselves serve as the collateral for structured finance securities that gather together an asset pool of various ABS securities and then issue a further round of derivative securities.

24. The most common type of structured finance securities collateralized by other securities are known as collateralized debt obligations ("CDOs"). According to the Securities Industry and Financial Markets Association, the value of CDOs backed by RMBS during 2005 was $177 billion, during 2006 was $314 billion, and during 2007 was $263 billion. Additionally,

from 2005-2007 there were hundreds of billions of dollars of CDOs backed by bonds and by high yield loans called collateralized loan obligations ("CLOs").

25. A key entity in the structured finance securities market is a structured investment vehicle ("SIV"). A SIV is a special purpose entity that borrows money by issuing short and medium term debt and then uses that money to buy longer term securities. A SIV's long term assets typically include investment grade rated RMBS and CDOs, which entitle the investor in the SIV to principal and interest drawn from the revenue generated by the underlying collateral.

26. As the market for mortgage related structured finance securities grew, the securities that provided the underlying value for these investments became increasingly complex. In addition to issuing CDOs made up of RMBS or other CDOs ("CDOs squared"), issuers began to use credit default swaps and other derivative securities to serve as the underlying collateral of the obligation, which were designed to replicate the performance of subprime RMBS and CDOs. In this case, rather than purchasing subprime RMBS or CDOs, the CDO primarily entered into credit default swaps referencing subprime RMBS or CDOs. These CDOs in some cases are composed entirely of credit default swaps (*i.e.*, "synthetic CDOs") or a combination of credit default swaps and actual cash RMBS (*i.e.*, "hybrid CDOs").

27. While the asset pool underlying a structured finance security may vary, the mechanism for transforming the pool of assets into an ABS by way of the securitization process is generally the same.

28. For example, the process for creating a RMBS begins when an arranger, generally an investment bank, packages mortgage loans into a pool and transfers them to a trust that will issue securities collateralized by the pool. The trust purchases the loan pool and becomes entitled to the interest and principal payments made by the borrowers, which is used to make monthly interest and principal payments to the investors in the RMBS.

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

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

31. Over-collateralization refers to the amount by which the principal balance of the mortgage pool exceeds the principal balance of the securities issued by the trust. This excess

principal creates an additional equity tranche below the lowest debt tranche. The equity tranche absorbs losses up to its total value before any debt tranche is affected by defaults in the underlying collateral. Commensurate with this "first loss" position, however, the equity tranche offers the greatest possibility for investment gains if the underlying collateral does not default. The equity tranche is often retained by the issuer / sponsor of the structured finance security.

32. Finally, excess spread refers to the difference between the interest rate on the underlying loans and the interest rate paid to the investors in the securities, which normally results in the trust taking in more money in interest payments than it is required to pay out. Part of the excess spread pays administrative expenses of the trust such as loan servicing fees. The excess spread also can be used to build up reserves or pay off delinquent interest payments due to a debt tranche. Any amount that is not used to pay expenses or paid over to the debt tranches is retained by the equity tranche.

33. The process for creating a typical CDO is similar to that of an RMBS. A sponsor creates a trust or other special purpose entity to hold assets and issue securities. Instead of the mortgage loans that are held in RMBS pools, a CDO trust is typically comprised of approximately 200 debt securities such as RMBS or other CDOs. The trust then uses the interest and principal payments from the underlying debt securities to make interest and principal payments to investors in the CDO securities issued by the trust. CDO trusts are among the largest purchasers of subprime RMBS and have been one of the biggest drivers of demand for these securities.

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

2. The Need for a Credit Rating

35. A necessary step in the process of creating and ultimately selling any ABS, including an RMBS or a CDO, is the assignment of a credit rating for each of the tranches issued by the trust. Indeed, many institutional investors can invest only in securities that have received a certain rating level from Moody's or another credit rating agency recognized by the Securities and Exchange Commission ("SEC").

36. Moody's engages in the following steps when rating a RMBS. Upon receiving a range of data on a pool of mortgage loans from an investment bank or some other arranger, Moody's assigns a lead analyst to the transaction. Information provided to the lead analyst about the transaction includes principal amount, geographic location of the property, credit history and FICO score of the borrower, loan to value ratio, type of loan, as well as the proposed capital

structure of the trust and the proposed levels of credit enhancement to be provided to each tranche. The lead analyst is responsible for analyzing the loan pool, proposed capital structure and proposed credit enhancement levels provided by the issuer.

37. The next step in the process is for the Moody's analyst to use Moody's rating methodologies to develop predictions, based on a quantitative expected loss model, as to how many loans in the collateral pool would default individually and in correlation with each other under varying levels of stress. The purpose of this default and loss analysis is to determine how much credit enhancement a given tranche security would need for a particular category of rating. Moody's runs the most severe stress test to determine the credit enhancement required for a RMBS tranche to receive its highest "Aaa" rating. The next most severe stress test is run to determine the amount of credit enhancement required of the next highest tranche, and so on down the capital structure.

38. After determining the level of credit enhancement required for each credit rating category, Moody's checks the proposed capital structure of the RMBS trust against Moody's requirements for a particular credit rating.

39. Upon analyzing the proposed capital structure, if Moody's determines that the issuer's proposal does not allow for sufficient credit enhancement to receive a "Aaa," then Moody's is supposed to let the issuer know that the most senior class of securities could only receive a "Aa" or lower rating. Presented with this information, the issuer could accept that determination and have the trust issue the securities with the proposed capital structure and lower

rating, or it could adjust the structure to provide the requisite credit enhancement for the senior tranche to receive the desired "Aaa" rating.

40. Moody's next step in the process is to conduct a cash flow analysis on the interest and principal expected to be received by the trust from the collateral pool to determine whether it is sufficient to pay the interest and principal due on each tranche of the trust. Ultimately, the monthly principal and interest payments derived from the loan pool needs to be enough to satisfy the monthly payments of principal and interest due by the trust to the investors in the RMBS tranches, as well as to cover the administrative expenses of the trust. Assuming that the proposed structure allows for sufficient cash flow, Moody's develops a recommendation for a final credit rating for each tranche of RMBS, which is presented to an internal Moody's ratings committee for final approval.

41. Similarly, the steps Moody's follows for assigning ratings to CDOs involves a review of the creditworthiness of each tranche of CDO. The process centers on an examination of the pool of assets held by the trust and, through the use of rating methodologies developed by Moody's, an analysis of how these assets would perform both individually and in correlation with each other during various stress scenarios. With respect to CDOs, however, the analysis is based primarily on the credit rating of each RMBS (or other structured finance security) in the underlying pool and does not include an analysis of the underlying loan pools collateralizing the RMBS.

B. The Market for Structured Finance Securities

42. The market for structured finance securities consists of the issuers (*i.e.*, sellers or sponsors), who create a trust to hold the underlying collateral and issue ABS such as RMBS and CDOs, and the buyers (*i.e.*, investors) that purchase these investments. Issuers of structured finance securities are financial companies such as banks, mortgage companies, finance companies and investment banks. Buyers of structured finance securities are institutional investors, including financial institutions, pension funds, insurance companies, mutual funds, hedge funds, money managers and investment banks.

43. Structured finance securities are typically not marketed to or purchased by retail investors. However, the credit ratings that RMBS, CDOs and other ABS receive, and the performance of these investments, have significant real world implications for the finances of individual investors. In particular, structured finance securities are often included in mutual fund and pension fund portfolios that play significant roles in the retirement and investment strategies of many individuals, including citizens of Connecticut.

44. In order for an issuer to successfully market and sell a structured finance security such as an RMBS or a CDO to a buyer / investor, the security must receive a credit rating. Moreover, due to SEC regulations limiting the type of investments that certain institutional investors can purchase, often ratings from multiple credit rating agencies are required for issuers to successfully market and sell a structured finance security to the broadest group of potential buyers / investors.

45. There are few credit rating agencies that assign ratings on structured finance securities. Consequently, the market for rating structured finance securities is extremely concentrated. Moody's, and its primary competitor, Standard & Poor's ("S&P"), dominate the rating of these investments.

46. For example, according to industry publication Asset-Backed Alert, Moody's rated 91.5% of the CDOs issued in 2003, 76.8% of the CDOs issued in 2004, 85.1% of the CDOs issued in 2005, and 96.8% of the CDOs issued in 2006.

47. The market for rating structured finance securities is also very lucrative. Moody's has repeatedly been one of the most profitable publicly traded companies in existence, frequently posting profit margins of over 40%. Much of the revenue that drives this profitability comes from Moody's ratings of structured finance securities. For example, by 2006, over half of Moody's total ratings revenue (*i.e.*, $800 million) originated from its rating of structured finance securities.

48. Finally, unlike the markets for most financial products, the market for structured finance securities is comprised of a relatively narrow group of sellers (*i.e.*, investment banks) that act as repeat issuers or sponsors of RMBS, CDOs and other ABS. Accordingly, there are a relatively small group of banks that hire Moody's to rate their products on a regular basis. For example, in 2006, of the 96,000 structured finance securities rated by Moody's that year, the ten largest issuers were responsible for over half of Moody's structured finance rating business.

49. The implication of these facts has been described by Professor John C. Coffee of Columbia University, a frequent expert witness before Congress on the credit rating agencies' role in the most recent financial crisis:

> The major change that destabilized rating agencies appears to have been the rise of structured finance . . . The rating agency is no longer facing an atomized market of clients who each come to it only intermittently (and thus lack market power), but instead large repeat clients who have the ability to take their business elsewhere. Today, structured finance accounts for a major share of some rating agencies' total revenues; equally important, these amounts are paid by a small number of investment banks that know how to exploit their leverage. . . .

C. Moody's Role in the Market for Structured Finance Securities

50. Credit rating agencies distinguish among grades of debt creditworthiness. In other words, a credit rating is a statement as to the likelihood that the borrower or issuer will meet its contractual, financial obligations as they become due. Thus, Moody's is a gatekeeper on whom investors and other market participants necessarily rely.

51. As Professor Coffee noted in his Congressional testimony: "Gatekeepers are reputation intermediaries who provide verification and certification services to investors. . . . [T]he professional gatekeeper essentially assesses or vouches for the corporate clients own statements about itself or a specific transaction. This duplication is necessary because the market recognizes that the gatekeeper has a lesser incentive to lie than does its client and thus regards the gatekeeper's assurance or evaluation as more credible."

52. Moody's role as a "gatekeeper" takes on special importance in the market for structured finance securities because its investment grade rating is a necessary condition before many institutional investors are permitted under SEC regulations to buy debt securities. In this sense, Moody's rating also acts as a defacto regulatory license that expands the universe of potential buyers / investors capable of purchasing a particular structured finance security. Moody's knows this fact.

53. Moody's role as a "gatekeeper" is also affected by the fact that structured finance securities are fundamentally different from other debt investments (*i.e.*, corporate and public bonds). For example, the issuing entity of a corporate bond has some independent existence and measurable value in and of itself that usually can be verified, at least in part, by reference to publicly available materials. This characteristic does not exist in the world of structured finance.

54. As a former senior managing director at Moody's has publicly noted, "[s]omewhat unique to the structured finance [security] market is the opacity of the rated securities. In certain situations, the details of the underlying asset pool and often the structure of the transaction are not publicly available for external scrutiny. . . . Moreover, the tools to analyze credit risk, even with transparent assets, are beyond the grasp of many investors. Rating methods are quite technical, often relying on advanced statistical techniques. Documentation supporting a transaction can be equally daunting, reading more like a legal brief than helpful financial guidance. In turn, a solid understanding of how to value structured [finance] securities remains elusive."

55. In light of the opaque nature of structured finance securities as an investment, buyers / investors in Connecticut (and elsewhere), issuers of structured finance securities, and other market participants are dependent on the ratings assigned by Moody's to obtain some relative assessment of the credit risk associated with the various RMBS, CDOs and other ABS tranches that are issued. Indeed, Moody's intends that buyers / investors of structured finance securities be the primary recipients of the information that a Moody's credit rating is meant to provide, and issuers obtain a credit rating from Moody's for the specific purpose of making the risk characteristics of the structured finance security understandable to investors.

56. As such, the rating that Moody's assigns to a particular structured finance security is a significant factor in any investor's decision to purchase or not to purchase a structured finance security. Moody's is well aware of buyers' / investors' and other market participants' use and reliance on Moody's credit ratings in this manner.

57. For example, in its Rating Symbols and Definitions publication, Moody's describes its credit ratings of structured finance securities as follows: "Moody's ratings on long-term structured finance obligations primarily address *the expected loss an investor might incur* on or before the legal final maturity of such obligations vis-à-vis a defined promise. As such, these ratings incorporate Moody's assessment of the default probability and loss severity of the obligations." (Emphasis added.)

58. Similarly, in its Code of Conduct, Moody's has noted that "[g]iven the vast amount of information available to investors today – some of it valuable, some of it not –

[Moody's] helps investors and others sift through this information and analyze the credit risk they face when lending to a particular borrower, or when purchasing an issuer's debt or debt like securities." Additionally, in its 2005 Best Practices Handbook Moody's acknowledged as follows: "We serve investors by providing them with timely credit research and independent, thoughtful, and accurate rating opinions on which they can base their investment decisions. Moody's has always derived its value from its acceptance by the investment community and such acceptance continues to be essential to the success of our business model."

59. There are many buyers / investors of structured finance securities in Connecticut, including, banks, mutual funds, insurance companies, hedge funds, and pension funds, as well as individual persons whose investment strategies are affected by the performance of these entities' structured finance security portfolios, that expect and depend on Moody's to independently and objectively fulfill its self described role as alleged above.

D. Moody's Credit Rating Scale for Structured Finance Securities

60. Moody's ratings for structured finance securities are expressed on what is called the Moody's Global Scale. Moody's describes its Global Scale as follows: ". . . an assessment of probability of default as well as expectation of loss in the event of default. It is Moody's intention that the expected loss rate associated with a given rating symbol and time horizon be the same across obligations and issuers rated on the Global Scale."

61. Moody's ratings for structured finance securities expressed on its Global Scale are 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 structured finance security rated "Aaa" by Moody's "judged to be of the highest quality, with minimal credit risk," and a structured finance security rated "Aa" by Moody's "judged to be of high quality and subject to very low credit risk." Structured finance securities 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.

62. 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.

63. Structured finance securities bearing a Moody's rating of "Baa" or above are also described as "investment grade."

64. A higher Moody's credit rating on a particular tranche of a structured finance security corresponds to a lower coupon (*i.e.*, interest) rate that the issuer becomes obligated to pay the buyer / investor. Thus, a tranche rated "Aaa" by Moody's generally carries a lower coupon rate than a tranche rated "Aa" by Moody's because it is assumed that there is a lower level of credit risk to the investor. Similarly, a structured finance security rated "Aa" by Moody's generally carries a lower coupon rate than a structured finance security rated "A" by Moody's, and so on down Moody's letter rating scale.

E. The Issuer Pays Business Model

65. Moody's is compensated by the same entities that issue the structured finance securities that Moody's is tasked with evaluating. Specifically, in exchange for providing its credit ratings on structured finance securities, Moody's charges the issuer a fee based on the complexity and size of the structured finance security being rated. As has been repeatedly noted in Congressional testimony, this business model ensures that Moody's is essentially "a watchdog paid by the persons it is to watch."

66. Prior to 1970, Moody's did not accept payment from any issuer of a security that it rated. Instead, Moody's financed its ratings operation primarily through a subscription based model where investors paid for access to Moody's publications. At that time, the primary subscribers to Moody's services were investors and libraries. Moody's routinely refused even to meet with companies it rated, and ratings were assigned by a relatively small group of inaccessible analysts and managers.

67. Beginning in the 1970s, however, Moody's shifted its business model from a subscription-funded business and began to receive the vast majority of its fees from issuers.

68. By 1994, Moody's began to rethink who its clients were and how best to deal with them. In particular, since issuers largely paid the bills, Moody's undertook a concerted effort to make the firm more issuer-friendly. The focus of Moody's shifted from protecting investors to being a marketing driven organization concerned with meeting the demands of issuers. Among

other things, Moody's implemented this new emphasis on customer service by conducting detailed surveys of client (*i.e.*, issuer) needs and attitudes.

69. In 2000, Moody's became a stand-alone public company. This move heightened Moody's focus on maximizing revenues by pleasing issuers. As one former Moody's Vice President described it: "Starting in 2000 there was a systematic and aggressive strategy to replace a culture that was very conservative, an accuracy and quality oriented culture, a getting the rating right kind of culture, with a culture that was supposed to be business friendly but was consistently less likely to assign a rating that was tougher than our competitors."

70. Another byproduct of this transition in 2000 was that managers who were considered good business people – not necessarily the best credit analysts – rose through Moody's ranks and began to set rating policies for the company. Unfortunately, despite Moody's public proclamations to the contrary, these rating policies were increasingly influenced by the financial incentives inevitably linked to the Issuer Pays business model, where Moody's desire for additional revenue and market share could only be realized by pleasing the issuers of the securities it was rating.

71. By at least 2004, the pressures of Moody's Issuer Pays business model on its rating of structured finance securities became particularly acute. As the volume of RMBS, CDO and other ABS issuance increased, the volume of opportunities to earn lucrative fees for issuing "Aaa" ratings on structured finance securities increased as well. For Moody's to take advantage of these opportunities and, therefore, realize additional revenue, it consistently had to please the

relatively small number of issuers of structured finance securities who had become Moody's repeat customers, or run the risk of not being retained by these issuers in the future.

72. Moody's ability to please issuers of structured finance securities is dependent on its rating models and rating committees requiring the smallest amount of additional credit enhancement to achieve the issuer's desired Aaa rating. The smaller or lower the credit enhancement, the more profitable the security is to the issuer.

73. Issuers of structured finance securities are well aware of the incentives built into the Issuer Pays business model and use it to their advantage to get higher ratings from Moody's. Specifically, an issuer typically requests ratings from not only Moody's but also from Moody's main competitors, S&P and Fitch, Inc. ("Fitch.") If the issuer is unhappy with the credit enhancement levels proposed by Moody's after it conducts its analysis, the issuer can inform Moody's of the credit enhancement levels proposed by either S&P or Fitch in order to influence the outcome of Moody's analysis. In such a situation, Moody's is faced with the dilemma of either adjusting its analysis to win the business, and therefore realize additional revenue, or staying true to its original assessment and potentially losing the business.

74. This practice is most commonly known as "ratings shopping" because issuers offer the business of rating their structured finance security to competing rating agencies and usually give the business to the firm (or firms) that find the least amount of credit enhancement necessary to achieve the rating levels desired by the issuer.

75. One former Moody's managing director confirmed the inherent dangers of the Issuer Pays business model in September of 2007 when he testified before Congress as follows: "Another aspect of conflict of interest . . . is that . . . rating agencies can come under pressure to loosen their standards for a whole sector. And this can happen from behavior from the issuers called ratings shopping, where . . . an issuer . . . shows a deal to multiple rating agencies and then picks one or two that have the easiest standards to rate the deal. Then the other rating agencies that had tougher standards become invisible, and, once more, they don't make any money, because the way you make money . . . is you rate the deal and charge the issuer. So it puts pressure on the rating agencies to loosen their standards . . . . [W]e call this competitive laxity."

IV. MOODY'S REPRESENTS ITSELF TO THE PUBLIC AS AN INDEPENDENT AND OBJECTIVE EVALUATOR OF STRUCTURED FINANCE SECURITIES

A. Moody's Pledge to Safeguard the Integrity of the Rating's Process

76. Moody's represents to investors and other participants in the financial markets, including those in Connecticut, that its credit ratings, including those of structured finance securities, are independent, objective and free from outside influence. Moody's repeatedly, consistently, and publicly emphasizes its independence and objectivity to investors and other market participants in a variety of public statements.

77. For example, in describing Moody's role in the global capital markets, Moody's current web site states: "Moody's independence and integrity have earned us the trust of capital market participants worldwide . . . . [Moody's] credit ratings and research help investors analyze

the credit risks associated with fixed-income securities. Such independent credit ratings and research also contribute to efficiencies in fixed-income markets . . . by providing credible and independent assessments of credit risk."

78. Similarly, in its 2003 Annual Report, Moody's noted that: "Moody's recognizes the vital role that credit rating agencies play in the capital markets. We carefully manage the potential conflicts of interest inherent in our business model, where the issuers we rate provide most of our revenue. We . . . appreciate the need to treat all market participants – issuers, intermediaries, and investors – professionally and fairly."

79. In Moody's 2005 annual report, Mr. McDaniel once again publicly reiterated Moody's emphasis on independence and objectivity when he stated: "**Moody's is committed to reinforcing** among all relevant stakeholders – debt issuers, the investment community, employees, governmental authorities and shareholders – **a sense of trust in the accuracy, independence and reliability of Moody's products and services, and our stewardship of the business.** To do this, we must keep pace with innovations in dynamic global financial markets, deliver products and services that sustain Moody's relevance, and enhance the perception that Moody's helps facilitate the fairness and efficiency of credit markets worldwide." (Emphasis added.)

80. Mr. McDaniel went on to emphasize as follows: "[I]n reflecting on my first year as Moody's Chief Executive Officer, I can do no better than to repeat the commitment in our shareholder letter of last year: **most importantly, we remain committed to upholding the**

independence and integrity of our business. We will preserve what Moody's has built over the last hundred years and we will prepare for what must be built in the years to come for Moody's to continue its track record of professional and financial success." (Emphasis in original.)

81. Moody's vow of independence, objectivity and integrity were codified in June of 2005, when it adopted a Code of Professional Conduct ("Moody's Code" or the "Code") for its ratings practices. In a 2006 report explaining its implementation of the Code, Moody's noted: "Moody's Code sets forth the overall policies through which we seek to further our objective to protect the integrity, objectivity and transparency of our credit rating process. The Code reflects the guidance provided in the International Organization of Securities Commissions ("IOSCO") Code of Conduct. . . . Moody's endorses the principles expressed in the IOSCO Code, and we are committed to implementing them through our own Code."

82. One of the key principles set forth in the IOSCO Code (first published in December of 2004) was the need for credit rating agencies such as Moody's to maintain independence from the issuers who pay it for its ratings.

83. In particular, the IOSCO Code sets forth the principle that "the essential purpose of the Code Fundamentals is to promote investor protection by safeguarding the integrity of the rating process. IOSCO members recognize that credit ratings, despite their numerous other uses, exist primarily to help investors assess the credit risks they face when making certain kinds of investments. Maintaining the independence of credit rating agencies vis-à-vis the issuers they

rate is vital to achieving this goal. Provisions of the Code Fundamentals dealing with credit rating obligations to issuers are designed to improve the quality of credit ratings and their usefulness to investors."

84. Similarly, 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."

85. With these principles as a guide, since June of 2005, Moody's has made several representations in its Code about the manner in which Moody's maintains its independence and avoids conflicts of interest with issuers. The most important of these representations are found in sections 1.14 and 2.1 – 2.4 of the Code, which currently remain in effect as purported limitations on the factors that Moody's considers when rating structured finance securities.

86. Specifically, Section 1.14 of Moody's Code states: "Moody's and its employees will deal fairly and honestly with issuers, investors, other market participants, and the public."

87. Section 2.1 of Moody's Code states: "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 participants."

88. Section 2.2 of Moody's Code states: "Moody's and its analysts will use care and professional judgment to maintain both the substance and appearance of independence and objectivity."

89. Section 2.3 of Moody's Code states: "The determination of a Credit Rating will be influenced only by factors relevant to the credit assessment."

90. Section 2.4 of Moody's Code states: "The Credit Rating Moody's assigns to an issuer or obligation will not be affected by the existence of, or potential for, a business relationship between Moody's (or its affiliates) and the Issuer (or its affiliates), or any other party, or the non-existence of any such relationship."

91. Moody's Code is available on its web site and the promises contained in Sections 1.14 and 2.1 through 2.4 have continued to be referenced in several public statements by Moody's since the Code's adoption in June of 2005.

B. Moody's Reassures the Public of its Role as an "Independent Expert"

92. Moody's 2006 Annual Report, published in March of 2007, picks up on the same themes and once again reiterates Moody's objectivity and independence from issuers. Specifically, Mr. McDaniel notes: "Moody's is a standards business: public and private sector organizations worldwide rely on the accuracy, stability, consistency and independence of our opinions and services for the contribution they make to fair and efficient financial markets. For Moody's to continue to meet or exceed these expectations requires that we embrace the demand for trust from several perspectives."

93. Recognizing the challenges presented by the Issuer Pays business model, Mr. McDaniel went on to state: "[S]ome will not find independence and customer focus to be an intuitive pairing. The nature of an independent expert is to communicate information that will be influential and that, from time to time, recipients will not welcome. To do so with the highest degree of professionalism and with attention to and respect for the perspectives of stakeholders being served is, however, both intuitive and good business."

94. Similarly, in Moody's 2007 Annual Report, published in March of 2008, Mr. McDaniel acknowledged the conflicts of interest inherent in Moody's compensation structure, but emphasized as follows: "The question is not whether potential conflicts exist – they always will – but whether they are properly managed. At Moody's, we have taken a leadership position in setting industry standards regarding the management of potential conflicts. Our Code of Professional Conduct sets forth rigorous procedures that govern the roles and responsibilities of our rating agency employees, with the primary goal of ensuring that our analytical activities remain appropriately distanced from commercial management of our business."

95. Furthermore, apparently in an attempt to provide additional reassurance to the marketplace, in this same public statement Mr. McDaniel noted: "Oversight by our internal Compliance Department as well as external examination by government authorities serves to reinforce, validate and improve our controls and procedures."

96. In sum, the statements made by Moody's in its Code of Conduct, web site, and public filings depict a pattern and practice of public statements intended to repeatedly emphasize

several basic representations by Moody's to buyers / investors and other market participants. First, that Moody's ratings of structured finance securities have been, and continue to be, independent, objective and free from consideration of Moody's desire for revenue or winning additional business from issuers.

97. Second, recognizing that Moody's holds a position of trust in the marketplace, Moody's represents that it deals fairly and honestly with the public, including the buyers / investors of the structured finance securities that it rates.

98. Third, that Moody's understands the Issuer Pays business model creates conflicts of interest, but that these conflicts have been adequately managed by its Compliance Department and the principles set forth in Moody's Code so as to ensure that its credit ratings are purely a function of credit analytics. Investors and other market participants depend on Moody's to properly manage this conflict and reasonably interpret Moody's representations to understand that Moody's does so.

99. Fourth, that Moody's agrees with and has implemented the principles set forth in the IOSCO Code of Conduct by maintaining independence, objectivity and integrity of its ratings of structured finance securities.

100. Fifth, that Moody's understands its role as an independent and objective expert sometimes requires it to provide answers that its clients (*i.e.*, issuers) don't like, but that doing so is critical to following through on its commitment to enhance the transparency and efficiency of the global capital markets.

101. The above representations made by Moody's are material to buyers / investors of structured finance securities, as well as other market participants located in Connecticut, and also have been reasonably interpreted by those same individuals and entities in light of the circumstances in which the representations have been made.

102. None of the above representations made by Moody's were true. Moody's knows of this fact and yet Moody's continues to make the same misrepresentations to this day with this full knowledge.

V. MOODY'S EVALUATION OF STRUCTURED FINANCE SECURITIES WAS NOT INDEPENDENT AND OBJECTIVE

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

104. Moody's sacrifice of its independence and objectivity due to its desire to please issuers of structured finance securities has manifested itself in several ways. Although not an exhaustive recitation, some examples of this conduct are set forth below.

A. Ratings Shopping Corrupts the Integrity of the Process

105. "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.

106. The effect of the practice has been described in industry publications 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 [our competitor'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 that 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."

107. Between at least 2004 and 2007, when the markets for RMBS and CDOs were particularly active, Moody's experienced this pressure on a daily basis. Unfortunately, contrary to its public representations, the pressure did in fact influence the ratings that Moody's assigned to structured finance securities, the recommendations that Moody's analysts made to their superiors, and the feedback that Moody's provided to issuers.

108. For example, in 2007 during the course of rating a particular RMBS a Moody's analyst reported to his superiors as follows: "I received a call from [the issuer] . . . – our levels are off the other agencies at both Aaa and B2 . . . . We added 35 [basis points] at Aaa to 2.25% . . . . If [Moody's managing director] believes that the adjustment at Aaa is ill-founded, I can be convinced to come back to 2% . . . – this would get us on the Aaa ratings. (I don't want to necessarily meet the rating competition – but it may be warranted to move back at Aaa)." Before

revising his initial insistence for additional credit enhancement, the Moody's managing director asks for the opinion of one of his colleagues. This individual writes that he "agrees with going down on the Aaa," thus allowing Moody's to match the same lower level of credit enhancement for the transaction that was calculated by its competitors.

109. Another issuer provided the following feedback to Moody's after being presented with its ratings analysis of a structured finance security. "This is literally the worst [over collateralization] levels since . . . when Moody's and the entire rating agency universe had no idea what to look for or how to model this collateral . . . . In the interest of full disclosure . . . here's S&P's levels – which, by the way, for over 3 years have been historically worse than Moody's [S&P's proposed levels of credit enhancement included] . . . . I'd appreciate a call to help me understand your results. These levels kill the current execution as well as the viability of the platform, and we'll have to pull the deal."

110. As part of this same transaction, the issuer went over the head of the analyst and forwarded its complaints, including the information about S&P's rating assessment, directly to senior managing directors within Moody's and emphasized that "[w]ith the kind of inconsistent or irrational results highlighted [above], [this type of transaction] goes away, which is unfortunate because we've been doing this longer (over 4 years), with more deals (15 to date) . . . than anyone we know of." The implicit threat embedded in the issuer's complaints is clear: that if Moody's holds true to its analysis, the opportunity to rate this type of structured finance security and, therefore, the revenue that accompanies it, will no longer be available to Moody's.

111. Additionally, in the context of rating a complex CDO in 2006, a Moody's analyst informed his superiors of S&P's willingness to accept a lower level of credit enhancement: "FYI – I communicated these levels to [the issuer] and they resisted somewhat saying that S&P was 6 notches lower at Aaa and their Ba2 was 6.15 v. our 9.15." Following this exchange, the Moody's analyst relented and contacted the issuer again with the recommendation that Moody's "reconsider the previously committeed loss coverage levels." Pressure from the issuer and the implication of S&P's lower credit enhancement levels clearly influenced Moody's process and its approach to rating this transaction.

112. Similarly, in the midst of voting on the rating for another structured finance security, a third Moody's analyst informed her team that "[the issuer] would like for us to consider a newly proposed loss trigger threshold . . . [because] S&P came back with wider thresholds than what the issuer originally proposed and what we approved in committee." Moody's repeated benchmarking of its analytics against the work of its primary competitor in this manner directly contradicts its public guarantees of independence and objectivity.

113. Furthermore, within the context of rating yet another structured finance transaction in 2006, a different Moody's analyst informed his supervisors of a number of different structures proposed by the issuer. After explaining one of these options, the analyst noted as follows: "I know [Moody's managing director] sent an e-mail that this should not be allowed but I want to understand what changes we would make if the bankers insisted this be the case." Notably, this mentality of pleasing the issuer by bending to its demands bears sharp

contrast to Moody's public affirmation of the "independent expert," ready to say "no" when necessary.

114. The above examples demonstrate that issuers influenced Moody's credit assessment, that this influence included pressure from ratings shopping as well as the threat of lost business and revenue, and that these factors routinely compromised the integrity of the ratings process because they effected the actions that Moody's took when rating structured finance securities.

115. In stark contrast to his public representations (see Section IV), in October of 2007 Mr. McDaniel privately conceded to his Board the import of these influences: "Analysts and MDs [managing directors] are continually pitched by bankers, issuers, investors . . . whose views can color credit judgment, sometimes improving it, other times degrading it (we drink the kool-aid). Coupled with strong internal emphasis on market share & margin focus, this does constitute a risk to ratings quality." Along these same lines, Mr. McDaniel confessed to his Board that "[i]t turns out that ratings quality has surprisingly few friends: issuers want high ratings; investors don't want rating downgrades; short-sighted bankers labor short-sightedly to game the rating agencies for a few extra basis points on execution."

116. The fact that these outside influences did in fact affect Moody's ratings of structured finance securities was not disclosed by Moody's in its public statements. To the contrary, Moody's represented quite the opposite by repeatedly stating that its ratings are not influenced by its business relationships.

B. Moody's Revenue / Market Share Goals Influenced its Rating Methodology

117. Moody's desire for more fees also influenced the entire rating methodology that Moody's developed for rating structured finance securities. Specifically, by at least 2004, Moody's focus on monitoring and growing market share and not losing out to S&P or Fitch on rating CDOs or other structured finance securities dominated the attention of Moody's senior management.

118. This compulsion to put new business before credit analytics and, therefore, maximize its revenue influenced the rating methodologies that Moody's developed and implemented for rating structured finance securities. Moody's believed that the only way for it to successfully compete for an issuer's structured finance business was to make sure that its levels of proposed credit enhancement reflected the issuer's expectations. As a result, there was a real fear at Moody's of losing new deals to a competitor and, consequently, Moody's internal business strategy focused on matching the ratings of S&P and Fitch, rather than providing an objective credit analysis uninfluenced by either Moody's or its clients' financial concerns.

119. Once again, these realities were confirmed no better than by Moody's CEO, Mr. McDaniel in October of 2007 when, unbeknownst to either the buyers / investors of the structured finance securities that Moody's rates, or any other market participants, he described in detail to his Board the role that Moody's quest for market share played in its rating practices:

> In an increasing number of markets, Fitch is an acceptable substitute for either S&P or Moody's. In other markets, any one of the three is

enough. With the loosening of the traditional duopoly, how do rating agencies compete?

Ideally, competition would be primarily on the basis of ratings quality, with a second component of price and a third component of service. Unfortunately, of the three competitive factors, rating quality is proving the least powerful . . . .

The real problem is not that the market does underweights [sic] ratings quality but rather that, in some sectors, it actually penalizes quality by awarding rating mandates based on the lowest credit enhancement needed for the highest rating. **Unchecked, competition on this basis can place the entire financial system at risk . . . .** [Emphasis added.]

Moody's for years has struggled with this dilemma. On the one hand, we need to win the business and maintain market share, or we cease to be relevant. On the other hand, our reputation depends on maintaining ratings quality (or at least avoiding big visible mistakes). For the most part, we hand the dilemma off to the team of MDs to solve. As head of corporate ratings, I offered my managers precious few suggestions on how to address this very tough problem, just assumed that they would strike an appropriate balance . . . .

Although the business does square the circle in some situations, the market share pressure persists in others. Moody's has erected safeguards to keep teams from too easily solving the market share problem by lowering standards . . . .

Ratings are assigned by committee, not individuals. (However, entire committees, entire departments, are susceptible to market share objectives.)

Methodologies & criteria are published and thus put boundaries on rating committee discretion. (However, there is usually plenty of latitude within those boundaries to register market influence.) . . . .

> This does NOT solve the problem though. The RMBS and CDO and SIV ratings are simply the latest instance of trying to hit perfect rating pitch in a noisy market place of competing interests.
>
> [B]ad ratings must be perceived to have (much) worse consequences than market share slippage. Accountability is key. (It is also tricky to implement.)

120. In practice, when this problem was turned over to the Moody's managing directors responsible for rating structured finance securities, they allowed the business concerns and pressure for enhanced market share and revenue generation that was so valued by the company to dominate their judgment and directly influence the methodologies developed to rate structured finance securities.

121. For example, by at least 2004, Moody's believed that it had started to lose out on rating many of the new CDOs backed primarily by RMBS because its existing rating methodology, called the Binomial Expansion Technique ("BET"), valued a diverse collateral base (*i.e.*, high diversity score). In particular, Moody's received feedback from its clients that its emphasis on the diversity score was outdated and was going to present a problem for the new type of deals being developed.

122. In short, older vintage CDOs were typically comprised of a variety of different types of assets such as aircraft leases, franchise loans, high yield bonds and mortgages, while the CDOs issued by at least 2004 were consistently dominated by one asset class such as RMBS. Typically, CDOs with diverse types of collateral show lower loss default correlations and, hence, require less credit enhancement to generate a particular rating. By contrast, collateral pools

dominated by a single type of collateral tend to show much higher correlation in default probabilities and demand greater credit enhancement.

123. The industry publication, Asset Backed Alert, confirmed Moody's perception of vulnerability to lost market share by reporting Moody's share of the market for rating CDOs as dropping from 91.5% in 2003 to 76.8% in 2004.

124. This drop in market share occurred primarily because, for CDOs dominated by one asset type (*i.e.*, RMBS), Moody's BET methodology was not generating the low credit enhancement levels that issuers demanded. Moody's started work in earnest on this problem and by August of 2004 developed a new ratings methodology for CDOs with a low diversity score called the Correlated Binomial Model. When it was introduced on August 10, 2004, Moody's stated that "the primary motivation behind the introduction of the Correlated Binomial is that the actual assets in a CDO portfolio are correlated and their default distribution has correspondingly higher probabilities of multiple defaults." In other words, Moody's believed the Correlated Binomial Model led to a more accurate reflection of credit risk because it was designed for the types of CDOs then going to market.

125. At first, Moody's implemented the Correlated Binomial Model only for a very limited group of CDOs that were comprised of a particularly concentrated asset base. In response to this action, Moody's encountered resistance from investment banks and other issuers, because it turned out that the Correlated Binomial Model actually was even more rigorous in

certain respects than Moody's BET. Put another way, as first introduced, Moody's Correlated Binomial Model gave structured finance securities even lower ratings that Moody's BET.

126. As a result, Moody's noticed that it continued to lose business to S&P for rating CDOs collateralized by RMBS, and senior management in the structured finance group became increasingly worried about how to further adjust its models to stem the erosion of its market share for rating CDOs backed predominantly by mortgaged backed securities. This concern was amplified by the fact that Moody's believed that S&P had adopted a rating methodology that enabled it to assign AAA ratings with relatively lower levels of credit enhancement to these same structured finance securities.

127. By early 2005, Moody's structured finance group agreed that a further update to Moody's Correlated Binomial Model was necessary, but there was disagreement over which direction the company should move. One Moody's managing director responsible for CDO rating methodology advocated for a methodology that built on the work previously done in the summer of 2004. However, more senior Moody's managing directors in the structured finance group rejected this suggestion and instead implemented a plan centered on modifying some of the correlation assumptions built into the Correlated Binomial Model, so that it more closely mimicked the lower credit enhancement levels that S&P was calculating when rating concentrated CDOs.

128. Thus, by at least late spring of 2005, Moody's was focused on keeping its rating methodology closely aligned to the results of S&P's methodology and Moody's employees

involved in methodology development were keenly aware that any actions that further hurt Moody's market share would be viewed negatively by Moody's upper management.

129. In June of 2005, Moody's implemented the first step in this strategy by publishing a follow-up paper entitled "Moody's Revisits its Assumptions Regarding Structured Finance Default (and Asset) Correlations for CDOs." This publication introduced a new set of correlation estimates for structured finance securities based on historical default data between approximately 1993 and 2003 and presented a framework for incorporating the revised correlation assumptions into the modeling of CDOs backed by these obligations.

130. On September 26, 2005, Moody's published a methodology paper entitled "Moody's Modeling Approach to Rating Structured Finance Cash Flow CDO Transactions," which implemented the concepts introduced in its June publication and officially "adopted a new quantitative modeling approach for structured finance cash flow CDO transactions." Essentially, Moody's had altered its Correlated Binomial Model to incorporate the new asset correlations published in June 2005 as an input that ultimately made the ratings methodology less conservative than the BET or the first version of the Correlated Binomial Model introduced a year earlier.

131. Moody's official public explanation for this transition was as follows: "As structured finance cash flow CDOs evolve towards transactions with increasingly concentrated collateral pools, mostly with more than 50% of the assets in the RMBS sector, it is important to

have a modeling method that can accurately capture the correlation among the underlying assets . . . . [T]he Correlated Binomial Model is better suited for this task than the BET."

132. In fact, the default correlations and loss estimates for the underlying RMBS and other ABS that Moody's built into its Correlated Binomial Model in September of 2005 were far too low because they had been developed on a relatively limited data set and were influenced by Moody's desire to mimic the credit enhancement levels calculated by its competitors. This reality led Moody's to knowingly underestimate the credit risk associated with these structured finance securities.

133. In sum, although presented publicly as an attempt to significantly improve analytical precision in credit risk evaluation, Moody's adaptations to its Correlated Binomial Model implemented in September of 2005 were in fact influenced by its desire to adopt an analytical approach that generated credit enhancement levels no more demanding than its chief competitor, S&P, and thereby regain its lost market share and enhance Moody's revenue. None of these objectives were consistent with Moody's Code of Conduct or its public commitment to maintaining the highest level of independence, objectivity and integrity in its credit ratings. The action did have the desired effect of boosting Moody's market share for rating CDOs, however, which increased to approximately 85% in 2005 and 96% in 2006.

134. The extent to which Moody's quest for market share factored into the development of rating methodologies, as well as the decision making of Moody's structured finance group generally, is also demonstrated by the routine inquiries senior Moody's executives

made to their subordinates about deal flow. For example, during the time period when key decisions about ratings criteria and methodology were being made, senior Moody's personnel, sent monthly e-mails to all of the managing directors in the structured finance group summarizing Moody's market share for structured finance ratings and inquiring about the transactions that Moody's did not rate.

135. For those transactions in which Moody's did not participate, the executives in the structured finance group were pressured to explain why the deal had not been rated by Moody's. One such e-mail posed the question as follows: "Please review your deal(s) and advise the reason for any rating discrepancy vis-à-vis our competitors." Even the slightest down-tick in market share caused a ripple effect from senior management to lower level executives. As one e-mail put it bluntly: "Market share by deal count dropped to 94%, though by volume it's 97%. It's lower than the 98+% in prior quarters. Any reason for concern, are issuers being more selective to control costs (is Fitch cheaper?) or is it an aberration." Faced with such a demand, a Moody's Group Managing Director immediately inquired of her subordinates as follows: "Can you please take a look at the deals that we didn't rate from the spreadsheet . . . sent out last night to double check the information and to let me know any of the stories?"

136. The message sent by Moody's senior management in monitoring market share in this manner was clearly heard and understood by Moody's managers. As one Moody's managing director responsible for rating structured finance transactions routinely told his staff, "I will be fired if we lose out on a single deal."

137. In 2008, Moody's made further adjustments to its methodology for rating CDOs backed by any ABS as the underlying collateral. Unfortunately, the influence of the revenue, market share and other business considerations identified above on Moody's approach to rating structured finance securities also played a role during this time frame. In the words of one former Moody's managing director, "[Moody's] continues to recklessly flout procedures and take analytical short cuts in their quest for revenue," and "the culture at Moody's [is] to never say no to a deal."

138. Specifically, in October of 2008, Moody's Credit Policy Team asked one of its managing directors who had previously been in charge of rating CDOs backed by sub-prime and other RMBS to evaluate the adjustments to its existing rating methodology. He informed them as follows:

> [M]y recommendation is that we do not rate ABS CDOs. The reasoning behind this recommendation is that due to the complexity of the product and multiple layers of risk, it is NEVER possible to have the requisite amount of information to rate . . . .
>
> [A]s to the issue of the adequacy of the proposal, I believe that it is completely inappropriate and irresponsible . . . .
>
> We are not using the best tools available to us . . . .
>
> [T]he presentation even acknowledges that the methodology is interim. I strongly argue, based on the regulatory expectations . . . that we do not rate based on incomplete data.
>
> The correlation numbers are generally too low. I am attaching an ABX research piece from JPM showing the expected write downs across the ABX series. The ABX serves as a great indicator of the

> average credit quality of the relevant vintages. As you can see, 100% average write downs in the base scenario extend from AA in 07-2 to BBB in 06. 100% write downs across and within several vintages also implies 100% loss correlation. This proposal does not appear to be capable of achieving such levels . . . .
>
> In many ways the methodology actually lowers standards: a) by adding strategic asset categories which when used in a tree structure actually reduce overall correlation . . . . It is inappropriate to lower correlations in this environment.

139. After receiving this report, members of Moody's Credit Policy Team asked: "Any suggestion on minimum numbers?" and "Do you think rating agencies can reasonably rate ABS CDOs but at some rating level lower than Aaa? If so, what level?" In response to these inquiries, the Moody's managing director who conducted the analysis replied:

> I believe the answer is no, given the present financial system. Let me give you a short answer and an invitation now and a longer answer later.
>
> What I have observed is that given a framework (be it a methodology, regulation, etc.) poorly incentivized individuals will try to arbitrage it. This arbitrage takes the form of delivering products or information which nominally meets the requirements, but actually holds far more risk than the regulations or methodology account for.
>
> The broader the framework, the more opportunity there is for arbitrage, and there is no broader framework than ABS CDOs . . . .
>
> I would like to invite you to a talk I am giving this morning to the [financial institutional group] entitled 'Lessons from the Crisis - - Origins, Hedged Trades, Counterparty Risk and Convexity." The main theme of the discussion is how poorly incentivized bankers took advantage of banking regulation by creating products or structures which fit the regulatory framework, but were in fact very risky.

140. In late 2008, despite the warnings, criticism, and ultimate rejection by the managing director tasked with evaluating Moody's proposed adjustments to its rating methodology, Moody's approved the adjustments and implemented them when rating structured finance securities in late 2008 and into 2009. This decision was directly influenced by Moody's desire to maximize its business opportunities (*i.e.*, participate in rating as many structured finance transactions as possible) and to enhance its revenue. As described by one Moody's managing director, ". . . the primary motivation for the rating methodology is increasing revenue and not actual credit [risk]." Moreover, "[Moody's] has become desperate to generate revenue. This has led to the approval and rating of more complex and highly questionable transactions."

141. Once again, neither of these objectives was consistent with Moody's Code of Conduct or its public commitment to maintaining the highest level of independence, objectivity and integrity in its ratings for structured finance securities. To the contrary, as of at least late 2008, Moody's independence and objectivity when formulating its rating methodologies for structured finance securities was still influenced and compromised by inappropriate business considerations such as revenue generation, catering to the preferences of issuers, and market share.

C. Moody's Compensation Plan Improperly Incentivized its Analysts

142. Moody's compensation plan for its analysts was a significant factor in the loss of independence and objectivity in its ratings of structured finance securities. Specifically, beginning in 2000, Moody's opened up its employee stock ownership plan to employees

involved in rating analysis, which meant that at the same time that Moody's was developing new rating methodologies for structured finance securities and assigning ratings for these investments, its mid-level managers and senior rating analysts were receiving a compensation bonus – in the form of stock options – that was tied directly to the performance of the company.

143. This form of incentive compensation further aligned the interests of those Moody's employees who interacted most directly with issuers of structured finance securities, and provided recommendations on the issuers proposed levels of credit enhancement, with the interests of the issuers themselves instead of the interests of the market participants who relied on Moody's ratings to be independent and uninfluenced by Moody's prospect for financial gain.

144. In practice, instituting a stock option component to an employee's compensation structure meant that junior Moody's employees who were in a position to influence the process on a day to day basis were much more likely to make decisions that could increase – rather than decrease – the value of Moody's stock.

145. The relative portion that this incentive compensation represented in an analyst's overall compensation could be quite significant. In the words of one former Moody's analyst, "there were mid-level managers responsible for analytics that were able to retire based on the stock options and other incentive compensation that they had received."

146. This mindset was precisely what senior Moody's managers had in mind, for at its core, a stock ownership plan is designed to incentivize employees to perform because the employee has a long term stake in the future of the company. This served to only exacerbate the

conflicts of interest inherent in the Issuer Pays business model. From a financial perspective, employees at nearly every level of Moody's management structure had every incentive to tell issuers "yes" instead of "safeguarding the integrity of the rating process" as Moody's committed to do when it endorsed the IOSCO Code in 2005.

D. Moody's Punished Employees Who Expressed Dissenting Views

147. Moody's sacrifice of its independence and objectivity due to its desire to please issuers of structured finance securities is also evidenced by the manner in which it responded to dissent within the organization. Specifically, those Moody's analysts who displeased issuers of structured finance securities (*i.e.*, those who disagreed with the proposed level of credit enhancement necessary to achieve a particular rating) were given negative performance evaluations and were reassigned away from issuers that lodged complaints with the relevant Moody's managing director. Similarly, those Moody's employees who internally raised concerns about the manner in which Moody's was rating structured finance securities were marginalized within the company, received less compensation and were demoted.

148. For example, in September of 2007, a Moody's managing director expressed concern to his direct supervisor with respect to the underlying credit quality of many ABS CDOs rated by Moody's. Specifically, he noted that market data suggested severe downgrades of RMBS collateralized by subprime mortgages were necessary and that Moody's RMBS group was currently in the process of calculating the appropriate downgraded ratings for all of the affected RMBS tranches. What particularly concerned this individual, however, was that during

this same time frame there were several CDOs backed by the affected RMBS that were still in the pipeline for issuance and waiting to be rated by Moody's.

149. As described in Section III.A, Moody's CDO rating methodology uses ratings on RMBS as a measure of credit risk to determine the rating ultimately assigned to a CDO collateralized by the securities. If the ratings on RMBS are faulty then the ratings on the CDOs backed by these investments will also be faulty.

150. Based on the looming threat of downgrades for subprime RMBS and the fact that issuers were still seeking ratings on CDOs backed by these assets, the Moody's managing director advised his supervisor that Moody's should stop rating all ABS CDOs until Moody's had completed its downgrades of RMBS, thus allowing the new CDOs backed by these assets to be rated in a manner that accurately reflected Moody's assessment of their credit risk.

151. When presented with the managing director's recommendation, his supervisor admonished him and was more concerned with losing market share to a competitor than addressing his concerns. Undeterred, the managing director facilitated a meeting with a more senior Moody's executive. Following this meeting, Moody's decided to continue rating ABS CDOs backed by subprime RMBS.

152. Equally as important, however, was the manner in which Moody's treated the employee, and the clear message it sent to his colleagues in Moody's structured finance group. Rather than being rewarded for bringing these concerns to the attention of Moody's senior management, the managing director was marginalized within the company. In particular, he was

excluded from meetings and decisions related to the rating of ABS CDOs. Additionally, he was transferred from his existing position to a position in another unit within Moody's structured finance department that was not budgeted at the managing director level. As a result, the managing director's role within the company, and concomitantly, his compensation were reduced.

153. In his new position, the managing director continued to voice his concerns regarding the manner in which Moody's rated structured finance securities and the rating methodologies developed to rate ABS CDOs. His recommendations were repeatedly rejected by Moody's senior management, who instead, unbeknownst to the buyers / investors in the structured finance securities that Moody's rated as well as other market participants, elected to continue to pursue a business strategy focused on revenue and market share enhancement to the detriment of ratings quality.

154. The powerful message conveyed to Moody's employees by the above actions was clear: if you speak up and potentially interfere with Moody's ability to please issuers and, therefore, generate additional revenue for Moody's, you should be prepared to pay the consequences. This set of incentives is directly at odds with Moody's public emphasis on maintaining independence and objectivity in its ratings of structured finance securities.

E. Moody's Compromised the Objectivity of its Compliance Department

155. Central to the success of Moody's plan to cater to the demands of the dominant issuers of structured finance securities rather than adhere to its commitment to safeguard the

integrity of the ratings process was Moody's decision to marginalize and render powerless its Compliance Department.

156. Despite Moody's public representations to the contrary, its Compliance Department was not valued within the company and was prevented from monitoring Moody's adherence to its Code of Conduct. For example, in the spring of 2006 two of the most competent and experienced compliance officers at Moody's were fired and replaced by employees from Moody's structured finance department. The replacements were not qualified for their new positions and their arrival hindered the Department's ability to do its job effectively.

157. What was particularly problematic about this personnel change is that it compromised the Compliance Department's own independence and objectivity. With the transfer of the former structured finance employees several compliance personnel were now in the unenviable position of judging the behavior of their friends and former colleagues.

158. What made this conflict even worse was that the former structured finance employees' stint in Compliance was only temporary and upon completion Moody's expected them to rejoin the structured finance group and resume working with the very managing directors and analysts that they were supposed to be policing. Such a revolving door mentality further compromised the integrity of Moody's compliance function because, as a group, it now had even less incentive to push back against the demands of the business. In short, Moody's Compliance officers were in the position of reviewing, and possibly criticizing, the same conduct they had

engaged in and might be expected to resume upon their rotation back to the structured finance group.

159. Starting in at least 2006, Moody's Compliance Department was marginalized within the company, excluded from receiving information necessary to do its job effectively and prevented from participating in decisions that would normally fall under the compliance function. In the words of the head of the Department during this time period, "my guidance was routinely ignored if that guidance meant making less money or emplacing separation requirements to address conflicts of interest between the ratings side and the business development side . . . . I was deliberately left out of discussions which had a significant compliance dimension and on which I would have given very strong guidance."

160. The takeover of Moody's Compliance Department by the structured finance group culminated in 2008, when the previous head of the Compliance Department was fired and replaced by a managing director from the structured finance group who previously had specialized in rating mortgage backed securities.

161. Moody's general lack of interest in its Compliance Department, despite its public representations to the contrary, is also evident by the response of Moody's senior management when problems were brought to its attention. Indeed, rather than being encouraged to follow up on concerns that were raised about Moody's ratings process, the head of Moody's Compliance Department was simply instructed by Moody's legal department "not to mention the issue in any e-mails or any other written form."

162. Moody's growing disdain for its compliance function and its perception of the Compliance Department as an obstacle rather than a partner was also expressed at meetings open to a broader group of Moody's employees. For example, at a dinner party following an end of the year Board Meeting attended by Moody's Compliance Department and several senior Moody's managing directors, the President at the time of Moody's Investors Service, Inc. walked by the head of the Compliance Department and said quite loudly, "Hey . . . how much revenue did Compliance bring in this year?"

163. Just as is the case with constantly monitoring market share, requiring senior managers to explain why deals had not been rated even after just the smallest drop in market share, punishing individuals with dissenting viewpoints and instilling a culture of fear if business development goals were not met, the implications of the above actions are the same. What was valued – and rewarded – at Moody's was rating the deal and not forgoing revenue that could be captured by a competitor. By contrast, adhering to the requirements of Moody's Code of Conduct and its public representations was denigrated.

164. In sum, the stated purpose and work of Moody's Compliance Department was subordinated to its desire to please the relatively small group of repeat issuers that were Moody's frequent customers, Moody's quest for market share, and its goals of revenue enhancement. These actions are yet more examples of the manner in which Moody's independence, objectivity and integrity have been sacrificed to achieve the same goals.

VI. CAUSES OF ACTION

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

1-164. Paragraphs 1 through 164 of the Complaint are hereby repeated and realleged as Paragraphs 1 through 164 of this First Count as if fully set forth herein.

165. At all times relevant to this Complaint, Moody's was engaged in the trade or commerce of providing credit ratings to issuers located in Connecticut and providing credit ratings for use by investors and other market participants within the State of Connecticut.

166. 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 Moody's ratings of structured finance securities are independent, objective, and free from consideration of Moody's desire for revenue or additional business from issuers;

b. that Moody's understands that it holds a position of trust in the marketplace and, as such, deals fairly and honestly with the public, including the buyers / investors of the structured finance securities that it rates;

c. that Moody's understands that the Issuer Pays business model creates conflicts of interest but that these conflicts have been adequately managed and neutralized by its Compliance Department and the principles set forth in Moody's Code of Conduct;

d. that Moody's agrees with and has implemented the principles set forth in the IOSCO Code of Conduct pertaining to its obligation as a credit rating agency to maintain the independence, objectivity and integrity of its ratings of structured finance securities; and

e. that Moody's understands that its independence and objectivity requires it to sometimes provide answers that its clients (*i.e.*, issuers) don't like, and that it undertakes this task because doing so is necessary for proper credit analytics.

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

a. that Moody's ratings of structured finance securities were influenced by its desire to please its clients, increase market share, and enhance revenue for the company;

b. that Moody's does not deal fairly and honestly with buyers / investors of structured finance securities or other market participants;

c. that Moody's allowed business and revenue considerations to influence the rating methodologies it developed to rate structured finance securities;

d. that Moody's Compliance Department was not valued within the company and, therefore, was incapable of preventing the demands of the Issuer Pays business model from compromising Moody's independence and objectivity;

e. that Moody's did not operate its business in conformance with either its own Code of Conduct, or the principles set forth in the IOSCO Code;

f. that Moody's structured finance ratings were based in part on the preferences of the narrow group of repeat issuers of structured finance securities that dominated Moody's revenues; and

g. that Moody's structured finance ratings were based in part on a desire to promote Moody's own economic interests.

168. 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; and

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

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

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

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

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;

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;

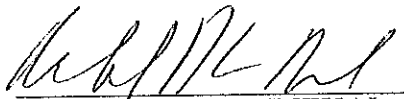
8. Costs of suit; and

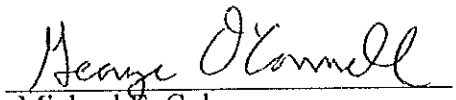
9. Such other relief as this Court deems just and equitable.

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

Dated at Hartford, Connecticut, this 10th day of March, 2010.

PLAINTIFF
STATE OF CONNECTICUT

By: 
RICHARD BLUMENTHAL
ATTORNEY GENERAL

By: 
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RETURN DATE: MARCH 30, 2010

STATE OF CONNECTICUT	:	SUPERIOR COURT
	:	
	:	JUDICIAL DISTRICT OF HARTFORD
Plaintiff,	:	
	:	AT HARTFORD
v.	:	
	:	
MOODY'S CORPORATION and	:	
MOODY'S INVESTORS SERVICE, INC.	:	
	:	MARCH 10, 2010
Defendants.	:	

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

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