13CV001703

STATE OF NORTH CAROLINA

COUNTY OF WAKE

IN THE GENERAL COURT OF JUSTICE
SUPERIOR COURT DIVISION
FILE NO:

STATE OF NORTH CAROLINA, ex rel.
ROY COOPER, Attorney General,

Plaintiff

v.

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

Defendants

COMPLAINT

I. SUMMARY OF THE CASE

1. This lawsuit seeks redress for The McGraw-Hill Companies, Inc.'s, Standard & Poor's Financial Services LLC's, and its business unit Standard & Poor's Ratings Services' (referred to herein collectively as "S&P") unfair, deceptive, and illegal business practice of systematically and intentionally misrepresenting that its analysis of structured finance securities was objective, independent and not influenced by either S&P's or its clients' financial interests. These representations were untrue and S&P knew they were untrue.

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

3. This principle has been further emphasized by S&P in its publicly available Code of Conduct in which S&P explicitly pledged that its analysis of structured finance securities is

objective and uninfluenced by "the potential effect . . . [on S&P,] an issuer, an investor, or other market participant."

4. Despite these intentional and explicit representations, S&P failed to live up to its promises of independence and objectivity when analyzing structured finance securities and thereby violated the trust that it successfully cultivated with the marketplace. Moreover, S&P 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.

5. Starting in at least 2001, S&P knowingly allowed its desire for increased revenue and market share in the structured finance ratings market to influence the analytical models it developed for analyzing structured finance securities and, ultimately, the ratings that were assigned to these investments. Similar revenue and market share concerns dictated the manner in which S&P monitored the performance of structured finance securities that S&P had already rated. S&P's desire to maximize revenue and market share by rating as many structured finance deals as possible led S&P to cater to the preferences of large investment banks and other repeat issuers of structured finance securities that dominated S&P's revenue base, rather than focusing on what S&P said it was doing, which was providing independent and objective credit analysis.

6. Thus, when formulating its analytical models for rating structured finance securities, S&P made adjustments to its models based on what would maximize its revenue and, therefore, be best for its business. As a result, S&P utilized analytical models that its senior managers knew were influenced by market share and revenue considerations. Similarly, S&P knowingly failed to use the best analytic tools available to it to conduct surveillance on those

structured finance securities that it already had rated. S&P engaged in this conduct because it enabled S&P to continue to assign the high ratings that S&P's frequent customers desired, thus enabling S&P to maximize its revenue and preserve its already high market share for rating structured finance securities.

7. In essence, S&P had its cake and ate it, too. In order to promote its overall business model and induce a wide range of investors and others to use and rely on its ratings, S&P held itself out as an entity that provided objective analysis and ratings of complex financial instruments. However, at the same time that S&P was making public representations regarding its objectivity, in practice it was privately compromising its objectivity to serve its own financial interests of obtaining and keeping the business of investment banks and other entities who were both issuing these instruments and paying S&P to analyze and rate them. This core misrepresentation by S&P undermined the very nature of the service S&P purports to provide, caused harm to the public in countless ways, and played a major role in creating the national financial crisis.

8. This lawsuit does not challenge S&P'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 S&P rating on a structured finance security was incorrect (*i.e.*, too high or too low).

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

10. By misrepresenting and omitting factors it considered when analyzing structured finance securities, S&P offered a service that was materially different from what it purported to provide to the marketplace.

11. S&P has steadfastly disavowed responsibility for its conduct.

12. S&P's conduct as described herein constitutes a deceptive, unfair and illegal business practice, as well as an unfair method of competition, in violation of N.C. Gen. Stat. § 75-1.1. Pursuant to N.C. Gen. Stat. § 75-1.1, the plaintiff State of North Carolina ("the State") seeks injunctive relief, disgorgement, and civil penalties to prevent these unfair, deceptive and illegal business practices from happening in the future.

II. PARTIES

13. The State, acting through its Attorney General, Roy Cooper ("Attorney General"), brings this action in its sovereign enforcement capacity pursuant to authority granted by Chapters 75 and 114 of the North Carolina General Statutes.

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

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

Financial Services LLC is the successor entity to a unit that previously operated within an unincorporated division of McGraw-Hill.

16. S&P holds a dominant position in the credit rating agency market, particularly with respect to the analysis of structured finance securities. For example, S&P routinely assigns ratings to over 90% of the structured finance securities issued into the global capital markets. As of 2009, S&P had rated and currently monitored ratings on approximately 198,000 structured finance obligations.

17. S&P regularly transacts business in the State of North Carolina and derives substantial revenue from its business within this State. S&P's analysis of structured finance securities is routinely used and relied on by investors, government regulators, and other participants in the financial markets located within this State. Based on S&P's public representations, these individuals and entities depend on S&P to provide independent and objective analysis of the credit risk of structured finance securities that is not affected by S&P's or its clients' financial interests.

III. BACKGROUND

A. Structured Finance Securities

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

19. The largest type of structured finance securities are securities backed by residential mortgages ("RMBS"). During 2006, approximately $2.5 trillion in mortgages were originated in the United States. Approximately 80% of those mortgages were securitized into RMBS. 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.

20. 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.

21. 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.

22. The most common types 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").

23. 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, which are extremely complex financial products, 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").

24. 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 S&P or another credit rating agency recognized by the Securities and Exchange Commission ("SEC").

25. S&P engages in the following steps when rating a RMBS. First, upon receiving a range of data on a pool of mortgage loans from an investment bank or some other arranger, S&P 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.

26. The next step in the process is for the S&P analyst to use S&P's analytical models to develop predictions as to how many loans in the collateral pool would default individually and in correlation with each other under varying levels of stress. S&P's analytical models are built on a series of assumptions with respect to probability of default and asset correlation and, like any model, their output is subject to adjustment based on changes made by S&P to S&P's underlying assumptions.

27. The purpose of S&P using its analytical models to carry out a default and loss analysis is to determine how much credit enhancement a given tranche security would need for a particular category of rating. S&P 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.

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

29. Upon analyzing the proposed capital structure based on S&P's analytical models, if S&P determines that the issuer's proposal does not allow for sufficient credit enhancement to receive a "AAA" rating, then S&P 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.

30. Similarly, the steps that S&P 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 analytical models developed by S&P, 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, S&P's analytical models look only to the credit rating of each RMBS (or other structured finance security) in the

underlying pool and do not include an analysis of the underlying loan pools collateralizing the RMBS.

B. The Market for Structured Finance Securities

31. 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.

32. 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 North Carolina.

33. The consumers of S&P's analysis of structured finance securities are not limited to just investors. For example, S&P's analysis is routinely used by government regulators to assist with capital adequacy evaluations and other assessments of the financial health of regulated entities.

34. There are few credit rating agencies that assign ratings to structured finance securities. Consequently, the market for rating structured finance securities is extremely concentrated. S&P, and its primary competitor, Moody's Investors Service, Inc. ("Moody's"),

dominate the rating of these investments. For example, according to industry publication Asset-Backed Alert, S&P rated 97.5% of the CDOs issued in 2006.

35. The market for analyzing structured finance securities is also very lucrative. S&P charges three or four times as much to analyze and rate a structured finance security as it does for a rating on a corporate bond. In 2006, S&P's revenues rose approximately 15% to $1.27 billion, with approximately one half of that growth derived from S&P's increased sale of structured finance security ratings. Industry publications also estimate that as much as 40% of S&P's total revenue is derived from its analysis of structured finance securities.

36. 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 S&P to analyze their products on a regular basis.

C. S&P's Role in the Market for Structured Finance Securities

37. 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, S&P is a gatekeeper on whom investors, government regulators, and other consumers necessarily rely.

38. S&P's role as a "gatekeeper" takes on special importance in the market for structured finance securities because historically its investment grade rating has been a necessary condition before many institutional investors are permitted under SEC regulations to buy debt securities. In this sense, S&P's rating also acts as a de facto regulatory license that expands the universe of potential buyers and investors capable of purchasing a particular structured finance security.

39. In light of the opaque nature of structured finance securities as an investment, buyers and investors in structured finance securities, government regulators, and other consumers depend on S&P's analysis to obtain some relative assessment of the credit risk associated with the various RMBS, CDOs and other ABS tranches that are issued. Indeed, issuers obtain a credit rating from S&P for the specific purpose of making the risk characteristics of the structured finance security understandable to the financial markets.

40. As such, the rating that S&P 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. S&P is well aware that buyers and investors, government regulators, and other consumers use and rely on S&P's analysis in this manner.

41. Buyers and investors of structured finance securities, government regulators and other consumers expect and depend on S&P to independently and objectively fulfill its self described role as alleged above.

D. S&P's Credit Rating Scale for Structured Finance Securities

42. The result of S&P's analysis of structured finance securities is summarized in a rating on a letter-based scale ranging from AAA to D. According to its ratings definitions, S&P's letter grades are expressed in relative rank order, with a structured finance security rated "AAA" by S&P having "the highest rating assigned by [S&P,]" meaning that "the [issuer's] capacity to meets is financial commitment on the structured finance security is extremely strong." Structured finance securities rated "AA," "A," "BBB," "BB," "B," "CCC," "CC," "C," and "D" are represented by S&P to have progressively less creditworthiness with each succeeding reduction in grade level.

E. The Issuer Pays Business Model

43. S&P is selected by the same entities that issue the structured finance securities that S&P is tasked with evaluating. In exchange for analyzing the transaction and assigning a credit rating to a security, S&P charges the issuer, or "special-purpose vehicle," a fee based on the complexity and size of the structured finance transaction being analyzed. Typically, this fee is ultimately passed on to the investors in the transaction. Nevertheless, as has been repeatedly noted in Congressional testimony, this business model ensures that S&P is essentially "a watchdog paid by the persons it is to watch."

44. The financial incentives and conflicts of interest inherent in the "Issuer Pays" business model led S&P to violate its public representations of independence and objectivity in S&P's credit analysis of structured finance securities.

45. Specifically, as the volume of RMBS and CDO issuance increased, the volume of opportunities to earn lucrative fees for issuing "AAA" ratings on these structured finance securities increased as well. For S&P 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 S&P's repeat customers, or run the risk of not being retained by these issuers in the future.

46. S&P's ability to please issuers of structured finance securities is dependent on its analytical models requiring the least amount of credit enhancement in order to achieve a desired rating. The smaller or lower the credit enhancement, the more profitable the security is to the issuer.

47. Issuers of structured finance securities are well aware of S&P's incentive to alter its credit analysis in favor of higher ratings and therefore more fees. An issuer typically requests ratings from not only S&P but also from S&P's main competitors, Moody's and Fitch, Inc.

("Fitch"). If the issuer is unhappy with the credit enhancement levels proposed by S&P after it conducts its analysis, the issuer can inform S&P of the credit enhancement levels proposed by either Moody's or Fitch in order to influence the outcome of S&P's analysis. In such a situation, S&P can either adjust its assumptions in its analytical model to win the business, or stay true to its original analytical judgments (and public representations) and potentially lose the business.

48. This practice is known as "ratings shopping" because issuers offer their business 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.

IV. S&P REPRESENTS ITSELF TO THE PUBLIC AS PROVIDING INDEPENDENT AND OBJECTIVE ANALYSIS OF STRUCTURED FINANCE SECURITIES

A. S&P's Pledge to Safeguard the Integrity of the Ratings Process

49. S&P represents to investors, government regulators and other consumers that its analysis of structured finance securities is independent, objective and free from outside influence. S&P repeatedly and publicly emphasizes its independence and objectivity to investors and other consumers in a variety of public statements.

50. For example, S&P's web site has stated that: "[S&P's] mission is to provide high quality, objective, independent, and rigorous analytical information to the marketplace" and explained that S&P "endeavors to conduct the rating and surveillance processes in a manner that is transparent and credible and that also maintains the integrity and independence of such processes in order to avoid any compromise by conflicts of interest, abuse of confidential information, or other undue influences."

51. Similarly, in its 2004 Code of Practices and Procedures, S&P noted that it "endeavors to conduct the rating and surveillance process in a manner that is transparent and credible and that also ensures that the integrity and independence of such processes are not

compromised by conflicts of interest, abuse of confidential information, or other undue influences." In this same document, S&P also promised that S&P's "mission has always remained the same – to provide high-quality, objective, independent, and rigorous analytical information to the marketplace" and that "in all analytic processes, [S&P] must preserve the objectivity, integrity and independence of its ratings. In particular, the fact that [S&P] receives a fee from the issuer must not be a factor in the decision to rate an issuer or in the analysis and the rating opinion."

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

53. Echoing the above pledge, S&P's Code also notes that "[S&P] fully supports the essential purpose of the IOSCO Code, which is to promote investor protection by safeguarding the integrity of the rating process. [S&P] believes that the Code is consistent with the IOSCO Code and appropriately implements IOSCO's Statements of Principles Regarding the Activities of Credit Rating Agencies."

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

55. 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."

56. 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."

57. With these principles as a guide, since October of 2005, S&P has made several representations in its Code about the manner in which S&P maintains the independence and objectivity of its analysis and avoids conflicts of interest with issuers. Section 2.1 of S&P's Code states: "[S&P] shall not forbear or refrain from taking a Rating Action, if appropriate, based on the potential effect (economic, political, or otherwise) of the Rating Action on [S&P], an issuer, an investor, or other market participant."

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

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

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

61. The Code has remained substantially in effect throughout the relevant time period until it was revised in 2012.

62. The statements made by S&P 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 S&P to buyers / investors, government regulators and other consumers:

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

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

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

d. That S&P understands the Issuer Pays business model creates conflicts of interest, but that these conflicts have been adequately managed by the company as demonstrated by the principles set forth in S&P's Code so as to ensure that its credit ratings are purely a function of credit analytics.

e. That S&P dedicates the resources necessary and does in fact conduct timely and thorough surveillance on its analysis of structured finance securities to ensure that the rating assigned by S&P continues to reflect S&P's assessment of the credit risk associated with the obligation.

63. The above representations made by S&P are material to buyers and investors of structured finance securities, government regulators, as well as other consumers and also have been reasonably interpreted by those same individuals and entities in light of the circumstances in which the representations have been made.

64. None of the above pattern of representations made by S&P were true.

V. S&P'S ANALYSIS OF STRUCTURED FINANCE SECURITIES WAS NOT INDEPENDENT AND OBJECTIVE

65. S&P's sacrifice of its independence and objectivity due to its desire to earn more revenue has manifested itself in several ways.

A. Ratings Shopping Corrupts the Integrity of the Process

66. "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.

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

68. The fact that these outside influences did affect S&P's analysis of structured finance securities was not disclosed by S&P in its public statements. To the contrary, S&P represented quite the opposite by repeatedly stating that its analysis was not influenced by its business relationships.

B. S&P's Quest for Revenue Influenced its Analytical Models

69. S&P's desire for more revenue led S&P to make adjustments to the assumptions built into its analytical models used to rate RMBS and CDOs or, alternatively, to intentionally refrain from updating its analytical models based on the best information available to S&P in order to preserve the use of analytical models that were appealing to issuers. S&P engaged in this conduct knowingly and for the explicit purpose of allowing it to assign its highest rating of "AAA" to as large a portion of the structured finance securities it rated as possible.

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

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

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

72. S&P's decision to compete on the basis of loosening its analytical models, thereby making it easier to assign a "AAA" rating to as large a portion of the structured finance securities it rated as possible, was entirely inconsistent with its public representations and resulted in a race to the bottom in the credit rating industry where robust credit analysis was actually an impediment to a credit rating agency maintaining or growing its revenue. Given S&P's dominant position in the market for rating structured finance securities, S&P's decision to compete for business in this manner also punished those credit rating agencies interested in living up to their public representations and made it impossible for such entities to successfully compete based on the strength of their credit analysis.

73. S&P's adjustment to its analytical models based on revenue and market share concerns began as early as 2001 and laid the foundation for S&P's mass downgrades of RMBS during the summer of 2007.

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

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

76. In sum, between at least 2001 and 2008, when analyzing RMBS, S&P's internal business strategy valued revenues over ratings quality. As stated by a former S&P senior executive, "profits were running the show," and business managers at McGraw-Hill were not interested in improving databases and models as requested by the analysts.

77. S&P's desire for increased revenue and maintenance of its high market share also led S&P to make several adjustments to the analytical model used by S&P to rate CDOs in order to make them more business friendly and appealing to CDO issuers.

78. Indeed, by at least 2004, S&P's unstated willingness to cater to the demands of issuers intruded on the entire analytical model that S&P developed for rating CDOs. During this time frame, S&P's senior management was primarily concerned about losing out on revenue to either Moody's or Fitch and believed that the only way for S&P to successfully compete for an issuer's business was to make sure that S&P's levels of proposed credit enhancement allowed S&P to assign a "AAA" rating to as large a portion of the CDOs it rated as possible.

79. During this time frame, S&P initiated a project to update its CDO Evaluator model, which was the primary analytical model that S&P used to rate CDOs. The stated purpose of this project was for S&P's analytical team to study the assumptions that served as the underpinnings of the model and make recommendations regarding changes that would allow the model to more accurately predict credit risk. In reality, another goal of the project became to develop assumptions that would allow S&P to maintain and grow its market share for rating as many different types of CDOs as possible.

80. Indeed, the release of S&P's revised CDO Evaluator model was specifically delayed due to negative feedback from S&P's CDO issuer clients. In the words of senior leaders in S&P's structured finance department: "Due to the not insignificant impact on lowly rated . . .

synthetic reference pools . . . we have toned down and slowed down our roll out of [CDO Evaluator] to the market, pending further measures to deal with such negative results . . . . Bear Sterns pointed out that the potential business opportunities we would miss by effectively having to walk away from such high yield structures would NOT be compensated for by any increase in rating volume for highly rated collateral pools."

81. As a result, the analytical team at S&P responsible for making recommendations on how best to improve S&P's analysis of CDOs was repeatedly pressured by senior S&P executives responsible for revenue generation to adjust their recommendations so that S&P's analysis would not become any more conservative than S&P's closest competitors. This pressure was placed on the analytical team for the explicit purpose of allowing S&P to increase its revenue and grow its market share.

82. At the conclusion of this special project, S&P introduced a revised CDO Evaluator analytical model ("E3") that explicitly took into consideration S&P's revenue and market share goals. In particular, the correlations and probability of default assumptions underlying this model were adjusted to reflect what was best for S&P's ratings business. Indeed, concerns of revenue generation and market share preservation were the prime influences on the assumptions ultimately adopted by S&P in its analysis. These influences directly contradicted S&P's public representations and were not disclosed to consumers.

83. In May of 2007, S&P privately acknowledged the full extent that its desire for increased revenue and market share had played, and was continuing to play, in its analysis of CDOs as part of a presentation made to the senior leaders of S&P's structured finance group. In particular, in a slide titled "A Better Mousetrap," S&P summarized its past analytical approach as follows: "To come up with [probability of defaults] and asset correlations in [CDO

Evaluator], we look at our raw data and come up with a statistical best fit. When this does not meet our business needs, we have to change our parameters ex-post to accommodate."

84. This private acknowledgment directly contradicts all of S&P's public representations with respect to the factors it considers when analyzing CDOs and other structured finance securities. But S&P went even further. The "Better Mousetrap" that S&P was developing called for S&P to first start with a set of assumptions that were best for its ratings business and then try to fit those assumptions into the available data. If the selected matrices were not "reasonable" for some reason, S&P simply tried a different set of business friendly matrices and started the process anew. This proposal for how S&P should conduct its analysis going forward was met with approval from S&P's structured finance leadership.

85. Those S&P employees who resisted S&P management's drive to adjust S&P's analysis in order to maximize revenue were ignored within the company and marginalized.

86. The undisclosed influences of market share and increased revenue outlined above did not just drive S&P analysis in the years leading up to the financial crisis. In 2011, S&P continued to adjust the assumptions of the analytical models that it used to rate structured finance securities so that S&P could more easily assign its highest ratings and, thereby, increase its market share and revenue. S&P engaged in this conduct in late 2011 at the request of and with the full knowledge and support of its senior leadership.

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

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

88. Prior to 2008, S&P performed only a sporadic and cursory review of its RMBS ratings and intentionally did not use the best surveillance tools that were at its disposal. This reality was in sharp contrast to the public representations of S&P's senior executives, including the managing director of RMBS, highlighting that the company maintained a robust surveillance process with substantial resources at its disposal that allowed S&P to timely and thoroughly monitor the performance of previously rated RMBS.

89. S&P did not dedicate the necessary resources to effectively conduct surveillance on previously rated RMBS and failed to use its analytical models as part of the monitoring process of these obligations.

90. S&P knew that there was very little profit in diligently monitoring the performance of previously rated RMBS because S&P had already been paid its fee and issuers continued to want only AAA ratings. Indeed, proper surveillance could actually lead to S&P earning less revenue because it could be perceived as calling S&P's initial analysis into question.

91. Accordingly, S&P failed to properly fund and dedicate the appropriate number of personnel to surveillance, and did not use the best tools that it had available to conduct surveillance on previously rated RMBS. This failure by S&P reached a breaking point in late 2006 and early 2007.

92. S&P's desire for increased revenue and market share also resulted in it ignoring the recommendations of its surveillance group and delaying the downgrade of impaired RMBS in order to further its own financial interests, as well as the financial interests of its issuer clients. Specifically, despite its meager resources, by January of 2007 S&P's surveillance group concluded that they needed to intensify their review of 2006 vintage subprime RMBS and begin

taking large scale negative rating action. In February of 2007, S&P's surveillance team made formal recommendations to that effect to S&P senior management.

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

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

95. Moreover, on or about June 11, 2007, S&P's surveillance group determined that, on average, tranches of subprime RMBS rated BBB and lower had greater than 100% severe delinquencies versus available credit support, which meant that the ratings of these RMBS tranches were, on average, almost certainly to be lowered. Despite this determination, after June 11, 2007, S&P continued to assign and confirm ratings for CDOs exposed to significant amounts of subprime RMBS tranches rated BBB and below. In sum, S&P took these RMBS ratings at face value as inputs for its analytical model and did nothing to account for the fact that many of the underlying RMBS tranches would almost certainly be downgraded. S&P engaged in this

conduct in part because it wanted to maximize its revenue and continue to please its CDO issuer clients.

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

VI. S&P's MISCONDUCT CONTINUES

97. On February 7, 2008, S&P publicly announced that it would take "leadership actions" to further strengthen the rating process and help restore confidence in the markets following the financial crisis.

98. S&P's "leadership actions" included separating S&P's criteria development groups from its commercial groups so they would be independent and not influenced by business concerns, and strengthening criteria on most of the major asset classes.

99. In May 8, 2008, S&P hired Mark Adelson – a former vocal critic of rating agencies – as its Chief Credit Officer to manage the new independent criteria group and supervise key changes to S&P's rating criteria and methodologies.

100. In August 2008, S&P hired David Jacob to manage S&P's Structured Finance group, on the commercial rating side of the business, as part of S&P's efforts "to improve transparency, build investor confidence, and continue to deliver high-quality, independent analytics." Jacob wanted to "ensure that S&P analysts didn't loosen standards at the request of bankers." Jacob, like Adelson, had been a critic of rating agency conduct. Prior to joining S&P, Jacob and Adelson had been partners in a consulting firm.

101. In October 2008, S&P President Deven Sharma reaffirmed S&P's promises of reform to the House Committee on Oversight and Government Reform, testifying that S&P had taken a number of actions to enhance its rating process and restore the market's confidence in its ratings following the financial crisis.

102. In keeping with his philosophy that rating criteria should be as reliable "as jet engines on an airplane," Adelson helped revise S&P's rating methodology for CMBS to a more conservative model that established a "AAA credit enhancement level that would be sufficient to enable tranches rated at that level to withstand market conditions commensurate with an extreme economic downturn without defaulting." With the release of the new criteria on June 26, 2009, the ratings on 1,586 tranches of CMBS transactions were immediately placed on Credit Watch negative, indicating that the rating may be lowered. After the revised methodology went into effect, S&P lost CMBS business to its competitors, Moody's and Fitch.

103. In September 2009, S&P President Sharma again reaffirmed S&P's promises of reform in testimony before the House Financial Services Subcommittee, who he assured that S&P had learned from the past regarding its ratings on structured finance securities, and that it had made "major changes" to restore confidence in its ratings. Sharma cited to S&P's separation of its criteria development groups from its commercial groups and other actions taken to avoid conflicts of interest.

104. In December 2010, under Adelson's leadership, S&P published an update that toughened its methodologies and assumptions for counterparty criteria. Counterparty risk is an important factor in determining the credit risk of structured finance securities. The updated criteria were criticized by market participants who contended that they were too onerous.

105. Despite the reform efforts by Adelson and Jacob, the emphasis on market share at the expense of analytics began growing again at S&P. In the spring of 2011, S&P President Sharma called Jacob and "gave him hell" about loss in business. Jacob explained that the loss was due in part to securities which required counterparty criteria that Adelson had toughened. Sharma pressured Jacob to do something about it, but Jacob said he was not able to do so because of the separation between the business and analytical sides at S&P. Sharma was unhappy with Jacob's response. Following the conversation, Sharma sent an email to Jacob and Paul Coughlin, global head of analytics and operations, stating that they needed to consider "changing direction."

106. In June 2011, S&P ratcheted up the pressure on Adelson and Jacob. It brought them to an S&P leadership meeting organized by Sharma based on the theme: "Relentlessly Driving Global Growth." Contrary to S&P's public claims that it was "further enhancing [its] independence," S&P executives were explicitly urged to let issuers influence them. For example, speakers and meeting materials emphasized that, "Structured finance criteria can easily be irrelevant if market feedback [is] ignored."

107. Meeting materials described S&P's strategy as follows: "Success in criteria development depends on ongoing collaboration between the criteria group and the business." Further, "Efforts are underway to improve the current processes and interactions in the development and dissemination of new criteria. This includes . . . integrating marketplace/investor viewpoints into the criteria process."

108. However, Adelson and Jacob still failed to "collaborate" or "change direction." In mid-2011 a report by S&P's Structured Finance Department emphasized that since January

2011, S&P was not asked to rate 13 deals due in part to its counterparty criteria, and that as a result, S&P lost approximately $2.275 million in potential revenue.

109. In December 2011, S&P announced Jacob's departure from the company, and Adelson's removal from his position of Chief Credit Officer.

110. Once S&P began to lose market share to its competitors as a result of toughening its criteria, the promised reforms were rolled back. S&P executives began to pressure staff to adjust methodologies and assumptions used to rate structured finance securities so that S&P could more easily assign its highest rating and increase its market share and revenue. Moreover, in May 2012, S&P's counterparty criteria were made generally more lenient.

111. Despite the foregoing pressures and revenue-based methodology adjustments, S&P continued to maintain that it was objective and independent, as evidenced by the following excerpt from Section 3.1 of S&P's January and June 2012 Codes of Conduct:

> Standard & Poor's will establish and maintain reporting lines and compensation arrangements for compliance officers and Employees in Control Roles and Analytical Roles that reinforce the independence of their respective judgments. For a compliance officer or Employee in a Control Role this means that Standard & Poor's will not consider its financial performance when evaluating the performance or determining the compensation (including incentive awards) of those Employees. **For an Employee in an Analytical Role this means that Standard & Poor's will not consider the commercial implications (such as revenue, fees, or market share) of that Employee's analytical decisions when evaluating the performance or determining the compensation (including incentive awards) of that Employee.**
>
> An **"Analytical Role"** means, regardless of title, a Ratings Services Employee who is directly involved in Credit Rating Activities, but not part of Ratings Services' Criteria organization. Examples include: Analysts and Analytical Managers.
>
> A **"Control Role"** or **"Control Officer"** means a Ratings Services Employee who is a Quality Officer, Criteria Officer, or Risk Policy Officer.
>
> (emphasis added)

VII. CAUSE OF ACTION: UNFAIR AND DECEPTIVE TRADE PRACTICES

112. Paragraphs 1 through 111 of the Complaint are hereby repeated and re-alleged as Paragraphs 1 through 111 of this First Count as if fully set forth herein.

113. At all times relevant to this Complaint, S&P was engaged in the trade or commerce of providing credit analysis to issuers and providing credit analysis for use by investors, government regulators, and other consumers within the State of North Carolina.

114. By engaging in the acts and practices alleged herein, S&P made or caused to be made to consumers, directly or indirectly, explicitly or by implication, representations which are material, deceptive, and likely to mislead, including, but not limited to, the following:

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

b. that S&P understands that it holds a position of trust in the marketplace and, as such, deals fairly and honestly with the public;

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

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

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

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

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

b. that S&P does not deal fairly and honestly with buyers and investors of structured finance securities or other market participants;

c. that S&P allowed business and revenue considerations to influence the analytical models it developed to rate structured finance securities;

d. that S&P's surveillance of its ratings on RMBS and judgment regarding when to downgrade certain structured finance securities was influenced by business concerns such as revenue enhancement and maintaining market share;

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

f. that S&P's analysis of structured finance securities was based in part on the preferences of the narrow group of repeat issuers of structured finance securities that dominated S&P's revenues; and

g. that S&P's analysis of structured finance securities was based in part on a desire to promote S&P's own economic interests.

116. S&P's acts and practices as alleged herein are unfair, oppressive or unscrupulous and violated the public policy of the State of North Carolina.

117. S&P's acts and practices as alleged herein have directly and proximately caused substantial injury to consumers within this State.

118. S&P's acts and practices as alleged herein; namely, its decision to compete for business in the market for analyzing structured finance securities by misrepresenting the characteristics of its product or service, constitute an unfair method of competition in violation of N.C. Gen. Stat. § 75-1.1.

119. S&P's acts or practices alleged herein were in or affecting commerce within this State and constitute unfair or deceptive acts or practices in violation of N.C. Gen. Stat. § 75-1.1.

PRAYER FOR RELIEF

WHEREFORE, the State requests the following relief:

1. A finding that by the acts alleged herein, S&P engaged in unfair and deceptive acts and practices in the course of engaging in the trade or commerce of a credit rating agency in violation of N.C. Gen. Stat. § 75-1.1;

2. A finding that by the acts alleged herein, S&P engaged in an unfair method of competition in the course of engaging in the trade or commerce of a credit rating agency within the State of North Carolina in violation of N.C. Gen. Stat. § 75-1.1;

3. An injunction under N.C. Gen. Stat. § 75-14 enjoining S&P from engaging in any acts that violate N.C. Gen. Stat. § 75-1.1, including, but not limited to, the unfair and deceptive acts and practices, and unfair methods of competition alleged herein;

4. An order under N.C. Gen. Stat. §§ 75-10 and 75-14 requiring that S&P submit to an accounting to determine the amount of improper fees and revenue paid to S&P as a result of its unfair and deceptive acts and practices;

5. An order under N.C. Gen. Stat. § 75-15.2 directing S&P to pay appropriate civil penalties for its violations of N.C. Gen. Stat. § 75-1.1;

6. An order under N.C. Gen. Stat. § 75-15.1 directing S&P to disgorge all revenues, profits, and gains achieved in whole or in part through the unfair and deceptive acts or practices complained of herein;

7. Costs of this action; and

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

This the 5 day of February, 2013

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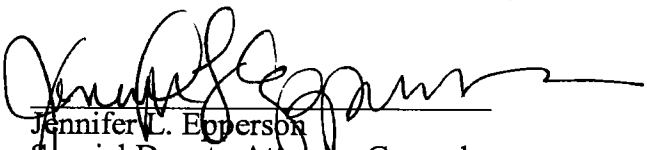
By: 

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