KAMALA D. HARRIS
Attorney General of California
MARTIN GOYETTE (SBN 118344)
Senior Assistant Attorney General
FREDERICK W. ACKER (SBN 208109)
Supervising Deputy Attorney General
SYLVIA KELLER (SBN 197612)
HEATHER B. HOESTEREY (SBN 201254)
NATHANIEL SPENCER-MORK (SBN 226886)
JOANNA ROSEN FORSTER (SBN 244943)
JERRY T. YEN (SBN 247988)
SUNEETA FERNANDES (SBN 257772)
ADELINA R. ACUÑA (SBN 284576)
Deputy Attorneys General
455 Golden Gate Avenue, Suite 11000
San Francisco, CA 94102-7004
Telephone: (415) 703-5506
Fax: (415) 703-5480
E-mail:Heather.Hoesterey@doj.ca.gov

Attorneys for the People of the State of California

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SUPERIOR COURT OF THE STATE OF CALIFORNIA

COUNTY OF SAN FRANCISCO

PEOPLE OF THE STATE OF CALIFORNIA, Plaintiff, **v.** **MORGAN STANLEY; MORGAN STANLEY & CO. LLC, f/k/a MORGAN STANLEY & CO. INCORPORATED; MORGAN STANLEY MORTGAGE CAPITAL HOLDINGS LLC f/k/a MORGAN STANLEY MORTGAGE CAPITAL INC.; MORGAN STANLEY ABS CAPITAL I INC.; MORGAN STANLEY CAPITAL I INC.; SAXON FUNDING MANAGEMENT LLC; SAXON ASSET SECURITIES COMPANY; and DOES 1-100,** Defendants.	Case No. CGC 16-551238 **COMPLAINT FOR TREBLE DAMAGES, CIVIL PENALTIES AND PERMANENT INJUNCTION FOR VIOLATION OF THE CALIFORNIA FALSE CLAIMS ACT, CORPORATE SECURITIES LAW OF 1968, UNFAIR COMPETITION LAW, AND FALSE ADVERTISING LAW**

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The People of the State of California, by and through Kamala D. Harris, Attorney General of the State of California, based on information and belief, allege as follows:

INTRODUCTION

1. As set forth herein, defendant Morgan Stanley was a major participant in the events leading up to the 2007-2008 financial crisis, including, of relevance to this action, creating, assembling and packaging risky structured finance securities.

2. Morgan Stanley knew the risks of the securities at issue in this complaint, yet consciously chose to ignore red flags and conceal hazards from potential and actual purchasers of the securities. In some instances, Morgan Stanley misrepresented key warning factors to buyers of the securities. In other instances, Morgan Stanley encouraged rating agencies to give the securities stronger ratings that failed to acknowledge the risks Morgan Stanley knew the securities posed for purchasers.

3. Relying on Morgan Stanley's misrepresentations and omissions, California investors, including the California Public Employees' Retirement System ("PERS") and the California State Teachers' Retirement System ("STRS"), purchased structured finance securities structured, arranged, underwritten or sold by Morgan Stanley and its affiliates. California investors, including PERS and STRS, suffered massive losses as a result of the conduct by Morgan Stanley alleged herein.

GENERAL BACKGROUND

4. "Structured finance" refers to the process of securitizing the cash flow from an asset or pool of assets, typically consisting of loans or other debt instruments. A structured finance security is the financial product that results from this securitization. The most significant types of structured finance securities for purposes of this action are Residential Mortgage Backed Securities ("RMBS") and notes issued by Structured Investment Vehicles ("SIVs"), described more fully herein.

5. From 2000 through 2007, Morgan Stanley was an active participant in the RMBS market. Morgan Stanley sponsored, underwrote, and brokered hundreds of RMBS during that

period, including the RMBS purchased by PERS and STRS listed in Appendix A, incorporated herein by reference.

6. Looking for opportunities to bring in more revenue from structured finance securities, Morgan Stanley entered the SIV market in 2004. SIVs were designed as special purpose entities to hold long-term asset backed securities (including, for example, RMBS) and issue short-term debt instruments. Because short-term instruments typically have a lower interest rate than long-term securities, a SIV could profit from the interest rate spread while providing investors with a more liquid short-term instrument. Morgan Stanley, as arranger, lead dealer, and structurer, helped Cheyne Capital Management Ltd. ("Cheyne") issue SIV notes through Cheyne Finance PLC and its wholly-owned subsidiaries Cheyne Finance LLC and Cheyne Capital Notes LLC ("the Cheyne SIV"). PERS bought millions of dollars' worth of Cheyne SIV notes, as described herein.

THE PARTIES

I. PLAINTIFF, THE PEOPLE OF THE STATE OF CALIFORNIA

7. Attorney General Kamala D. Harris is the chief law officer of the State of California ("State"). She brings this action on behalf of Plaintiff, the People of the State of California.

II. DEFENDANTS

8. Defendant Morgan Stanley is a global financial services firm and financial holding company organized as a corporation under the laws of the State of Delaware, with its principal place of business in the State of New York, and doing business in the State of California. Together with its subsidiaries and affiliates, Morgan Stanley provides products and services to a large and diversified group of clients and customers, including corporations, governments, financial institutions and individuals. Morgan Stanley and the other Morgan Stanley-affiliated defendants identified below in paragraphs 11-17 are collectively referred to as "Morgan Stanley."

9. On its website, the company boasts, "[s]ince Morgan Stanley was founded in New York City in 1935, it has evolved into one of the world's foremost financial institutions." It

states, ". . .we offer the finest in financial thinking, products and execution to individual investors, companies, institutions and government agencies."

10. Morgan Stanley's business units include its Institutional Services division, which conducts investment banking and sales, trading, and financing activities. As set forth herein, Morgan Stanley, among other things, acted as a sponsor and underwriter of RMBS; provided warehouse lending (i.e., short-term financing used to acquire—or "warehouse"—assets prior to issuance of a RMBS) to subprime and other mortgage originators; and traded, made markets in, and structured debt securities and derivatives involving mortgage-related securities. According to drafts of a December 2005 business plan, Morgan Stanley sought to become "the dominant global residential mortgage franchise on Wall Street in [its] target markets (Alt-A, Alt-B, subprime)."

11. Defendant Morgan Stanley & Co. LLC ("Morgan Stanley & Co."), f/k/a Morgan Stanley & Co. Incorporated, is a limited liability company organized under the laws of the State of Delaware, with its principal place of business in the State of New York, and doing business in the State of California. Morgan Stanley & Co. is successor in interest to Morgan Stanley & Co. Incorporated. Morgan Stanley & Co. is a wholly-owned subsidiary of defendant Morgan Stanley. Morgan Stanley & Co. is a Securities and Exchange Commission ("SEC") registered broker-dealer and a member of the Financial Industry Regulatory Authority, Inc. ("FINRA") and other self-regulatory organizations. During the time period at issue, Morgan Stanley & Co. was also registered with the SEC as an investment advisor firm. Morgan Stanley & Co. is registered as a broker-dealer with the State of California pursuant to the California Corporate Securities Law. Morgan Stanley & Co. was arranger and placement agent for the Cheyne SIV described herein, and was underwriter for several of the RMBS listed in Appendix A. In addition, several of the RMBS listed in Appendix A were purchased by PERS and STRS through licensed individual brokers who were, at the time of the purchases, employed by and registered with Morgan Stanley & Co.

12. Defendant Morgan Stanley Mortgage Capital Holdings LLC, f/k/a Morgan Stanley Mortgage Capital Inc., is a New York limited liability company, with its principal place of business in the State of New York, and doing business in the State of California. Morgan Stanley

Mortgage Capital Holdings LLC is an affiliate of Morgan Stanley ABS Capital I Inc. and a direct wholly-owned subsidiary of Morgan Stanley. Morgan Stanley Mortgage Capital Holdings LLC provided warehouse and repurchase financing to mortgage lenders and purchased closed residential mortgage loans for securitization or resale. Morgan Stanley Mortgage Capital Holdings LLC performed due diligence reviews on loans it purchased to be securitized by Morgan Stanley and made representations to investors, including PERS and STRS, about the purportedly high quality of its due diligence process. Morgan Stanley Mortgage Capital Holdings LLC is successor in interest to Morgan Stanley Mortgage Capital Inc., which sponsored several of the RMBS listed in Appendix A.

13. Defendant Morgan Stanley ABS Capital I Inc. is a Delaware corporation with its principal place of business in the State of New York. Morgan Stanley ABS Capital I Inc. is a direct, wholly-owned subsidiary of Morgan Stanley. Morgan Stanley ABS Capital I Inc. was depositor for the MSAC 2007-NC4 securitization described herein, as well as several other RMBS listed in Appendix A. As depositor, Morgan Stanley ABS Capital I Inc. acquired residential mortgage loans deposited into RMBS trusts and deposited, sold, transferred or conveyed the loan assets to the trusts.

14. Defendant Morgan Stanley Capital I Inc. is a Delaware corporation with its principal place of business in the State of New York. Morgan Stanley Capital I Inc. is a direct, wholly-owned subsidiary of Morgan Stanley. Morgan Stanley Capital I Inc. was depositor for several of the RMBS listed in Appendix A, including the MSM 2006-15XS and MSM 2007-6XS securitizations described herein.

15. On or about December 4, 2006, Morgan Stanley completed an acquisition of Saxon Capital Inc., a residential mortgage originator and servicer.

16. Defendant Saxon Funding Management LLC, a Delaware limited liability company, a subsidiary of Saxon Capital, Inc. and an indirect subsidiary of Morgan Stanley, was sponsor and seller for the SAST 2007-2 and SAST 2007-3 securitizations described herein.

17. Defendant Saxon Asset Securities Company, a Virginia corporation with its principal place of business in Virginia, a direct subsidiary of Saxon Funding Management LLC,

and an indirect subsidiary of Morgan Stanley, was depositor for three of the RMBS listed in Appendix A, including the SAST 2007-2 and SAST 2007-3 securitizations described herein. Defendants Saxon Capital, Inc., Saxon Funding Management LLC and Saxon Asset Securities Company are collectively referred to herein as "Saxon."

18. Defendants DOES 1 through 100, inclusive, are sued herein under fictitious names. Their true names and capacities are unknown to Plaintiff. When their true names and capacities are ascertained, Plaintiff will amend this complaint by inserting their true names and capacities herein. Plaintiff is informed and believes and thereon alleges that each of the fictitiously named defendants is responsible in some manner for the occurrences herein alleged, and that Plaintiff's damages and injuries as herein alleged were proximately caused by such defendants.

19. Morgan Stanley is the ultimate owner and parent company of the other Morgan Stanley and Saxon Defendants alleged herein, and controlled the activities and conduct of such defendants in connection with the securities alleged herein.

20. The named and unnamed defendants in this action are collectively referred to as "Defendants."

21. Unless otherwise alleged, whenever this Complaint refers to any act of Defendants, such reference shall mean that each Defendant acted individually and jointly with the other Defendants named in this Complaint.

22. Unless otherwise alleged, whenever this Complaint refers to any act of any corporate or other business Defendant, such reference shall mean that such corporation or other business did the acts alleged in this Complaint through its officers, directors, employees, agents and/or representatives while they were acting within the actual or ostensible scope of their authority.

OTHER RELEVANT ENTITIES

23. The California Public Employees' Retirement System is the largest public pension fund in the United States. It provides retirement and health benefits to more than 1.6 million

California public employees, retirees, and their families. PERS's members include California firefighters, peace officers, and other public employees.

24. The California State Teachers' Retirement System provides retirement, disability, and survivor benefits for over 850,000 of California's pre-kindergarten through community college educators and their families. STRS's mission is to secure the financial future of California's educators, and it is the largest teachers' retirement fund in the United States.

25. PERS and STRS (collectively, "the Pension Funds") are arms of the State of California, and monies held by the Pension Funds are State funds within the meaning of the California False Claims Act. (See *Westly v. California Public Employees' Retirement System Bd. of Administration* (2003) 105 Cal.App.4th 1095; Gov. Code § 12650, subd. (b)(1).)

26. The assets held by the Pension Funds come from a variety of sources, including taxpayer dollars. The Pension Funds are funded through employee contributions, employer contributions such as those from public agencies that employ public employees who are PERS or STRS members, and investment income. (See, e.g., Gov. Code §§ 20177, 20822, subd. (a), 20824, subd. (a).)

27. By statute, the State is obligated to make certain contributions to the Pension Funds, and money may be appropriated to pay the State's contribution to the Pension Funds. (See, e.g. Gov. Code §§ 20177, 20822, subd. (a), 20824, subd. (a); Ed. Code § 22950 et seq.)

28. The Pension Funds are also funded by taxpayer money insofar as State employees, who are paid with State funds, are required to contribute a certain amount of their pay to fund the Pension Funds.

29. The Pension Funds are part of the public treasury, and any diminution in PERS or STRS funds harms or may harm State taxpayers. (See *Westly v. California Public Employees' Retirement System Bd. of Administration*, 105 Cal.App.4th 1095.)

30. The benefits provided to State employees through the Pension Funds are contractual obligations of the State. Once vested, pension rights may not be destroyed without impairing a contractual obligation of the employer State or State agency. Pensioners with vested

pension benefits have a contractual right to those vested pension benefits. (See *Valdes v. Cory* (1983) 139 Cal.App.3d 773.)

31. Accordingly, if money held by the Pension Funds is insufficient to pay benefits owed to State employees, the State is obligated to pay money to pensioners from other sources. The State's General Fund could be required to make additional contributions to the Pension Funds. (See *Westly v. California Public Employees' Retirement System Bd. of Administration*, 105 Cal.App.4th 1095; Gov. Code §§ 20177, 20822, subd. (a), 20824, subd. (a); Ed. Code § 22950 et seq.) Indeed, in 2014, the California State Legislature passed a bill that aimed to close a STRS funding gap in part by doubling the State's contribution to the fund. (Stats. 2014, ch. 47, §§ 8-9.) The Governor signed the bill into law that same year.

32. Morgan Stanley's representations and the representations it caused to be made, as set forth herein, were material to decisions by PERS and STRS to use State funds to purchase the securities listed in Appendix A, and material to PERS's decision to use State funds to purchase the Cheyne SIV notes identified in Paragraph 214. The Pension Funds and/or their agents were presented with claims for payment on those purchases, usually in the form of trade tickets. PERS and STRS suffered hundreds of millions of dollars in damages a result of Morgan Stanley's conduct alleged herein.

JURISDICTION

33. This Court has jurisdiction to hear the claims alleged in this Complaint and is a court of competent jurisdiction to grant the relief requested.

VENUE

34. At all relevant times alleged in this Complaint, Defendants maintained an office and/or did business in the City and County of San Francisco.

35. Violations of law alleged in this Complaint occurred in the City and County of San Francisco.

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FACTUAL ALLEGATIONS

I. TYPES OF STRUCTURED FINANCE SECURITIES INVOLVED IN THIS ACTION

36. The two types of structured finance securities most relevant to this action are RMBS and SIVs.

37. RMBS are securities issued by a trust containing a pool of residential mortgages. The underlying residential mortgages serve as collateral for investors who purchase the securities. Payments by the mortgage borrowers create the income received by those investors.

38. Before they imploded during the 2007-2008 financial crisis, SIVs were special-purpose entities that held portfolios of RMBS and other long-term asset-backed securities ("ABS") and bonds. SIVs borrowed money through the issuance of notes, such as those that are the subject of this action, which constituted low-interest short-term debt, then used the capital raised from the sale of those notes to purchase high-interest long-term assets, profiting off of the interest rate spread.

II. MORGAN STANLEY'S RMBS FRAUD

A. Morgan Stanley's RMBS Role Generally

39. The process of creating an RMBS begins with residential mortgages. Borrowers apply for home loans from mortgage loan originators ("originators"). Originators review a potential borrower's income, employment, and credit history and assess the property that will serve as collateral for the mortgage. If an originator approves the borrower for the loan and the borrower decides to take out the loan, the originator completes the transaction with the borrower and, in many cases, sells the resulting mortgage to a sponsor. Defendant Saxon originated mortgage loans backing at least four of the RMBS listed in Appendix A.

40. A sponsor (also known as a "seller"), which is typically a financial institution, packages home mortgage loans into pools and transfers the loan pools to a depositor to be placed into a certificate-issuing trust. One or more of the Morgan Stanley defendants acted as the sponsor/seller and/or depositor for at least fifteen of the RMBS listed in Appendix A.

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41. To market and sell the securities, sponsors like Morgan Stanley (or their issuing affiliates) first file a "shelf" registration with the SEC. Shelf registrants make certain representations to the SEC and to potential securities purchasers in the form of a Prospectus.

42. After the shelf is registered, securities from multiple securitizations can then be issued from the shelf. For each securitization, the sponsor or issuing affiliate must also register a more detailed and specific Prospectus Supplement. The Prospectus Supplement contains key representations and warranties about the specific loans covered. Sponsors or issuing affiliates may also release marketing materials such as Free Writing Prospectuses and term sheets, which contain additional representations about the securities to be sold, and may provide other information upon request by investors.

43. Underwriters buy certificates from the issuing entities and sell the certificates to investors. To appeal to investors with different risk appetites, the underwriters split the deal into different classes of securities, known as "tranches," which offer a sliding scale of return rates based on the riskiness of the tranche. The tranches are typically arranged in a "waterfall" in which the tranche at the top of the waterfall is paid first, the tranche immediately below that is paid next, and so on. Each tranche is paid only if every tranche above it has been paid in full. The bottom tranches are the riskiest and receive the highest rate of return to compensate their holders for the possibility that they might not be paid at all. The top tranches are the safest and therefore receive the lowest rates of return. One or more of the Morgan Stanley defendants acted as an underwriter for all but one of the RMBS listed in Appendix A.

44. Underwriters have a duty to conduct a reasonable investigation to confirm that the registration statements and prospectuses for the securities they underwrite do not contain material misrepresentations or omissions. Underwriters fulfill this duty by conducting due diligence to independently verify the accuracy of the issuer's representations. As alleged in more detail herein, Morgan Stanley failed to fulfill its duty to perform reasonable due diligence on the RMBS it underwrote.

45. Each of the securities listed in Appendix A was underwritten, issued, sponsored, and/or brokered by Defendant Morgan Stanley and/or its subsidiaries.

B. Morgan Stanley's RMBS Securitization Process

46. As alleged below, Morgan Stanley consciously and systematically ignored warning signs throughout the due diligence process. Morgan Stanley knowingly securitized risky loans and underrepresented and misrepresented the risky nature of those loans to investors.

1. Mortgage Loan Acquisition

47. When Morgan Stanley sponsored an RMBS deal, its trading desk assembled the collateral pools for the RMBS using either loans that Morgan Stanley purchased from originators or loans originated by Morgan Stanley. Most of the loans not originated by Morgan Stanley were acquired either through Morgan Stanley's "conduit" acquisition process, which involved purchasing and aggregating loans from a wide range of small originators; its "bulk" acquisition process, which involved purchasing pools of several hundred loans from single originators; or by extending a warehouse line of credit to an originator to originate loans in which Morgan Stanley would automatically hold a collateral security interest.

48. Beginning in 2005, as the subprime mortgage market heated up, subprime loan originators such as New Century, Decision One, Accredited Home Loans, and WMC Mortgage Corporation began pressuring Morgan Stanley to purchase as many loans as possible. Originators persuaded Morgan Stanley to lift categorical prohibitions on purchasing certain high-risk loan products, such as interest-only first liens, and frequently demanded that Morgan Stanley overlook inflated appraisals and failures to comply with underwriting guidelines. Morgan Stanley was concerned that originators were "not [using] a lot of common sense" when approving such loans. However, concerns about underwriting quality were seen within Morgan Stanley as "relationship killer[s]" that would lead to loss of profitable subprime market share to its competitors. Thus, Morgan Stanley often succumbed to pressure by the originators and agreed to purchase high-risk loans.

2. Due Diligence

49. In the mortgage acquisition context, "due diligence" refers to the process of re-underwriting a sample of loans in a given purchase pool in order to confirm that those loans comply with the loan originators' and/or securitizers' underwriting guidelines and applicable

lending laws. Re-underwriting typically consists of comparing the borrower information (such as income statements) and collateral information (such as appraisal reports for the mortgaged property) for a particular loan with the loan originator's and loan purchaser's own internal underwriting guidelines and representations about the loan. The process is intended to weed out loans that pose a higher-than-normal risk of default because of failure to comply with risk-mitigating lending standards and to identify loans with characteristics that do not match representations made by loan originators. The due diligence Morgan Stanley did do was typically performed before it "funded," or purchased, a pool of loans and before the acquired loans were securitized.

50. Although Morgan Stanley performed a due diligence review on all pools of loans offered to it for sale by originators ("purchase pools"), this diligence was flawed and inadequate, as alleged below. Morgan Stanley appeased originators by overlooking or ignoring its own due diligence results and purchasing loans with serious underwriting problems. As early as 2005, one Morgan Stanley due diligence manager complained that Morgan Stanley's "buy whatever the hell we want to close the deal mentality" was driving down loan quality and making it difficult for her to keep bad loans out of purchase pools. In a 2006 performance evaluation, that same Morgan Stanley due diligence manager was advised to "stop fighting and begin recognizing that we need monthly volume from our biggest trading partners and that . . . the client does not need to sell to Morgan Stanley." An internal review conducted in 2007 found that Morgan Stanley's Boca Raton office — Morgan Stanley's primary conduit for subprime and Alt-A (a risk category that falls between prime and subprime) loans —saw itself as a "deal driven loan funding shop" and suffered from "significant deficiencies" in credit-risk-management operation. Traders, who had little or no underwriting experience but were anxious to securitize loans and profit off the sale of mortgage backed securities, reviewed and overrode the due diligence staff's decisions, pressuring them to minimize the number of loans dropped from purchase pools and to let as many loans through for purchase and securitization as possible.

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a. Credit and Compliance Due Diligence

51. When a purchase pool was offered to Morgan Stanley for sale, the originator would send Morgan Stanley a "loan tape" containing data for the purchase pool.

52. A loan tape is a voluminous spreadsheet that provides data on each individual loan in a given purchase pool. Loan tapes produced by originators for the purpose of due diligence typically contain:

a. The borrower's name;

b. Information about the borrower's creditworthiness, such as income, FICO score, credit history, employment status, liquidity, and payment history;

c. Information about the mortgaged property, such as address, appraised value, and occupancy;

d. Other information specific to the loan being made, such as an originator-issued loan identification number and the principal loan amount;

e. Details about the terms and structure of the loan being made, such as the type (fixed or adjustable rate), interest rates, interest maximums, loan seniority, balloon dates, and prepayment penalties; and

f. Other factors relevant to risk calculations on the loan, such as loan-to-value ratio ("LTV"), debt-to-income ratio ("DTI"), and loan purpose.

53. Once Morgan Stanley received the loan tape from the originator, it used the loan tape to select either a representative, adverse, or mixed sample set, and it requested loan origination files from the loan originators for each loan identified in the sample. Samples generally consisted of approximately 25% to 35% of the loans in each pool.

54. After Morgan Stanley received the origination files for the sampled loans from the originator, Morgan Stanley passed the files on to a third-party due diligence firm for review. Much of the due diligence performed on the loans backing the RMBS at issue here was performed by Clayton Holdings, Inc. ("Clayton") or other third-party due diligence contractors and overseen by Morgan Stanley's due diligence managers.

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55. Once the due diligence contractor received the loan tape and sample loan origination files, its underwriting team compared the borrower and collateral information in the origination file for each sampled loan with the originator's underwriting guidelines, Morgan Stanley's underwriting guidelines, and lending laws in the state where the loan originated.

56. When the due diligence contractor found a loan that did not meet underwriting guidelines or comply with applicable law, it would record that finding as an "exception." Exceptions were categorized as either "credit" exceptions, which related to failures to comply with standards for borrower creditworthiness or collateral quality, or as "compliance" exceptions, which related to failures to provide the borrower with proper documentation or disclosures. All reviewed loans were assigned an "event" level for both credit and compliance based on the types of exceptions they had in each category. Loans with "no material exceptions" were assigned an Event Level 1, loans with "non-material exceptions" were assigned an Event Level 2, and loans with material exceptions—i.e., those that posed the highest default risk—were assigned an Event Level 3. If an Event Level 3 was "curable," meaning the originator could easily take steps to resolve the problem, the vendor coded it as a "3C" instead of a 3. Curable exceptions included problems such as a missing Department of Housing and Urban Development Settlement Statement ("HUD-1") or a missing pay stub, which the originator could obtain from the borrower after origination.

57. Throughout the credit and compliance review process, the due diligence contractor provided Morgan Stanley with daily reports that listed exceptions, event levels, and brief explanations of the findings for each loan reviewed up to that point. Morgan Stanley's due diligence managers reviewed these reports closely and asked originators to cure as many of the Event Level 3C exceptions as possible before Morgan Stanley purchased the loans. Morgan Stanley due diligence managers also looked to see whether there was a way to resolve any of the Event Level 3 exceptions, and to resolve as many Event Level 3 exceptions as possible.

58. If a loan had an Event Level 3 exception that the originator could not resolve, this indicated that the loan had a material credit or compliance defect that rendered the loan unfit for securitization. Morgan Stanley nonetheless "waived in"—an industry term of art for putting a

loan that should be excluded into the pool—many Event Level 3 loans, disregarding the dramatically heightened risk of borrower default that those loans presented.

59. Morgan Stanley claimed and represented to RMBS purchasers that it only waived in loans whose material exceptions were counterbalanced by other compensating factors, but in reality that was often not the case. Eager to acquire and securitize as many loans as possible, and under intense pressure from originators to maximize the number of loans it purchased each month (known as "pull-through"), Morgan Stanley habitually waived in loans with serious, material credit and compliance exceptions based only on illusory or nonexistent compensating factors. To keep originators happy, Morgan Stanley managers frequently revisited or reconsidered due diligence staff's decisions to reject certain loans, "just for team participation in trying to improve pull through. :)." Those same managers occasionally even agreed to purchase Event Level 3 loans without the pretext of the waiver process.

60. Trading desk managers with no underwriting expertise often inserted themselves into the due diligence process to waive in Event Level 3 loans, insisting that traders should have a separate chance to analyze "grey area" loans before they were removed from the purchase pool, "to see if they fit [in]to the overall strategy." One due diligence manager who resisted the trading desk's pressure to bring in bad loans was criticized in her annual performance reviews for failing to "incorporate trading risks" and competitiveness concerns into her due diligence decisions.

61. Even when Morgan Stanley due diligence teams did remove or "kick" loans with Event Level 3 defects out of a pool, they never extrapolated those due diligence findings to other loans that were not included in the sample, even though the findings from the sampled loans indicated it was likely that the unsampled portions of the pools also contained loans that did not conform to Morgan Stanley's representations to investors. Under pressure from originators to keep its diligence sample sizes as small as possible, Morgan Stanley also never increased its standard 25% to 35% sample size to a size that would capture more risky loans, and Morgan Stanley rarely exercised its contractual right to increase the sample size if the initial review warranted further analysis.

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b. Loan Tape Discrepancy Review

62. The due diligence contractors' review process also involved checking the information in the originators' loan files against the data reflected in the loan tape.

63. If the contractor found that the information in the loan tape differed in any way from the information in the loan file, its underwriters noted the discrepancy in due diligence exception reports and provided a brief explanation.

64. Loan tape accuracy is extremely important in the RMBS market because loan tape data is used to generate the offering documents that are given to investors when a deal goes to market. Traders also use the loan tape to generate tables, or "strats," describing the securitized loan pool, which investors such as PERS and STRS rely on when deciding whether to buy RMBS.

65. Morgan Stanley frequently ignored the due diligence contractor's loan tape discrepancy findings. When Morgan Stanley did make corrections, it often did so selectively, such as by correcting loan-to-value ratios that were too high—and which therefore would have made securitizations look risky to potential purchasers—but choosing not to correct those that were too low—which, when left uncorrected, made the loans look less risky than they actually were. As a result, erroneous loan-level data propagated through Morgan Stanley's record-keeping systems and tainted the offering documents and strats that Morgan Stanley presented to investors.

c. Valuation Due Diligence

66. Valuation due diligence assesses whether the appraisal values used to calculate loan-to-value ratios accurately reflected the values of the underlying properties, or whether they had been inflated by the originator or the appraiser. Morgan Stanley explained the purpose of its valuation due diligence in presentations made to potential investors: "Morgan Stanley has taken the fundamental view that managing loss severity is the best way to manage portfolio performance. Accordingly, Morgan Stanley has designed a comprehensive valuation review process to target loans with valuation risk." Morgan Stanley's valuation review involved three levels.

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67. As described below, Morgan Stanley's first two levels, Hansen PRO review and Broker Price Opinion, were designed to identify the risky loans. The third level, however, known as "mitigation," allowed more risky loans to be included in the securitization, rather than serving to reduce risk.

68. Originators were expected to send Morgan Stanley the appraisal files for every loan offered for sale, though Morgan Stanley did not always receive those files in a timely fashion. On occasions when it received all of the appraisal files on time, Morgan Stanley would first send those files to a vendor to run a proprietary "Hansen PRO" review. The Hansen PRO review assessed the reliability of each appraisal using both an Automated Valuation Model ("AVM")—an industry-accepted method for estimating appraisal values for particular pieces of real property using sales data for comparable properties in the same geographic area—and a desk review by a licensed appraiser. On occasions when an originator failed to send Morgan Stanley a complete set of appraisal files in time for the Hansen PRO review, Morgan Stanley instead ran each loan through a "History PRO" review. History PRO reviewed a range of potential fraud indicators associated with each loan to assess the likelihood of fraud or irregularity in the underlying appraisal. Typically, if a purchase pool was made up entirely of subprime loans, Morgan Stanley would order Hansen or History PRO scores for 100% of the loans in the pool. If the purchase pool contained loans to less risky borrowers, such as prime or Alt-A loans, Morgan Stanley would order Hansen or History PRO scores for a smaller percentage, usually ranging from 40% to 60% of the pool.

69. The second level of scrutiny was a Broker Price Opinion ("BPO"). A BPO is a property value estimate made by a qualified individual, such as a real estate broker, who is not a licensed appraiser but is familiar with the local real estate market and can visit a property in person. Morgan Stanley used Hansen PRO and/or History PRO scores to identify the loans in each pool that were most likely to be based on an inflated or otherwise incorrect appraisal value and ordered BPOs on the underlying properties. Morgan Stanley usually ordered BPOs for approximately 25% of the loans in a given pool. The other 75% were presumed to have accurate appraisal values and were not subjected to further valuation review. Morgan Stanley represented

to potential investors that "[u]ltimately, Morgan Stanley excludes loans with unacceptable properties or any loan with a BPO value exhibiting an unacceptable negative variance from the original appraisal," but Morgan Stanley now admits that it "never rejected a loan based solely on BPO results."

70. Once Morgan Stanley received the results of the BPO sample, the loans underwent a third and final process, known as "mitigation." Mitigation consisted of a detailed review by a Morgan Stanley appraisal expert, who compared each BPO report with its corresponding appraisal file and determined what the final, most accurate value for the underlying property should be.

71. In theory, if this final "mitigation value" kept a loan within Morgan Stanley's underwriting and purchase guidelines (meaning it did not raise the LTV to an unacceptable level), the reviewer would clear the loan for purchase. If the mitigation value pushed the loan outside of Morgan Stanley's guidelines, the reviewer placed the loan on a "tie-out" spreadsheet, indicating the loan would be kicked out of the purchase pool unless the originator could persuade Morgan Stanley to keep it. However, in reality, the mitigation process was biased toward including more risky loans in the securitization. One Morgan Stanley due diligence employee described mitigation as "the process before tieout where we look at that appraisals and bpo's and try to pull as many files as we can into the deal before we get to tieout." A loan originator employee, in an email concerning an October 2006 loan pool, encouraged a Morgan Stanley employee to "[p]lease, Mitigate, mitigate, mitigate!!!" In another instance, a valuation due diligence employee sent the head of valuation due diligence a list of problematic loans, adding "I assume you will want to do your 'magic' on this one."

72. Neither Morgan Stanley's Offering Documents (typically including a Prospectus, a Term Sheet, a Free Writing Prospectus Supplement, and a Prospectus Supplement) nor other marketing and presentation materials it used with potential investors mentioned the realities of the mitigation process and how it was biased to include more risky loans.

73. Once these three levels of review were complete, Morgan Stanley's valuation diligence staff would sit down with the originator and discuss each loan that Morgan Stanley had

placed on the "tie-out" spreadsheet—i.e., the loans that Morgan Stanley tentatively deemed unfit to purchase. If the originator was able to convince Morgan Stanley that its original appraisal value for a loan had been correct, or that Morgan Stanley's mitigation value was incorrect, the two parties would agree to move the loan back into the purchase pool. If the originator was unable to defend the underlying appraisal for a particular loan, Morgan Stanley's mitigation value would be accepted as final and the loan would be permanently kicked out of that pool.

74. This valuation due diligence process revealed glaring problems with originators' property valuations. As early as 2005, the due diligence managers who oversaw valuation diligence began voicing concerns about "deteriorating appraisal quality" and flagrant property value inflation in loans from certain originators.

75. Morgan Stanley's due diligence managers responded to these concerns by adjusting Morgan Stanley's own diligence criteria to avoid finding valuation problems in the first place. Morgan Stanley's trading desk—which sought to purchase and securitize as many loans as possible—pressured the due diligence team to reduce its BPO sample size and loosen its sampling criteria, thereby ensuring that more loans with inflated appraisals would slip through the cracks. Senior management criticized the due diligence managers for spending too much money on BPO orders and pressured them to reconsider mitigation values whenever pull-through rates dipped below levels the originators wanted.

76. Under pressure from both Morgan Stanley traders and outside originators, Morgan Stanley's due diligence managers and staff manipulated their valuation diligence process in order to let as many loans through as possible. One manager systematically reversed his own staff's findings throughout 2006, deleting mitigation values that raised a loan's LTV over 100 and replacing them with higher appraisal values already shown to be unfounded. In 2006 and 2007, a due diligence contractor repeatedly criticized Morgan Stanley's diligence staff for making "sloppy" mistakes and for ignoring obvious signs of appraisal fraud, but Morgan Stanley management dismissed his concerns.

77. Morgan Stanley was well aware that these changes led to the securitization of risky "underwater" loans, or loans where the loaned amount exceeded the value of the property,

contrary to the representations made to investors. In April 2006, the head of valuation due diligence notified his supervisor: "Attached you will find the analysis for the final kick outs for New Century this month. I also included the figures to show what we pulled in that had CLTVs to 110% and 120%." This manager also presented a "risk decisioning methodology" to allow valuation due diligence staff to accept loans with CLTVs up to 105, 110, or 120, depending on the borrower's credit characteristics. When a member of the valuation due diligence team referred to the "slightly higher risk tolerance" implemented in the valuation due diligence process, the head of valuation due diligence instructed, "please do not mention the 'slightly higher risk tolerance' in these communications. We are running under the radar and do not want to document these types of things." As a result of this "slightly higher risk tolerance," one valuation team member wrote that "[o]ur team pulled in everything possible, so the loans that were kicked are the worst of the worst."

78. This reckless disregard for rampant valuation problems led Morgan Stanley to knowingly purchase and securitize thousands of loans with inflated appraisal values, many of which had actual loan-to-value ratios in excess of 100%, i.e. were "underwater." By manipulating the final values reported in loan tapes and loan records, Morgan Stanley managed to conceal these high loan-to-value ratios from investors, and thus to conceal the true risk associated with its RMBS.

d. Morgan Stanley Knew Its Due Diligence Process Was Inadequate

79. Morgan Stanley knew that its due diligence procedures were failing to catch all of the loans that were unfit for securitization, but it actively avoided making changes that would result in more loans being kicked out of purchase pools. In those cases where Morgan Stanley's adverse sampling methodology actually worked too well—meaning, the criteria captured more loans with high-risk characteristics than Morgan Stanley wanted to review—Morgan Stanley loosened the criteria until the sample size shrunk back to its "target" percentage for that particular originator. Similarly, when certain originators began openly violating their agreements with Morgan Stanley by stuffing pools with loans so risky that Morgan Stanley had earlier

categorically refused to buy them, Morgan Stanley's traders insisted that the due diligence team give "no special focus" to the noncompliant loans. "[W]e just need to handle this as a normal D[ue]D[iligence]," they explained, because the originators are "extremely sensitive." In other words, Morgan Stanley took deliberate steps to weaken or circumvent due diligence to avoid discovering bad loans because it did not want to upset its business partners. These practices allowed thousands of high-risk loans to be purchased and securitized without any review.

80. In the second half of 2006, as default and foreclosure rates on securitized loans began to accelerate dramatically, Morgan Stanley's internal analyses showed that its internal sampling methodologies were capturing only a fraction of the loans most likely to default. In response, Morgan Stanley changed some of its adverse sampling criteria to capture loans that shared the same characteristics as those that had defaulted, but studiously avoided making changes that would increase the size of the due diligence sample overall.

3. Securitization and Marketing

81. Once Morgan Stanley had completed credit/compliance and valuation due diligence on a purchase pool and the risky loans supposedly had been kicked out, Morgan Stanley would purchase, or "fund," the remainder. Funded loans were then available to be securitized by Morgan Stanley's traders.

82. Morgan Stanley's trading desk compiled funded loans into collateral pools for RMBS, often drawing from a number of different purchase pools to create a single security.

83. Typically, Morgan Stanley traders would compile a preliminary collateral pool consisting of several thousand mortgage loans. Once that preliminary pool was established, Morgan Stanley would divide the loans into subgroups, slice each subgroup into separately rated and priced tranches, and calculate the strats that would be included in marketing materials for the deal as a whole. The marketing materials, or "Offering Documents," typically included a Prospectus, a Term Sheet, a Free Writing Prospectus Supplement, and a Prospectus Supplement. Morgan Stanley either drafted or reviewed and approved all of the Offering Documents circulated by its brokers to investors—including PERS and STRS.

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84. The Offering Documents contained a host of representations about the quality and risk profile of the deal's underlying collateral pool. The Offering Documents typically represented that "[n]one of the mortgage loans have loan-to-value ratios at origination, or with respect to second-lien mortgage loans, combined loan-to-value ratios at origination, in excess of 100%." However, these representations were based on the appraisals or purchase prices provided by originators. The Offering Documents did not reflect the additional information Morgan Stanley developed for certain loans during valuation due diligence showing a lower value for the collateral than shown in the appraisals. For example, in 2006 and 2007, Morgan Stanley securitized nearly 5,000 loans in 18 deals on its MSAC shelf, including the MSAC 2006-NC1, MSAC 2007-NC2 and MSAC 2007-NC4 deals set forth on Appendix A herein, where the BPO value was at least 15% below the appraisal value at origination or the property purchase price. In those same trusts, Morgan Stanley securitized nearly 9,000 loans with BPO values resulting in CLTV ratios over 100 percent and approximately 1,000 loans where the property values Morgan Stanley calculated during mitigation resulted in CLTV ratios over 100 percent.

85. The Offering Documents also included strats detailing various characteristics of the collateral pool. Typically, the Free Writing Prospectus was based on the preliminary loan tape for the deal. The preliminary loan tape, often called an "investor tape," contained much of the same underwriting data as the due diligence loan tape, including borrower income, property value, and loan-specific risk calculations such as LTV, but with data specific to the loans anticipated to be backing that securitization.

86. Morgan Stanley brokers disseminated RMBS Offering Documents directly to PERS and STRS. PERS and STRS, like most RMBS investors, regularly relied on the strats set out in those Offering Documents as accurate indicators of investment risk. The strats contained in Offering Documents drafted and/or circulated by Morgan Stanley were a key factor in the Pension Funds' decision-making process.

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a. Loan Level Risk Metrics in the Investor Tape and Offering Documents

87. The most important loan-level data points, from an investor perspective, included:

a. Value: the value of the mortgaged property. This was typically based on the appraisal report included in the originator's loan file. For some loans, however, the value was based on a BPO ordered by Morgan Stanley during the due diligence process.

b. Owner Occupancy: an indication of whether the borrower physically resides in the mortgaged property. Homeowners who physically reside in a mortgaged property are statistically less likely to default on their mortgage than borrowers who use properties as investments or rentals. A mortgage on a non-owner-occupied property is therefore riskier than one on an owner-occupied property.

c. Loan-to-value ratio ("LTV"): the principal balance of the present mortgage divided by the appraised value of the mortgaged property. An inflated appraisal value will make LTV appear lower than it actually is. The higher the LTV, the lower the borrower's equity and the higher the risk of default.

d. Combined loan-to-value ratio ("CLTV"): the principal balance of the present mortgage plus any other loans secured by the same property, divided by the appraised value of the mortgaged property. The higher the CLTV, the lower the borrower's equity and the higher the risk of default.

e. Debt-to-income ratio ("DTI"): a borrower's total monthly debt payment obligations (including payment obligations on the present mortgage), divided by the monthly income the borrower has available to pay those debts. The higher the DTI, the closer the borrower is to insolvency and the higher the risk of default.

f. Loan purpose: the borrower's reason for taking out the mortgage loan. Typically, "Purchase" indicates that the borrower took out the loan in the course of purchasing a new property; "Cash-out Refinance" indicates that the borrower extracted a significant amount of cash—usually any amount over $2000—from a property she already owned; and "Rate-Term Refinance" indicates that the borrower refinanced an existing mortgage to obtain a better interest rate, such as one that was lower or guaranteed for a period of time. Cash-out Refinance loans are considered the riskiest, because extracting large amounts of cash from an existing property could signal that a borrower does not have sufficient cash flow to meet her existing debt obligations.

g. Paid-through or next payment date: a date that reflects either the last due date through which a borrower has made his payments (the paid-through date), or the first due date following the borrower's last payment (next payment date). Regardless of which convention a tape follows, the date can be used to determine whether a loan is in default. The cumulative rate at which the loans in a loan pool are defaulting is referred to as the delinquency rate.

88. Morgan Stanley's Collateral Analysis group used the loan-level data in the preliminary loan tape to calculate the strats set forth in the Offering Documents. Those strats included the following:

(1) CLTV

89. The CLTV strats in Morgan Stanley's Offering Documents purported to show the weighted average (calculated by loan principal balance rather than by number of loans) CLTV of the entire collateral pool and its subgroups, as well as the distribution of CLTV across the collateral pool and its subgroups.

90. CLTV distribution was typically presented in the form of a table like the one on the next page. A CLTV distribution table breaks CLTV into bands ranging from 0% to 100%, and shows the percentage of the total loan pool (calculated by principal balance rather than by number of loans) that falls within each band.

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Range of Combined Original LTV Ratios (%)	Number of Mortgage Loans	Aggregate Cut-off Date Principal Balance ($)	% of Mortgage Pool by Aggregate Cut-off Date Principal Balance	Weighted Average Gross Interest Rate (%)	Weighted Average Remaining Term (months)	Weighted Average Combined Original LTV (%)
10.00 or less	1	$ 75,012	0.01%	8.725%	355	9.69%
10.01 - 15.00	2	99,177	0.01	9.900	264	11.54
15.01 - 20.00	4	490,395	0.05	8.298	357	18.47
20.01 - 25.00	7	589,886	0.06	7.817	357	23.47
25.01 - 30.00	13	1,355,121	0.13	8.555	357	28.34
30.01 - 35.00	15	2,657,896	0.25	8.718	357	33.11
35.01 - 40.00	21	2,752,461	0.26	7.768	353	37.68
40.01 - 45.00	18	2,501,589	0.24	7.670	347	43.28
45.01 - 50.00	19	3,702,274	0.35	7.242	358	48.06
50.01 - 55.00	24	4,070,790	0.39	7.855	346	53.18
55.01 - 60.00	83	16,373,014	1.56	7.859	355	58.16
60.01 - 65.00	82	17,933,577	1.71	7.858	356	63.25
65.01 - 70.00	139	30,571,236	2.91	8.244	355	68.81
70.01 - 75.00	178	41,908,658	3.99	8.176	356	74.10
75.01 - 80.00	1,394	353,928,096	33.68	7.923	356	79.88
80.01 - 85.00	441	96,491,495	9.18	8.635	355	84.59
85.01 - 90.00	711	165,777,782	15.78	8.801	356	89.69
90.01 - 95.00	762	207,078,230	19.71	8.606	356	94.76
95.01 - 100.00	1,423	102,424,766	9.75	10.876	356	99.99
Total/Weighted Average/ % of Mortgage Loan Pool:	5,337	$1,050,781,456	100.00%	8.566%	356	84.91%

Minimum: 9.69%
Maximum: 100.00%
Weighted Average: 84.91%

A typical CLTV strat table.

91. Because loans with high CLTV are riskier than loans with lower CLTV, prospective investors—including PERS and STRS—paid close attention to how many loans fell within the highest bands. For most investors, the two most important data points were the percentage of the pool with a CLTV over 80% ("CLTV >80") and the percentage with a CLTV over 90% ("CLTV >90").

92. Morgan Stanley claimed in its Offering Documents that the collateral pools backing its RMBS did not contain loans with a CLTV over 100%. A CLTV over 100% would mean that the total loans secured by a property exceeded the value of the property—in other words, it was "underwater." Most investors, including PERS and STRS, would have been extremely concerned by the inclusion of loans with CLTVs over 100% in a collateral pool, because those loans carry a very high risk of default.

93. The Offering Documents for a number of the securities listed in Appendix A misstate the CLTV strats for their respective collateral pools, either by understating the

percentage of the pool with loans in the CLTV >80 or CLTV >90 bands and/or by concealing the number of loans that would have had a CLTV over 100% if Morgan Stanley had properly reviewed and adjusted inflated property appraisals. PERS and STRS were misled by these misrepresentations when they chose to purchase the securities in question.

94. Morgan Stanley knew as early as 2005 that some originators were including significant numbers of loans with CLTV over 100% in the wholesale loan pools that they offered to sell Morgan Stanley, but Morgan Stanley continued buying and securitizing those loans anyway.

(2) Delinquency

95. The Offering Documents also stated the number of delinquent loans in the mortgage pool. Morgan Stanley typically tracked and reported loan-level delinquency rates using an accounting method set forth by the Office of Thrift Supervision and popular among subprime lenders and servicers (the "OTS" method). Under the OTS accounting method, if a borrower misses a loan payment, the loan is not considered delinquent until the close of business on the next payment due date. For example, if a borrower misses a payment due March 1st, that payment will be considered "delinquent" if not made by the close of business April 1st. Other accounting methods, such as a widely used method set forth by the Mortgage Bankers' Association, consider a loan delinquent if payment is not received by the close of business on the day *before* the next payment due date—March 31st, in the example above.

96. Though the methods technically differ by only one day, the OTS accounting method actually builds a one-month lag time into the delinquency figures reported by loan servicers to issuers like Morgan Stanley. This is because loan servicers collect monthly payment data on the day before the borrower's next payment is due—i.e., the same day that the Mortgage Bankers' Association identifies the delinquency, but a day *before* the OTS method acknowledges it. A loan that becomes OTS-delinquent the day after the data sweep will not be captured until the servicer collects payment data again at the end of the following month. In the example above, the borrower who missed her March 1st payment will technically be OTS delinquent as of April 1st,

but will not be reported as delinquent until the April 30th data sweep, nearly three months after she made her last payment on February 1st.

97. Because of the lag time in reporting missed payments under the OTS method, Morgan Stanley usually did not receive up-to-date delinquency information in time to include it in its preliminary Offering Documents. Instead, Morgan Stanley would leave the number of delinquent loans blank in the Free Writing Prospectus and include a note assuring investors that the final number, once filled in, would "represent no more than approximately 1% of the mortgage loans in the final mortgage loan pool." After the Free Writing Prospectus was released to prospective investors, Morgan Stanley would receive an updated servicing report reflecting borrower payments made up through the deal's cut-off date. Morgan Stanley then used that payment data to calculate the number of loans in the preliminary mortgage pool that were OTS-delinquent as of the cut-off date. Ostensibly, if the number exceeded 1%, Morgan Stanley would bring it down by removing delinquent loans from the pool and replacing them with performing loans during a process known as "cutting" the final pool, where nonperforming loans were supposedly replaced with performing ones. Once the final pool was cut, Morgan Stanley filled in the delinquency rate blank in the Prospectus Supplement and disseminated the final figure to investors.

98. As described further below, however, the final delinquency figure disclosed in the Prospectus Supplement was not always accurate. For at least one of the securitizations listed in Appendix A, MSAC 2007-NC4, Morgan Stanley "cut" the pool with delinquent loans that it knew would exceed 1% of the final pool at closing, actually *adding* nonperforming loans to the pool, and dramatically underreported the final number of delinquent loans in the Prospectus Supplement. PERS relied on those misrepresentations when it chose to purchase the security.

(3) Loan Purpose

99. The Offering Documents for several of the securities listed in Appendix A also misrepresented the number of Cash-out Refinance loans in their respective collateral pools. PERS and STRS were misled by these misrepresentations when they purchased the securities in question.

b. Morgan Stanley Knew It Was Securitizing Loans That Were Likely to Default

100. Morgan Stanley routinely monitored the performance of the mortgage-backed securities it issued, and in so doing identified certain loan products and loan characteristics that were disproportionately associated with borrower default and delinquency. Several internal reports identified Stated Income loans (those where the borrowers' income is not verified by, for example, W-2s or other records), loans with CLTV over 90%, and loans carrying simultaneous silent second liens (such as a second loan being used for the purchaser's "down payment") as especially likely to default. Nonetheless, Morgan Stanley continued to securitize loans with these heightened risk characteristics and continued to conceal these characteristics from investors.

101. The failures in Morgan Stanley's due diligence process, misrepresentations and reckless disregard by Morgan Stanley set forth above and detailed for specific deals below are representative of the fraud throughout Morgan Stanley's RMBS business, including Morgan Stanley's role in the securities purchased by PERS and STRS listed on Appendix A. As a result of the fraud described herein, PERS and STRS suffered hundreds of millions of dollars in damages.

C. The MSAC 2007-NC4 Securitization

102. The MSAC 2007-NC4 deal provides a clear example of the types of reckless practices and widespread misrepresentations endemic to Morgan Stanley's RMBS business between 2004 to 2007.

103. Morgan Stanley sponsored and underwrote the MSAC 2007-NC4 RMBS securitization in or around June 2007. The collateral pool backing MSAC 2007-NC4 contained many high-risk subprime loans that were extremely likely to default. As alleged herein, Morgan Stanley knowingly hid these loans' heightened risk factors from prospective purchasers.

104. Morgan Stanley prepared and distributed Offering Documents for MSAC 2007-NC4 and marketed the deal directly to PERS and other California consumers. The marketing information that Morgan Stanley provided to PERS and other prospective purchasers included a number of significant, material misrepresentations about the quality of the loan collateral backing

MSAC 2007-NC4. Relying on those misrepresentations, PERS purchased $94.2 million in AAA-rated, A2a-tranche certificates.

105. In the year after PERS purchased the MSAC 2007-NC4 certificates, catastrophic delinquencies in the underlying mortgages caused the certificates' value to plummet and prompted rating agencies to downgrade the certificates. For example, rating agency Standard & Poor's ("S&P") downgraded the certificates from AAA to CC. AAA is the highest rating that can be obtained from the rating agencies and is equivalent to the ratings assigned to United States Treasury bonds. CC is a "junk" or below-investment-grade rating. PERS sold its MSAC 2007-NC4 certificates in July of 2008, at a loss of nearly $20 million.

1. Morgan Stanley's Relationship with New Century

106. The collateral pool for MSAC 2007-NC4 was composed entirely of subprime loans originated by New Century Mortgage Corporation, a wholesale mortgage loan division of New Century Financial Corporation ("New Century").

107. From 2004 to 2007, New Century was one of the largest and fastest-growing subprime originators in the United States, and Morgan Stanley was the largest purchaser of mortgages originated by New Century. In 2005, a Morgan Stanley employee described Morgan Stanley as New Century's "largest and most important counter-party." The two companies enjoyed an extremely close relationship, with Morgan Stanley routinely advising on New Century's loan origination practices and involving itself "in all elements of their operation."

108. Morgan Stanley typically acted as a warehouse purchaser, providing New Century with a line of credit it could use to originate loans that were then immediately transferred to Morgan Stanley. Morgan Stanley's appetite for New Century loans was notorious: by 2006, it was advancing cash for the purchase of subprime mortgage loans weeks or months before they had even been originated, driving New Century to churn out loans at unprecedented rates just to keep up. New Century, in turn, started (in its own words) "getting aggressive" in its sales to Morgan Stanley and other purchasers, circumventing its own underwriting guidelines and risk standards in order to originate and sell as many loans as possible.

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109. Morgan Stanley was aware that the frenetic pace of New Century's originations was contributing to a steady decline in loan quality and straining all of the originator's operations. New Century frequently failed to transfer origination files in time for Morgan Stanley to conduct proper due diligence—a failure that Morgan Stanley management recognized "not as glitches but now as a pattern, something endemic to their infrastructure." Rather than modify its relationship with New Century or demand higher quality and improved performance, Morgan Stanley simply "help[ed] them band-aid the issues as best we can" and continued to do business as usual.

110. During this period, New Century pushed senior Morgan Stanley traders to loosen Morgan Stanley's due diligence criteria and reduce the amount of scrutiny given to New Century-originated loans. When risk management personnel protested these types of changes, senior management dismissed them as "making a bigger deal out of this than [they] should," and decided that improving Morgan Stanley's ability to identify bad loans was not "worth annoying our largest whole loan partner."

111. New Century stopped originating loans entirely on March 8, 2007, was delisted by the New York Stock Exchange on March 13, 2007, and ultimately filed for Chapter 11 bankruptcy on April 2, 2007.

112. Though Morgan Stanley bragged in investor roadshow materials that all of its originator partners had "strong credit cultures," its own due diligence managers complained in 2006 that New Century's lending decisions "d[id] not make sense." For example, one Morgan Stanley manager complained that New Century had pushed Morgan Stanley to purchase "$900k in combined loans to a renter with no prior [mortgage] history" who claimed to make "$16k a month as a manager of a knock off gold club distributor via the internet and mailings," as well as a loan to "a borrower that makes $12k a month as an operations manager of an unknown company," later revealed to be a "tarot reading house." "Bottom line," that same manager observed, there was, "not a lot of 'common sense' being used" at New Century.

113. Morgan Stanley was also aware of "deteriorating appraisal quality" at New Century. In a December 2006 memorandum titled "New Century Kick Out Drivers," the head of

Morgan Stanley's valuation due diligence team identified numerous valuation problems with New Century loans, such as the "use of dated sales in declining or soft markets," "use of sales from outside the neighborhood to support higher value," "use of sales clearly superior in quality of construction and/or appeal," and the overriding of appraisal reviews by New Century management.

114. By late 2006, Morgan Stanley began to see unprecedented early foreclosure and delinquency rates in loans that New Century had originated just months earlier—double and triple the rates it had seen previously. Rather than demand more accountability or cease doing business with New Century, Morgan Stanley traders simply carried on buying New Century loans.

115. In late March 2007, just days before New Century filed for bankruptcy, Morgan Stanley purchased the originator's entire mortgage inventory in return for $265 million in new financing. This "warehouse pool" consisted of new loans New Century had originated during its final few frantic months of operation, as well as seasoned loans that Morgan Stanley had reviewed and rejected from numerous pools throughout the previous year. Many of the loans in the warehouse pool were delinquent and many did not comply with New Century or Morgan Stanley's underwriting guidelines.

116. Morgan Stanley contracted with a third party to conduct due diligence on the warehouse pool just as it had with other acquisitions in the past, but it largely ignored the due diligence team's results when choosing which loans to securitize. Morgan Stanley's traders assembled the MSAC 2007-NC4 collateral pool from this warehouse inventory, securitizing an alarming number of loans that Morgan Stanley knew were high risk and likely to default.

2. Morgan Stanley's Due Diligence Review Revealed Problems with the New Century Loans, Which Morgan Stanley Ignored

117. When Morgan Stanley acquired New Century's entire mortgage inventory in March 2007, Morgan Stanley's Whole Loan division hired Clayton to conduct due diligence on the loans just as it had for prior acquisitions from New Century.

118. In the course of the March 2007 New Century due diligence review, Clayton re-underwrote a sample of 1078 loans from the warehouse pool and found that 23.75% of the due

diligence sample selected by Morgan Stanley had incurable Event Level 3 credit or compliance exceptions. That means *nearly a quarter* of the loans sampled failed to meet either New Century's or Morgan Stanley's minimum underwriting guidelines, indicating a dramatically higher risk of default for those loans.

119. Rather than exclude the high-risk Event Level 3 loans that Clayton identified in its March 2007 due diligence, Morgan Stanley included them in its later RMBS securitizations. *Nearly half*, 49.6%, of the incurable Event Level 3 loans identified in Clayton's sample went into the collateral pool for MSAC 2007-NC4, which PERS later purchased.

120. Morgan Stanley also securitized loans that it had refused to purchase from New Century in the past. At least 300 of the loans that Morgan Stanley placed into the MSAC 2007-NC4 collateral pool had already been subjected to Clayton due diligence during the preceding year, but Morgan Stanley had rejected them as too risky and kicked them out of previous purchase pools. In March 2007, however, Morgan Stanley disregarded its own due diligence history and securitized some of the loans that had been kicked out of previous purchase pools. Of the 300 loans rejected over the previous year, at least 280 of them were placed into the MSAC 2007-NC4 collateral pool without any additional due diligence review.

121. Of the 300 loans rejected over the previous year, 152 were flagged for some kind of tape discrepancy. Morgan Stanley failed to correct at least 100 of those discrepancies before including the loans in the MSAC 2007-NC4 collateral pool and used the incorrect data to calculate Offering Document strats.

122. Morgan Stanley knew the loans failed to comply with underwriting guidelines and knew the loans carried a disproportionately high risk of default, but nevertheless included them in the MSAC 2007-NC4 collateral pool. In an instant message exchange with a coworker, one Morgan Stanley due diligence team member joked that a trader "could probably retire by shorting these upcoming NC deals," glibly observing that "someone needs to benefit from this mess."

123. For the due diligence that was completed in March 2007, 1078 loans, or 11% of the total 9719 loans were sampled. In this sample, Clayton found tape discrepancies in over 660 of the loans—a discrepancy rate of over 60%. Nevertheless, at least 358 loans flagged for tape

discrepancies went into the MSAC 2007-NC4 collateral pool, resulting in extensive misrepresentations in information provided to investors.

3. Morgan Stanley Made Numerous Misrepresentations to Investors about the Quality of the MSAC 2007-NC4 Loan Collateral, and Those Misrepresentations Were Material to PERS's Decision to Invest

124. In the days leading up to its June 15, 2007 launch date, Morgan Stanley prepared, signed, and released the MSAC 2007-NC4 Free Writing Prospectus and Term Sheet (collectively, "MSAC 2007-NC4 Offering Documents") to its brokers, instructing them to distribute the materials to prospective investors. A Morgan Stanley & Co. broker forwarded the MSAC 2007-NC4 Offering Documents to PERS on June 14, 2007.

125. The MSAC 2007-NC4 Offering Documents misrepresented the number of high-LTV loans, high-CLTV loans, Cash-out Refinance loans, and non-owner occupied properties in the MSAC 2007-NC4 collateral pool. They also drastically understated the rate at which the underlying loans were defaulting.

126. These fraudulent and misleading figures were material to PERS's decision to invest in MSAC 2007-NC4 certificates.

4. Morgan Stanley Knowingly Concealed the Existence of Simultaneous Second Liens and Understated the Number of High-CLTV Loans in the MSAC 2007-NC4 Collateral Pool

127. The MSAC 2007-NC4 Free Writing Prospectus included three tables setting out CLTV distributions for the aggregate collateral pool, Group I collateral pool, and the Group II collateral pool, respectively. The Group II loan pool was of particular interest to PERS, because the tranche that PERS purchased was backed by Group II loans.

128. According to the MSAC 2007-NC4 Free Writing Prospectus, 29.56% of Group II had a CLTV over 90%.

129. That figure was not accurate, however, because it omitted simultaneous second liens. Simultaneous second liens are junior liens taken during the same transaction, on the same property, generally with the same originator.

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130. By definition, a CLTV calculation is supposed to include simultaneous second liens. Indeed, the MSAC 2007-NC4 Free Writing Prospectus explained that "[t]he 'combined loan-to-value ratio' of a mortgage loan at any time is the ratio of the principal balance of the second-lien mortgage loan, together with the outstanding balance of the first-lien mortgage loan, at the date of determination to [the appraised value at time of sale or refinance.]" Or, written as a formula:

$$\textbf{CLTV} = \frac{\textbf{[Principal Balance of Second Lien] + [Principal Balance of First Lien]}}{\textbf{Appraised Value at Sale or Refinance}}$$

131. Morgan Stanley's MSAC 2007-NC4 Offering Documents did not disclose the existence of a single simultaneous second lien, thereby seriously misleading investors about the degree to which the collateral property was encumbered. In reality, the loan files establish that 28.2% of loans in the collateral pool carried simultaneous second liens, all of which were omitted from the CLTV calculations reported to investors. When simultaneous second liens as reflected in the loan files for Group II loans are properly factored in, the real percentage of loans with a CLTV over 90% for the Group II pool jumps from 29.6% to at least 61.1%.

	Stated Percentage in Offering Documents	Actual Percentage	Difference Between Stated Percentage and Actual Percentage
Percentage of Loans with Simultaneous Second Liens	0.0%	28.2%	**28.2**
Percentage of Loans with CLTV>90%	29.6%	61.1%	**31.5**

132. Thus, the MSAC 2007-NC4 Free Writing Prospectus understated the Group II CLTV >90 figure by more than half. Morgan Stanley knew which loans in the pool carried silent second liens and had been warned by its due diligence contractor, Clayton, that a substantial proportion of the CLTV figures in the underlying loan tape were inaccurate because they omitted those liens from CLTV calculations. Nonetheless, Morgan Stanley chose to conceal the existence

of the simultaneous second liens from prospective investors, knowing full well that it would be material to their decision to purchase MSAC 2007-NC4 certificates.

5. Morgan Stanley Knowingly Understated the Number of High-LTV Loans in the MSAC 2007-NC4 Collateral Pool

133. The MSAC 2007-NC4 Offering Documents stated that 53.9% of the Group II loans had an LTV, or loan-to-value ratio, over 80%, and that none of the loans in the pool had an LTV over 100%.

134. Those figures were based on radically inflated appraisal values, which Morgan Stanley knew to be incorrect. An AVM analysis of the loans in the MSAC 2007-NC4 collateral pool shows that an enormous percentage had unreliable or grossly overstated appraisal values. Morgan Stanley knew or should have known that the appraisals in these loan files were unreliable, but nonetheless used the inflated values when calculating LTV figures for investors.

135. When MSAC 2007-NC4 Group II LTV data is adjusted to reflect AVM values, the percentage of the loans in the pool with an LTV over 80% jumps from 53.9% to an estimated 84.5%, and *the percentage of loans in the pool with an LTV over 100% jumps from 0% to an estimated 43.3%.* These results show that a substantial portion of the loans in the NC4 Group II pool were almost certainly overvalued and underwater. Morgan Stanley concealed that fact from investors.

	Stated Percentage in Offering Documents	Estimated Percentage from AVM Analysis	Difference Between Stated Percentage and AVM Estimate
Percentage of Loans with LTV > 80%	53.9%	84.5%	**30.6**
Percentage of Loans with LTV > 100%	0.0%	43.3%	**43.3**

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6. Morgan Stanley Understated the Number of Cash-out Refinances in the MSAC 2007-NC4 Collateral Pool

136. The MSAC 2007-NC4 Free Writing Prospectus included three tables showing the Loan Purpose distribution for the aggregate, Group I, and Group II collateral pools, respectively. The Group II table stated that 35.85% of the Group II loan balance was associated with Cash-out Refinances, and 23.03% was associated with Rate Term Refinances.

137. Those figures were not accurate. Approximately 17% of the loans in the Group II pool were classified under the wrong Loan Purpose, labeled as Rate Term Refinances even though the mortgage borrower had received over $2000 in cash. According to New Century's underwriting guidelines, those loans should have been classified as Cash-Out Refinances.

138. Though New Century was the original source for the incorrect Loan Purpose data, Morgan Stanley knew of the errors and did not take steps to correct them before providing that data to investors. During the due diligence process, Clayton flagged at least 114 instances where the loan tape for the due diligence pool failed to properly identify a Cash-Out Refinance loan. Morgan Stanley corrected less than a third of those discrepancies before securitizing the loans and generating a preliminary MSAC 2007-NC4 loan tape that it knew contained loan-purpose misrepresentations.

139. Morgan Stanley knew that the number of risky Cash-Out Refinance loans in the loan pool would be material to prospective investors' decision to purchase MSAC 2007-NC4 certificates. Nonetheless, it ignored known inaccuracies in the data and knowingly concealed the true number of Cash-Out Refinance loans in the final pool.

7. Morgan Stanley Understated the Number of Non-Owner-Occupied Properties in the MSAC 2007-NC4 Collateral Pool

140. Morgan Stanley's MSAC 2007-NC4 Offering Documents understated the number of non-owner-occupied properties in the MSAC 2007-NC4 collateral pool. As explained above, homeowners who live in a mortgaged property are statistically less likely to default than landlords, investors, and owners of second homes. Non-owner-occupied properties are therefore riskier, and higher numbers of them in loan pools would be of material concern to RMBS investors such as PERS and STRS.

141. The MSAC 2007-NC4 Offering Documents stated that 7.8% of the loans in the collateral pool were not owner-occupied. In reality, however, over 15% of the properties were not owner-occupied. Morgan Stanley, aware that the loan-level data it received from New Century was riddled with errors, nonetheless disseminated this false and misleading owner-occupancy statistic to investors with reckless disregard for its accuracy.

	Stated Percentage in Offering Documents	Actual Percentage	Difference Between Stated Percentage and Actual Percentage
Percentage of Loans Not Backed By Owner-Occupied Properties	7.8%	15.5%	**7.7**

8. Morgan Stanley Understated the Delinquency Rate of the MSAC 2007-NC4 Collateral Pool

142. Morgan Stanley's MSAC 2007-NC4 Offering Documents drastically understated the rate at which the loans in the underlying collateral pool were defaulting.

143. The first MSAC 2007-NC4 Offering Document published to investors that contained representations about the deal's delinquency rate was the MSAC 2007-NC4 Free Writing Prospectus, based on preliminary loan tape data. Morgan Stanley drafted, reviewed, approved, and distributed the Free Writing Prospectus to investors before it had received the most up-to-date borrower payment information from its loan servicer. Because it did not have sufficient information to provide a current, precise number of delinquent loans, Morgan Stanley simply left a blank placeholder and assured investors that the final number of delinquent loans would "represent[] no more than approximately 1% of the mortgage loans in the final mortgage loan pool." That assurance was false.

144. On June 11, 2007, as Morgan Stanley's Collateral Analysis group was cutting the final MSAC 2007-NC4 loan pool, the Executive Director for Fixed Income emailed the group with instructions to remove loans that were paid through April 1 and replace them with loans that were only paid through March 1. In other words, he told them to remove loans that were only one month behind in payments and replace them with loans that were two months behind in

payments. Doing so, he explained, would buy the trading desk a little "more room in delinquency . . . on other deals" that it was structuring simultaneously.

145. At the time the Executive Director sent these instructions, Morgan Stanley had not yet received a May servicing report capturing payments missed on May 1. Therefore, under the OTS accounting method, neither the loans paid through April 1 nor the loans paid through March 1 were yet considered "delinquent." However, the Executive Director knew full well (or was reckless or deliberately ignorant in not knowing) that Morgan Stanley would receive the servicing report before the deal launched, and that the loans paid through only March 1 would therefore need to be reported as OTS delinquent. Indeed, two days later, on June 13, 2007, Morgan Stanley received a May servicing report showing that all of the loans paid only through March 1 were now considered delinquent, and that the number of OTS-delinquent loans in the pool was more than four times higher than it had been the month before. Morgan Stanley ignored this information and proceeded to draft the MSAC 2007-NC4 Offering Documents as though it never received the May servicing report.

146. Morgan Stanley finalized its Prospectus Supplement on June 19, 2007—six days after it received updated servicing information—and filled in the delinquency blank to read that "41 mortgage loans . . . were more than 30 days but less than 60 days Delinquent" as of the cut-off date of May 1, 2007. This was patently false. The May servicing report showed that 133 loans were between 30 and 60 days delinquent as of the deal's May 1 cut-off date, not 41. The same report also showed that an additional 42 loans were between 60 and 90 days delinquent—meaning those borrowers had not made a single payment since February 1. This means that the actual, measured delinquency rate as of the cut-off date was over three times higher than the maximum rate Morgan Stanley had promised investors in the draft Free Writing Prospectus Supplement.

147. Morgan Stanley knew that its representations about the MSAC 2007-NC4 delinquency rate were incorrect, but nonetheless chose to conceal the true delinquency rate from investors. PERS relied to its detriment on those misrepresentations.

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9. Morgan Stanley's Misrepresentations Concealed the Most Dangerous Loans

148. As discussed above, Morgan Stanley's due diligence sample was limited, but even within the limited due diligence sample, nearly a quarter of the loans were found to have incurable Event Level 3 exceptions, and nearly half of the loans actually reviewed and known to have incurable Event Level 3 exceptions were nevertheless included in the MSAC 2007-NC4 pool. Morgan Stanley also knowingly included in the pool previously rejected loans and loans with known tape discrepancies. Despite being aware of these problems with the loans, Morgan Stanley securitized the loans and misrepresented key loan characteristics to potential purchasers.

149. Within the Group II collateral pool, $547.3 million in loans were associated with at least some form of misrepresentation by Morgan Stanley. That sum represents 68.3% of the original Group II principal balance.

150. Within the Group II collateral pool, $492.0 million in loans that contained some form of misrepresentation defaulted or went into foreclosure before October 2012. That sum represents more than 61.4% of the original Group II principal balance.

151. Morgan Stanley's misrepresentations about these loans concealed their danger and misled investors to underestimate the risk associated with the MSAC 2007-NC4 certificates.

10. Morgan Stanley's Misrepresentations Were Material to PERS's Decision to Purchase MSAC 2007-NC4

152. Morgan Stanley's representations about LTV, CLTV, Loan Purpose, Owner Occupancy, and Delinquency were misleading and false and material to the PERS investment officers' decision to bid on and purchase the MSAC 2007-NC4 certificates.

D. Similar Misrepresentations in Other Securitizations

153. Morgan Stanley's material misrepresentations were by no means isolated to the Offering Documents for the MSAC 2007-NC4 deal. Below are other examples that typify the kind of misleading and false representations on which PERS and STRS relied when deciding to invest in RMBS underwritten and/or sponsored by Morgan Stanley between 2004 through 2007.

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1. Misrepresentations in the SAST 2007-2 Securitization

154. Morgan Stanley underwrote the SAST 2007-2 RMBS deal in or around April 2007. The mortgage loans backing the deal were originated by Morgan Stanley's subsidiary, Saxon.

155. Morgan Stanley drafted the Offering Documents for SAST 2007-2 and Morgan Stanley distributed those documents in the course of marketing the deal to PERS. The marketing information that Morgan Stanley provided to PERS and other potential purchasers included a number of significant, material misrepresentations about the quality of the loan collateral backing SAST 2007-2. Relying on those misrepresentations, PERS agreed to purchase $40 million in AAA-rated, A2A-tranche certificates.

156. The SAST 2007-2 Offering Documents state that 42.4% of the Group II collateral pool, which backed the certificates PERS purchased, had an LTV over 80%, and that none of the loans in the pool had an LTV over 100%.

157. Those figures were based on radically inflated appraisal values. Morgan Stanley conducted its own AVM analysis on the loans that went into the SAST 2007-2 collateral pool, and therefore knew or should have known that many of the appraisals in its files were unreliable. Morgan Stanley nonetheless used the inflated values when calculating LTV figures for investors.

158. When SAST 2007-2 LTV data is recalculated using AVM values, the percentage of Group II loans with an LTV over 80% jumps from 42.4% to approximately 62.4%. Loans with an LTV over 100% jump from 0% to 19.6%. These results show that a substantial portion of the loans in the SAST 2007-2 pool were almost certainly overvalued and underwater. Morgan Stanley concealed that fact from investors.

	Stated Percentage in Offering Documents	Estimated Percentage from AVM Analysis	Difference Between Stated Percentage and AVM Estimate
Percentage of Loans with LTV > 80%	42.4%	62.4%	**20.0**
Percentage of Loans with LTV > 100%	0.0%	19.6%	**19.6**

159. Approximately $167.7 million in loans in the SAST 2007-2 collateral pool were falsely represented as having an LTV equal to or under 80%, when in reality they had an LTV over 80%. Approximately $108 million of those loans eventually defaulted or went into foreclosure.

160. Approximately $121.1 million worth in loans in the SAST 2007-2 collateral pool were falsely represented as having an LTV equal to or under 100%, when in reality they had an LTV over 100%. Approximately $78.7 million of those loans eventually defaulted or went into foreclosure.

161. In the year after PERS purchased the SAST 2007-2 certificates, the certificates' value plummeted. The certificates were downgraded by rating agency S&P from AAA to CCC, and by rating agency Moody's Investor Service ("Moody's") from Aaa to Caa3. PERS sold its SAST 2007-2 certificates in October of 2009 at a significant loss.

162. Morgan Stanley's representations about LTV were misleading and false and material to PERS investment officers' decision to bid on and purchase the SAST 2007-2 certificates.

2. Misrepresentations in the SAST 2007-3 Securitization

163. Morgan Stanley underwrote the SAST 2007-3 deal in or around August 2007. The mortgage loans backing the deal were originated by Morgan Stanley's subsidiary, Saxon.

164. Morgan Stanley drafted the Offering Documents for SAST 2007-3, and Morgan Stanley distributed those documents in the course of marketing the deal to PERS. The marketing information that Morgan Stanley provided to PERS and other potential purchasers included a number of significant, material misrepresentations about the quality of the loan collateral backing SAST 2007-3. Relying on those misrepresentations, PERS agreed to purchase over $138 million in AAA-rated, 2A1-tranche certificates. That tranche was backed by loans in the Group II collateral pool.

165. The SAST 2007-3 Offering Documents state that 61.4% of the Group II collateral pool had an LTV over 80%, and that none of the loans in the pool had an LTV over 100%.

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166. Those figures were based on radically inflated appraisal values. Morgan Stanley conducted its own AVM analysis on the loans that went into the SAST 2007-3 collateral pool, and therefore knew or should have known that many of the appraisals in its files were unreliable. Morgan Stanley nonetheless used the inflated values when calculating LTV figures for investors.

167. When SAST 2007-3 LTV data is recalculated using AVM values, the percentage of Group II loans with an LTV over 80% jumps from 61.4% to approximately 79.1%. Loans with an LTV over 100% jump from 0% to 31.2%. These results show that a substantial portion of the loans in the SAST 2007-3 Group II pool were almost certainly overvalued and underwater. Morgan Stanley concealed that fact from investors.

	Percentage Stated in Offering Documents	Estimated Percentage from AVM Analysis	Difference Between Stated Percentage and AVM Estimate
Percentage of Loans with LTV > 80%	61.4%	79.1%	**17.7**
Percentage of Loans with LTV > 100%	0.0%	31.2%	**31.2**

168. Approximately $206.4 million in loans in the SAST 2007-3 collateral pool were falsely represented as having an LTV equal to or under 80%, when in reality they had an LTV over 80%. Approximately $152.3 million of those loans eventually defaulted or went into foreclosure.

169. Approximately $218.7 million in loans in the SAST 2007-3 collateral pool were falsely represented as having an LTV equal to or under 100%, when in reality they had an LTV over 100%. Approximately $168.5 million of those loans eventually defaulted or went into foreclosure.

170. Morgan Stanley's representations about LTV were misleading and false and material to the PERS investment officers' decision to bid on and purchase the SAST 2007-3 certificates.

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171. In the year after PERS purchased the SAST 2007-3 certificates, the certificates' value plummeted. The certificates were downgraded by S&P from AAA to CCC, and by Moody's from Aaa to B2. PERS sold its SAST 2007-3 certificates in August of 2009 at a significant loss.

3. Misrepresentations in the MSM 2007-6XS Securitization

172. Morgan Stanley sponsored and underwrote the MSM 2007-6XS RMBS securitization in or around March 2007.

173. Morgan Stanley produced Offering Documents for MSM 2007-6XS, and marketed the deal directly to PERS. The marketing information that Morgan Stanley provided to PERS and other potential purchasers included a number of significant, material misrepresentations about the quality of the loan collateral backing the security. Relying on those misrepresentations, PERS agreed to purchase over $42 million in AAA-rated, 2A1SS-tranche certificates.

174. The MSM 2007-6XS Offering Documents state that 8.3% of the loans in the Group II collateral pool had an LTV over 80%, and that none of the loans in the pool had an LTV over 100% (i.e., were underwater.)

175. Those figures were based on radically inflated appraisal values. Morgan Stanley conducted its own AVM analysis on the loans that went into the MSM 2007-6XS collateral pool, and therefore knew or should have known that many of the appraisals in its files were unreliable. For example, Morgan Stanley's own valuation due diligence results, including its own AVM analysis, showed that a troubling number of loans in the purchase pools that fed into the MSM 2007-6XS collateral pool had AVM values that were significantly lower than the appraisal values stated on the loan tape. Morgan Stanley nonetheless neglected to request BPOs for all of the loans whose AVM results signaled trouble, and allowed dozens of inflated-value loans to be securitized as a result.

176. Morgan Stanley knew or should have known that the appraisals in its files were unreliable, but nonetheless used the inflated values to calculate LTV figures for investors. When MSM 2007-6XS Group II LTV data is recalculated using AVM values, the percentage of the pool with an LTV over 80% jumps from 8.3% to approximately 46.1%. Loans with an LTV over

100% jump from 0% to 12.2%. These results show that a substantial portion of the loans in the MSM 2007-6XS Group II pool were almost certainly overvalued and underwater. Morgan Stanley concealed that fact from investors.

	Percentage Stated in Offering Documents	Estimated Percentage from AVM Analysis	Difference Between Stated Percentage and AVM Estimate
Percentage of Loans with LTV > 80%	8.3%	46.1%	**37.9**
Percentage of Loans with LTV > 100%	0.0%	12.2%	**12.2**

177. Approximately $120.3 million in loans in the MSM 2007-6XS collateral pool were falsely represented as having an LTV equal to or under 80%, when in reality they had an LTV over 80%. Approximately $80.8 million of those loans eventually defaulted or went into foreclosure.

178. Approximately $37.1 million in loans in the MSM 2007-6XS collateral pool were falsely represented as having an LTV equal to or under 100%, when in reality they had an LTV over 100%. Approximately $22.7 million of those loans eventually defaulted or went into foreclosure.

179. Morgan Stanley's representations about LTV were misleading and false and material to PERS investment officers' decision to bid on and purchase the MSM 2007-6XS certificates.

180. In the year after PERS purchased the MSM 2007-6XS certificates, the certificates' value plummeted. The certificates were downgraded by S&P from AAA to B-, and by Moody's from Aaa to Baa3. PERS sold its MSM 2007-6XS certificates in October of 2009 at a significant loss.

4. Misrepresentations in the MSM 2006-15XS Securitization

181. Morgan Stanley sponsored and underwrote the MSM 2006-15XS RMBS securitization in or around October 2006. Unlike some of the other RMBS securitizations, the loans for this securitization were not divided into "groups."

182. Morgan Stanley produced Offering Documents for MSM 2006-15XS, and marketed the deal directly to PERS. The marketing information that Morgan Stanley provided to PERS and other potential investors contained a number of significant, material misrepresentations about the quality of the loan collateral backing MSM 2006-15XS. Relying on those misrepresentations, PERS agreed to purchase nearly $180 million in AAA-rated, A1-tranche certificates.

183. The MSM 2006-15XS Offering Documents state that approximately 2.97% of the loans in the collateral pool had an LTV over 80%, and that none of the loans in the pool had an LTV over 100% (i.e., were underwater).

184. Those figures were based on radically inflated appraisal values, which Morgan Stanley knew to be incorrect. AVM analysis shows that an enormous percentage of the loans in the MSM 2006-15XS collateral pool had unreliable or grossly overstated appraisal values. Morgan Stanley knew or should have known that the appraisals in its files were unreliable, but nonetheless used the inflated values when calculating LTV figures for investors.

185. When MSM 2006-15XS LTV data is recalculated to reflect AVM values, the percentage of the principal balance associated with an LTV over 80% jumps from 2.97% to approximately 45.1%. The percentage of the principal balance associated with an LTV over 100% jump from 0% to 16.1%. These results show that a substantial portion of the loans in the 15XS pool were almost certainly overvalued and underwater. Morgan Stanley concealed that fact from investors.

	Percentage Stated in Offering Documents	Estimated Percentage from AVM Analysis	Difference Between Stated Percentage and AVM Estimate
Percentage of Loans with LTV > 80%	2.97%	45.1%	**42.22**
Percentage of Loans with LTV > 100%	0.0%	16.1%	**16.1**

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186. Approximately $291.1 million in loans in the MSM 2006-15XS collateral pool were falsely represented as having an LTV equal to or under 80%, when in reality they had an LTV over 80%. Approximately $164.2 million of those loans eventually defaulted or went into foreclosure.

187. Approximately $109.3 million in loans in the MSM 2006-15XS collateral pool were falsely represented as having an LTV equal to or under 100%, when in reality they had an LTV over 100%. Approximately $59.9 million of those loans eventually defaulted or went into foreclosure.

188. Morgan Stanley's representations about LTV were misleading and false and material to PERS investment officers' decision to bid on and purchase the MSM 2006-15XS certificates.

189. In the years after PERS purchased the MSM 2006-15XS certificates, the certificates' value plummeted. The certificates were downgraded by S&P from AAA to D, and by Moody's from Aaa to Ca. PERS sold its MSM 2006-15XS certificates in June of 2009 at a significant loss.

III. THE CHEYNE SIV

190. Looking to reap more profits from asset backed securities, Morgan Stanley also entered the SIV business with Cheyne, a London-based asset management firm established by former Morgan Stanley employees. Its involvement in the Cheyne SIV afforded Morgan Stanley the opportunity to earn management fees and share in the SIV profits. Morgan Stanley saw the opportunity with Cheyne as a chance to gain entry into the lucrative SIV businesses.

A. SIVs Generally

191. Before they imploded during the 2007-2008 financial crisis, SIVs were special-purpose entities that held portfolios of RMBS and other long-term asset-backed securities ("ABS") and bonds. RMBS were among the largest classes of long-term assets held by SIVs. SIVs also held ABS investments drawn from pools of student loans, credit cards, and auto loans.

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192. A SIV borrows money through the issuance of debt such as commercial paper, medium-term notes, and junior capital notes, which constitute its short-term debt. The SIV then uses the capital raised from the sale of its notes to purchase long-term assets.

193. Because long-term assets typically have higher interest rates and yields than short-term securities, a SIV could reap profits (after subtracting management fees and other costs) on the interest rate spread between its long-term assets and its short-term liabilities. Thus, the higher the interest rate spread, the more money a SIV could make.

194. SIVs were typically structured and marketed by an investment bank with access to the ABS markets and with the capability to market SIV notes to institutional and high-net-worth investors. In structuring a SIV, the investment bank would normally lead discussions with rating agencies regarding the rating of the SIV notes, develop simulation models to justify ratings and monitor the SIV's assets, manage all the legal work, and set up a warehouse facility to purchase and hold assets prior to the official launch of the SIV. The investment bank also acted as placement agent (i.e. dealer) for the SIV notes, and marketed those notes worldwide to institutions and other qualified investors.

195. SIV asset managers had the responsibility to provide advice and support and actively manage a SIV's assets, meaning that they had the authority to purchase and sell within the limits outlined in the SIV's formation and operating documents. These asset managers were also responsible for a number of operating tests on the long-term assets held by the SIV, often conducted daily, to determine whether the SIV possessed adequate capital, collateral, and liquidity.

196. Because SIVs relied on their ability to continually issue short-term debt, it was important that SIVs passed their operating tests. If a SIV could not pass its operating tests, it could fall into a restricted state where it is prohibited from issuing new debt. If the SIV manager could not correct the problems within a specified period of time so that the SIV could pass its operating tests, then the SIV enters enforcement. Upon entering enforcement, a SIV is required to follow an investment defeasance plan, a process of selling off assets with the aim of repaying

senior note holders, then other creditors and investors after the senior obligations have been satisfied.

197. SIV notes were only offered as unregistered securities, meaning they were exempt from registration under SEC Rule 144A. Thus, the SIV notes could only be sold to a few types of qualified investors (e.g., pension funds or high-wealth investors).

198. In order to be marketable, the SIV notes needed to be rated by rating agencies. In particular, the SIV notes needed to receive the highest credit ratings because, without those ratings, many qualified investors would not be able to purchase them.

B. Morgan Stanley's Role in the Cheyne SIV

199. Beginning in late 2003, Morgan Stanley, together with Cheyne, designed and structured the Cheyne SIV. Morgan Stanley's role as arranger, lead dealer, and structurer of the Cheyne SIV included "build[ing] . . . a . . . simulation model," "leading rating agency negotiations and overseeing legal work." Morgan Stanley also drafted the operational manual for the Cheyne SIV. "[I]n fact," as a Morgan Stanley senior executive bragged, Morgan Stanley "buil[t] EVERYTHING."

200. Morgan Stanley's extensive role was not surprising. The Cheyne management team had no SIV experience, so Morgan Stanley, also new to the SIV business, did much of the work in creating the SIV. For over a year, one of the primary architects of the Cheyne SIV, a Vice President at Morgan Stanley, complained that, "[t]he fundamental problem at Cheyne is . . . a lack of capable resources to work on the project." He expressed concern that, "the current lack of wider understanding of the transaction within the Cheyne team and the limited integration with [SIV administrator] QSR [Management Limited ("QSR")] to date would be an operational risk," and that the Cheyne team has "shown no evidence of having used the tools at their disposal to conduct the extensive portfolio optimization/exploration that I would conduct if [I] was in their shoes."

201. As the arranger and lead placement agent, Morgan Stanley led the effort to get the ratings needed to market the Cheyne notes. Morgan Stanley boasted it "ended up writing" the Moody's New Issue Report and edited S&P's Presale Report, which were sent to prospective

investors. These reports included the ratings assigned by the rating agencies and rating agencies' language describing the meaning of the ratings. Morgan Stanley knew that the Cheyne SIV ratings were far too optimistic, given the flawed assumptions on which the ratings were based and the poor quality of the underlying assets, as described herein. Indeed, after reviewing evidence submitted in a private lawsuit regarding the structuring and rating of the Cheyne SIV, Judge Scheindlin in the Southern District of New York concluded that "a jury could reasonably infer that . . . Morgan Stanley had actual knowledge that the Rating Agencies were assigning ratings they did not believe in." (*Abu Dhabi Commercial Bank v. Morgan Stanley & Co. Inc.* (S.D.N.Y. 2012) 888 F.Supp.2d 431, 478.)

202. Morgan Stanley also authored and distributed the Cheyne SIV investment materials, presentations, marketing books, and other offering materials that were sent to or made available to prospective investors, including PERS. These documents set forth the ratings assigned to the Cheyne SIV notes by the rating agencies, which Morgan Stanley knew to be unsupportable.

1. The Cheyne SIV's Inflated Ratings

203. Throughout the process of structuring the Cheyne SIV, Morgan Stanley worked to convince the rating agencies to issue ratings that it knew the Cheyne SIV notes did not deserve.

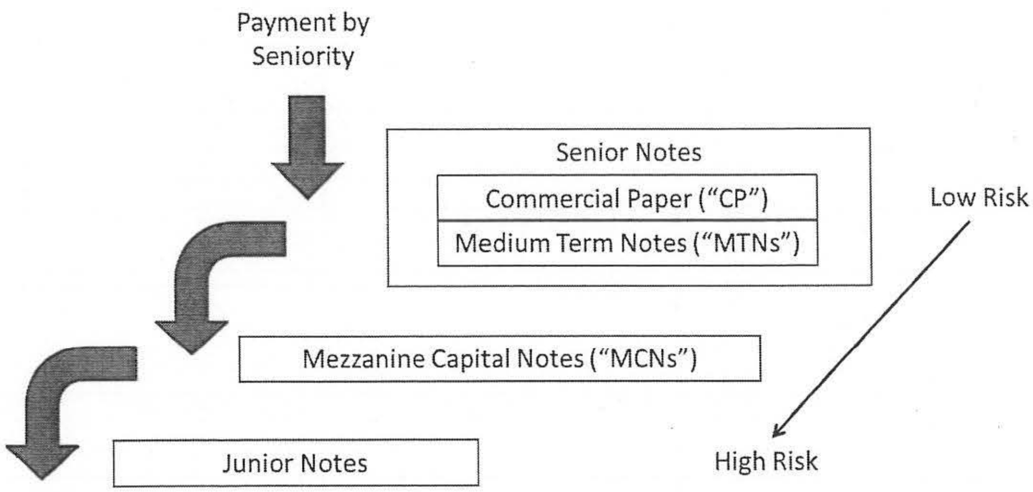
204. In fact, even before receiving formal ratings from the rating agencies on the Cheyne SIV notes, Morgan Stanley assured Cheyne that the "Senior notes . . . will be rated AAA/Aaa by S&P and Moody's." Morgan Stanley also marketed and distributed documents in 2004 emphasizing that the Cheyne SIV's Senior Notes would receive S&P's and Moody's top rating, or be nearly risk-free, and that the Mezzanine Capital Notes would be "investment grade."

205. The Cheyne SIV, like all SIVs, had a liability "waterfall" similar to RMBS: SIV equity (effectively the bottom tranche of a SIV) took the first losses, followed by junior and mezzanine capital notes, and, lastly, commercial paper and medium-term notes.

206. The Cheyne SIV was structured so that Cheyne Finance PLC (now in receivership as a bankrupt entity, and known as SIV Portfolio PLC) and its wholly-owned subsidiaries Cheyne Finance LLC and Cheyne Capital Notes LLC issued four categories of notes: (1) Senior Capital

Notes ("Senior Notes"), comprised of both Commercial Paper and Medium Term Notes; (2) Mezzanine Capital Notes; (3) Junior Capital Notes ("Junior Notes"); and (4) Combination Capital Notes, which contain a mix of Mezzanine Capital Notes and Junior Notes.

207. As illustrated below, the Senior Notes were senior to the Mezzanine Capital Notes, which in turn were senior to the Junior Notes. This meant that if the SIV declined in value, the Junior Notes would bear the first losses. The Mezzanine Capital Notes would bear any losses greater than the face value of the Junior Notes, and the Senior Notes would bear any further losses exceeding the face value of the Mezzanine Capital Notes.



208. In theory, this structure allowed qualified investors to purchase Senior SIV Notes and Mezzanine Capital SIV Notes at a lower risk. In reality, as described herein, Morgan Stanley pressured rating agencies to issue ratings that did not disclose the true risk of the notes, which was well known to Morgan Stanley.

209. On May 17, 2005, S&P issued a credit rating of A-1+/AAA to Cheyne SIV Senior Notes. Similarly, on August 2, 2005, Moody's published a credit rating of P-1/Aaa to the Cheyne SIV Senior Notes. These are the highest ratings that can be obtained from the two rating agencies and are equivalent to the ratings assigned to United States Treasury bonds. The ratings for Cheyne's Senior Notes are described in the following way:

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S&P

> **A-1+**: Obligor's capacity to meet its financial commitment on the obligation is strong.
>
> **AAA**: The best quality borrowers, reliable and stable (many of them governments).

Moody's

> **P-1**: Issuers (or supporting institutions) rated Prime-1 have a superior ability to repay short-term debt obligations.
>
> **Aaa**: Obligations rated Aaa are judged to be of the highest quality, with minimal credit risk.

210. The Cheyne SIV Mezzanine Capital Notes received a rating of A from S&P and A3 from Moody's. These ratings fall within the third-highest major category of ratings that can be obtained from S&P and Moody's. These ratings for the Cheyne SIV's Mezzanine Capital Notes are described in the following way:

S&P

> **A**: An obligation rated 'A' is somewhat more susceptible to the adverse effects of changes in economic conditions than obligations in higher-rated categories. However, the obligor's capacity to meet its financial commitment on the obligation is still strong.

Moody's

> **A3**: Obligations rated A are considered upper-medium grade and are subject to low credit risk.

211. The Cheyne SIV launched and issued its first set of notes on August 3, 2005.

212. These ratings were critical to the success of the Cheyne SIV because they communicated information to investors about the quality of the assets backing the notes. In other words, investors believed that, because the SIV notes received high credit ratings and were supposedly comprised of highly rated instruments, it was unlikely that the SIV's investors would suffer a loss. Cheyne SIV investors were willing to invest in large part because of the high credit ratings assigned to the notes.

213. In fact, PERS's investment rules place specific limits on its investments in securities. The relevant guidelines in this case required that the securities meet minimum rating levels. Had the Cheyne SIV Senior Notes purchased by PERS been accurately rated, they would not have met these standards, and, therefore, PERS would not have purchased the notes.

214. Morgan Stanley's offering and marketing materials described the Cheyne SIV Senior Notes purchased by PERS, as described in more detail herein, as AAA/ A-1+ rated, the equivalent of a U.S. Treasury note but with higher interest rates. Relying on this description and on the ratings, PERS purchased the following Cheyne SIV Senior Notes: Cheyne SIV Senior Note with CUSIP 16705EAX1, with a February 15, 2006 trade settlement date; Cheyne SIV Senior Note with CUSIP 16705EAV5, with an April 21, 2006 trade settlement date; Cheyne SIV Senior Note with CUSIP 16705EBN2, with an April 25, 2006 trade settlement date; Cheyne SIV Senior Note with CUSIP 16705ECK7, with a September 12, 2006 trade settlement date; and Cheyne SIV Senior Note with CUSIP 16705EDA8, with a November 10, 2006 trade settlement date. The par value of these investments totaled $403 million.

215. PERS suffered massive losses on its purchases of Cheyne SIV Senior Notes.

216. Morgan Stanley and other placement agents continued to sell the Cheyne SIV notes at least through July 2007, only a few months before the Cheyne SIV collapsed.

2. Morgan Stanley Convinced Rating Agencies to Incorporate Flawed Modeling Assumptions That Would Ensure Artificially High Ratings

217. Morgan Stanley colluded with credit rating agencies to develop simulation models that would give Cheyne SIV notes higher ratings than they deserved. In one Morgan Stanley Vice President's words, Morgan Stanley's influence over the rating agencies' models fundamentally "shaped rating agency technology" and allowed Morgan Stanley to "get . . . the rating we wanted in the end."

218. Simulation models were an integral part of the SIV rating process. To rate the Cheyne SIV, the rating agencies built customized portfolio simulation models that ostensibly tested how the SIV would perform in various economic crises or "stress scenarios."

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219. The simulation model would be run under different stress scenarios resulting in a probability of defeasance and expected loss in defeasance for the Mezzanine Capital Notes. The expected losses and probability of defeasance would then be used, with a model known as a capital matrix model, to determine the discounts, or "haircuts," that should be applied to various assets in the event the SIV were forced to liquidate them. These haircuts were then used to determine the amount of capital notes cushion the SIV was required to hold in order to protect the Senior Notes from losses and ensure that Senior Note holders, at the top of the waterfall, would be repaid even in the event of an economic crisis.

220. Though the models were supposed to inform objective third-party credit risk ratings, the rating agencies worked extensively and iteratively with Morgan Stanley as they developed them. As part of this process, Morgan Stanley developed its own model and, according to a Morgan Stanley memo "assist[ed] Cheyne . . . in building their own equivalent model" that closely mirrored the rating agencies' models. Morgan Stanley used this opportunity to push the rating agencies to incorporate inaccurate modeling inputs and flawed assumptions that underestimated the vehicle's true risks and produced inflated ratings the SIV notes did not deserve.

a. Morgan Stanley's Model Failed to Apply Adequate Discounts in Order to Protect Senior Note Holders

221. A SIV's survival depended on its ability to roll over its debt (e.g., as a Senior Note matures, it is re-financed into another Senior Note), instead of having to pay back principal on maturity. If a SIV could not roll over its debt, then the SIV would be forced to sell assets in order to meet its obligations to its note holders. Further, if market conditions had deteriorated to the point where one SIV could not roll over its debt, there was a substantial risk that other SIVs would face similar problems. Thus, multiple SIVs would all be engaging in extremely discounted sales, or "fire sales," of their asset portfolios—which held similar assets—at the same time, potentially flooding the markets. Making matters worse, those markets are likely to be already distressed due to the same factors preventing the SIVs from rolling over their debt. Morgan Stanley was aware of these risks and claimed that its model took them into account. They

purportedly worked with the rating agencies to rate the Cheyne SIV notes based on the SIV's ability to meet its obligations through a "fire sale" of its assets. In fact, receiving a top rating for the Senior Notes from the rating agencies supposedly meant that the SIV could fully meet its obligations if it engaged in such a "fire sale." Morgan Stanley was aware of this and mirrored its models to the rating agencies' methodologies.

222. By failing to even account for the expected market environment in the event of a default, Morgan Stanley's model utilized insufficient liquidation discounts on the sale of assets and, thus, underestimated the amount of capital the SIV needed to hold to protect its Senior Note holders. Morgan Stanley's models assumed that, in the event of defeasance or inability of the SIV to roll its Senior Notes, assets could be liquidated or sold near the prices at the time of defeasance. Neither data nor common sense supported such an assumption. On the contrary, historical data showed that the liquidation discounts argued for by Morgan Stanley were extremely inadequate. Further, Morgan Stanley's discounts failed to account for the likelihood that a SIV would default when the entire market for the SIV's assets dropped. Because Morgan Stanley also knew that all of the SIVs held similar assets, it should have expected the simultaneous failure of multiple SIVs (and the subsequent liquidation of their assets) would compound the severity of the drop in asset values.

223. Morgan Stanley knew that the rating agencies' models were similarly flawed. Morgan Stanley took advantage of those flaws and successfully persuaded the rating agencies to use these inadequate assumptions in their models.

224. The simulation models incorporated tests that evaluated how well the SIV would perform under certain stress scenarios. For example, the Capital Loss Tests measured whether the SIV's net asset value (the value of investment assets less outstanding senior obligations) would drop below a predefined amount when certain market conditions were present. In order to mask weaknesses in the SIV that would be exacerbated by a real economic downturn, Morgan Stanley ran its models using market condition inputs that represented only below-average stress levels, which permitted the SIV to "pass" its Capital Loss Tests in the simulation models. Pursuant to the SIV's Operating Manual, it would fail its Minor Capital Loss test when its net

asset value dropped below 70% of the principal amount of the Mezzanine Capital Notes and Junior Notes, and it would fail its Major Capital Loss test (sending the SIV into enforcement) if its net asset value dropped below 50% of the principal amount of the Mezzanine Capital Notes and Junior Notes. Had Morgan Stanley used stress levels that were closer to historical averages, the models would have shown the SIV breaching its Capital Loss Tests only a few months after launch, and before PERS bought the Senior Notes.

b. Morgan Stanley's Models Used Faulty and Inadequate Data

225. For a financial model to have integrity, the model's assumptions and parameters must be set before results are generated. Morgan Stanley, however, perverted the process, building models to reach the results it needed, rather than first finalizing the model's parameters and then letting the model dictate the results. Morgan Stanley convinced the credit rating agencies to "calibrate" their models to the biased Morgan Stanley model to ensure that they would produce the necessary ratings. As a Morgan Stanley Vice President explained, Morgan Stanley influenced the rating agencies to "fix the inputs to get the outputs they want." Thus, the credit rating agencies' models ultimately incorporated inputs and assumptions that were virtually identical to the flawed and result-oriented ones Morgan Stanley incorporated into both the Cheyne model and its own.

226. In the course of calibrating its models, Morgan Stanley pushed the rating agencies to accept flawed, unreliable, and insufficient data assumptions that it knew would produce the outputs it wanted. For example, the data that Morgan Stanley used to build its simulation models were, in an S&P analyst's words, "quite generic, and not specific" to the type of asset held by the SIV. Similarly, Moody's expressed concern that Morgan Stanley had "no actual data backing the current model assumptions" relating to the spread volatility modeled for the SIV's Aa- and A-rated subprime home equity loan ("HEL") assets, and "absolutely no spread data backing the assumptions" for the home equity line of credit ("HELOC") exposures. ("Spread" here refers to a measure of the difference in yields between a particular asset and a Treasury bond or other benchmark—an important data point for incorporating future risks in asset prices relative to treasuries.) Despite those concerns, Morgan Stanley insisted that "HELs are so critical" to the

Cheyne SIV that without the HEL product, "the vehicle is very limited and not scalable," and "the deal does not work." Morgan Stanley therefore "[led] the charge" in convincing the rating agencies to ignore the fact that there was no support for the HEL or HELOC assumptions used in the simulation models, and eventually succeeded in convincing them to permit the inclusion of both HEL and HELOC assets in the SIV. Although the Cheyne SIV was one of the first SIVs to be permitted to purchase large allocations of HELs and HELOCs, investors were never made aware that the assumptions related to HELs and HELOCs in the models Morgan Stanley designed and encouraged the ratings' agencies to use were not properly supported.

227. For example, with respect to the spread data used in the models, Morgan Stanley was only able to provide standard deviations (which indicate the riskiness of assets) for roughly 10% of the asset classes and maturities included in the SIV. For the remaining 90%, Morgan Stanley interpolated standard deviations from other types of assets, such as credit card debt, to interpolate the standard deviations for RMBS, auto loans, and CDOs. This *ad hoc* interpolation methodology ultimately resulted in a lower capital cushion for protecting Senior Note holders from losses.

228. Morgan Stanley also knew that only minimal data regarding RMBS ratings and defaults existed at the time that it developed its SIV rating models. Instead of accounting for this lack of data and working to develop more accurate models, Morgan Stanley based its modeling assumptions on outdated and non-analogous information. For example, Morgan Stanley calculated loss rate assumptions for the mortgage assets being placed into the Cheyne SIV using idealized default probabilities and historical default rates associated with higher-quality assets. By using this data, Morgan Stanley failed to account for the high-risk features of the assets it was actually modeling, such as the increased number (and percentage) of subprime loans, loan-to-value ratio loans in excess of 90%, second lien mortgage loans, and nontraditional mortgages (e.g., "interest only" adjustable rate mortgages). Had Morgan Stanley built the model to account for the lower quality and higher risk of the subprime assets going into the SIV, the model would have predicted a dramatically higher probability of defeasance. Nevertheless, Morgan Stanley convinced the rating agencies to adopt the same faulty assumptions in their models.

229. The simulation models developed by Morgan Stanley also made inaccurate and indefensible "correlation" assumptions about how frequently the SIV's assets would default together, and Morgan Stanley persuaded the rating agencies to use inaccurate correlation assumptions. Further, because the degree of "correlation" in a simulation model has a direct impact on the safety of the notes, the rating correlations also needed to be stressed in order for the model to provide an accurate rating. Morgan Stanley, however, took the position "that rating correlation [was] not a key driver of results" and failed to adequately stress the correlations. On the contrary, Morgan Stanley influenced Moody's to use correlation assumptions that would "improve the numbers" produced by the model—i.e., that would produce the outputs it wanted and boost the SIV's ratings—rather than using correlations and stressing those correlations to accurately reflect how the assets would perform during times of stress.

230. Morgan Stanley's model, and thus the models employed by the rating agencies, assumed a low correlation—meaning a low probability that the SIV's underlying assets would default at the same time—that was not based on any actual history, data, studies, or common sense. Morgan Stanley acknowledged this lack of support for its correlation assumption in an internal memo conceding that its simulation model "d[id] not have enough data to parameterise the majority of the input points required" for an accurate correlation matrix. However, none of this was disclosed to investors.

c. Morgan Stanley's Capital Matrix Proposal Underestimated Risk

231. Morgan Stanley also provided the rating agencies with a capital matrix proposal (used in conjunction with the simulation models). The matrix was critical to determining (a) how much of a buffer, or capital notes cushion, the SIV would need in order to protect Senior Notes from losses, and (b) the ratings the SIV's Senior Notes would receive. Morgan Stanley, however, used haircuts that were lower than the ones initially proposed by Moody's. Moody's also told Morgan Stanley that its capital matrix "lack[ed] relevant data backing [the] proposal in general" and warned that Morgan Stanley had placed "a lot of reliance in interpolation." Nevertheless, Morgan Stanley continued to rely on the matrix.

232. In one example of how Morgan Stanley used inadequate haircuts, the haircuts for HEL assets were lower than the haircuts for Commercial Mortgage Backed Securities ("CMBS"), even though HEL spreads in the market were higher than CMBS spreads—an indication that they were *riskier* than CMBS. This meant that Morgan Stanley's model underestimated the risks of HELs and allowed Morgan Stanley to improperly reduce the SIV's capital buffer against losses on HEL assets. Moreover, the haircut matrices were never updated despite changes in market conditions and deterioration in the value and liquidity of the SIV's assets, particularly HELs. Based on spread changes for the various assets over the life of the SIV, the haircuts (and capital buffer) should have been increased. Morgan Stanley thereby failed to properly protect Senior Note holders by allowing the SIV to keep a much smaller capital buffer or cash cushion than its assets required.

233. In sum, Morgan Stanley knew that its models and assumptions underestimated the risk of the underlying Cheyne SIV assets, and nonetheless colluded with the rating agencies to structure the Cheyne SIV so that the Cheyne SIV notes could be given high ratings. Morgan Stanley knew full well that the Cheyne SIV notes did not deserve the ratings they received, and purposefully concealed the SIV's vulnerabilities from investors.

3. Morgan Stanley Convinced the Rating Agencies to Ignore Cheyne's Lack of Experience

234. Cheyne's track record as an investment manager was another important consideration to the rating agencies. For example, S&P initially informed Morgan Stanley that the targeted A rating on the Cheyne SIV Mezzanine Capital Notes was not possible and that S&P was willing to assign a BBB rating. An S&P analyst advised Morgan Stanley that S&P's ratings "hinge[] very much on the ability/track record of the SIV manager," and that the rating methodology "makes fundamental simplifying assumptions such as the ability of the manager to keep the capital buffer and that the portfolio today [] is a good proxy of the portfolio for the next 10 years." SIV managerial experience was important because SIVs—including the Cheyne SIV—were especially complex, in part because they held various types of assets that changed

over time. Accordingly, Cheyne's lack of managerial experience with SIVs was one of the reasons that S&P initially refused to give an A rating.

235. Morgan Stanley knew that S&P's concerns were well founded. Morgan Stanley's own Private Wealth Management team (a group that manages assets for high net worth individuals) even declined to sell the Cheyne SIV notes to its clients due to the lack of a SIV track record by both Morgan Stanley and Cheyne. Further, in order to close the SIV on schedule, Morgan Stanley had to take on "roles/work that really should sit with Cheyne," including taking over "the process of managing and supervising" the SIV administrator, QSR.

236. Nevertheless, the Morgan Stanley executives responsible for the Cheyne SIV repeatedly pressured S&P to ignore Cheyne's lack of a track record, including sending a threatening email to S&P management making "it clear that [Morgan Stanley] believe[s] the position the [S&P rating] committee is taking is very inappropriate." Morgan Stanley eventually persuaded S&P to assign an A rating to the Cheyne SIV Mezzanine Capital Notes and to disregard Cheyne's lack of experience. A few months before the SIV collapsed, a Morgan Stanley Managing Director acknowledged that Cheyne's lack of experience had turned into a significant problem, as Cheyne had "consistently mismodelled and over paid for assets." Another Managing Director later confirmed that Cheyne "really started reaching" in its purchase decisions and, consequently, the SIV ended up holding "a bunch of junk."

4. Morgan Stanley Convinced the Rating Agencies to Allow the Cheyne SIV to Hold More Risky Assets

237. Morgan Stanley also "push[ed] hard at senior levels" of the rating agencies to allow the Cheyne SIV to hold subprime HELs in its portfolio despite internal concerns about "the future risks in the HEL market." Once the rating agencies permitted the Cheyne SIV to hold HELs, Morgan Stanley went even further by pushing Moody's to increase the size of the SIV's HEL and HELOC "buckets," thereby expanding its ability to fill the SIV with securities backed by high-risk loans. In fact, Morgan Stanley convinced both Moody's and S&P to treat HEL assets as liquid eligible assets (i.e., assets that could be quickly sold to raise cash without materially

impacting the value of the asset) despite knowing that the risks associated with HELs might mean that Cheyne would need to sell them at a discount.

238. Morgan Stanley even negotiated to have "[b]oth Moody's and S&P . . . amend the Junior Capital Maximum Leverage Test . . . [so that] the Junior Capital Notes now have to be at least 0.75% of the Total Portfolio Value . . . (instead of 1% previously)." This had the effect of reducing the SIV's buffer against losses to the Senior Notes, and further increased the risk to the SIV's Senior Note holders. Morgan Stanley purposefully kept this information from investors. In the words of one Morgan Stanley analyst, the authors of the Cheyne SIV offering materials "aimed to remain vague on the subject," and drafted the materials so as to "not reflect these changes."

239. Comments from Cheyne's management right before the official launch of the Cheyne SIV summed up the effectiveness of the pressure Morgan Stanley placed on the rating agencies: "it is an amazing set of feats to move the rating agencies so far."

240. Despite knowing that the ratings were flawed, Morgan Stanley, as the lead placement agent, marketed and sold the Cheyne SIV notes to potential investors, and knew the ratings would be material to potential investors' decisions to purchase the notes.

5. Morgan Stanley Knew the Cheyne SIV Held Risky Assets, and Profited from It

241. In its role as arranger, Morgan Stanley also provided the warehousing facilities which allowed the SIV to acquire assets prior to launch. In this role, Morgan Stanley helped select assets for the Cheyne SIV and approved the selection of assets placed in that warehouse.

242. Morgan Stanley helped identify and locate assets for the warehouse, including the "final 800mm," with the expectation that Cheyne would, in the words of a Morgan Stanley Managing Director, "take every reasonable offering [Morgan Stanley] show[ed] them." Because it was in charge of the warehouse and helped identify potential assets, Morgan Stanley was able to steer Cheyne into making trades that were, as the same Managing Director put it, "a little more useful" for Morgan Stanley. According to him, Morgan Stanley's traders could "push" Cheyne to purchase any assets that met the SIV's basic investment criteria, which Morgan Stanley itself had

formulated. In this way, Morgan Stanley traders were able to orchestrate Cheyne's asset purchases so as to maximize the benefit to Morgan Stanley, while passing all of the risk along to the Cheyne SIV.

243. Morgan Stanley sold many of its own ABS assets to the Cheyne SIV warehouse with the "goal [of] short[ing] many of the high risk assets by buying term protection from the SIV." In these early stages, Morgan Stanley, which financed the warehouse facilities, did not focus on the quality of the assets because Morgan Stanley knew that it would not suffer the consequences of weak assets. As one Morgan Stanley executive explained: "[w]e must approve each and every bond that goes on the w[arehouse] line. If we don't like the bond we'll short it."

244. Morgan Stanley executives knew there were problems with the assets they put into the Cheyne SIV. "The more I think about this trade the worse I feel about the risk/reward that it has," one said. Prior to the SIV's launch, one of the traders approving the CDO assets going into the Cheyne SIV commented that Morgan Stanley was already feeling a "continue[d] … softening in the [secondary CDO] market."

245. This was especially the case with assets Morgan Stanley itself had issued. Morgan Stanley sold the Cheyne SIV a number of its own RMBS assets, which it knew contained risky, low-quality subprime mortgages. As alleged above, Morgan Stanley purchased and securitized large numbers of loans with unsupported property values, insufficient borrower credit quality, and insufficient borrower assets or cash reserves, often after ignoring or overriding findings and warnings from due diligence staff. Morgan Stanley also knowingly securitized loans to recently bankrupt borrowers, as well as seriously delinquent loans. Despite knowing about these issues, the Morgan Stanley traders responsible for providing details about subprime RMBS to Cheyne, and for selling those RMBS to the Cheyne SIV, remained silent about the toxic loan assets contained in Morgan Stanley's securitizations.

246. Ultimately, Morgan Stanley used the launch of the Cheyne SIV as an opportunity to get rid of millions of dollars of its riskiest ABS assets, almost half of which were HELs in the AA and A buckets. According to one of Morgan Stanley's ABS salesmen, Morgan Stanley's own securities made up a "very healthy 68%" of Cheyne's lowest-rated assets at launch. Over the life

of the SIV, Morgan Stanley continued to sell millions of dollars of its risky assets to Cheyne, dramatically increasing the probability of delinquency, default, and foreclosures that eventually led to significant losses by the SIV's investors.

247. Even after the launch of the Cheyne SIV, Morgan Stanley considered it to be an "ongoing deal[]" given its financial stake in the performance of the SIV. Specifically, Morgan Stanley received 20-25% of "both the management fees and the ecess [sic] spread [between the interest received from the SIV's assets and the interest paid to investors]." Because of its stake in the SIV, Morgan Stanley continued to be involved in the SIV's "post-launch" operations, which included carrying out "ongoing structuring and distribution responsibilities" for the SIV notes, updating program documents, holding due diligence calls with Cheyne, and discussing new developments with rating agencies. Morgan Stanley also helped maintain, improve, and debug the portfolio simulation models that Cheyne used to monitor its portfolio health and credit ratings. None of this was disclosed to investors, and Morgan Stanley purposely withheld the exact details of the fee split from the Cheyne SIV marketing book.

6. Morgan Stanley Marketed the Cheyne SIV to PERS and Other Investors

248. At all relevant times herein, Morgan Stanley knew that the success of the Cheyne SIV depended upon its Senior Notes receiving AAA/ A-1+ ratings. Morgan Stanley knew it was vital that the Cheyne SIV notes be available for purchase by large institutional investors, such as PERS. In fact, Morgan Stanley marketed the Cheyne SIV notes directly to a number of institutional investors, including PERS. Morgan Stanley knew that PERS had investment guidelines and rules requiring that securities it purchased with state funds met minimum rating levels. As such, Morgan Stanley knew that the Cheyne SIV's ratings would be material to any decision by PERS to purchase notes issued by the Cheyne SIV.

249. Morgan Stanley's conduct, as described herein, was intended to and did cause the rating agencies to issue inflated ratings for the Cheyne SIV. That the ratings would be material to PERS's decision to purchase the Cheyne SIV notes was a natural, ordinary, reasonable and foreseeable consequence of Morgan Stanley's conduct as described herein.

250. Morgan Stanley received nearly $17 million for its work on the Cheyne SIV.

C. The Cheyne SIV Collapses

251. By 2007, problems with subprime and other RMBS assets began to emerge. In July 2007, S&P announced that it was placing hundreds of RMBS on CreditWatch and, a day later, announced a mass downgrade of many of those RMBS. Moody's made similar downgrades on almost 400 RMBS assets and warned that it might downgrade several more.

252. With the truth regarding subprime assets coming to light, Morgan Stanley knew that the Cheyne SIV was in trouble. A Morgan Stanley Vice-President admitted that the Cheyne SIV was "worse than I thought it was," that the price of Mezzanine Capital Notes "should be lower," and that, as a result, "the deal could unravel." In fact, Morgan Stanley knew that if proper market prices were used, it would "trigger outright" the Major Capital Loss Test and send the Cheyne SIV into enforcement. Research groups at Morgan Stanley also became concerned about the impact that "panic selling" would have on the market for SIV notes and were "staying away from [SIV] deals without put protection." Nevertheless, Morgan Stanley continued "to push SIVs through the franchise" and sell them even though some Morgan Stanley senior Managing Directors were "saying SIVs are going to blow up."

253. By the end of July 2007, according to a Morgan Stanley Marketing Director, the Cheyne SIV was "selling [its] highest quality assets" and was left holding a "high-proportion [of] subprime [assets]." Investors stopped buying Senior Notes and existing note holders began exiting the SIV.

254. The Cheyne SIV also began to breach its Capital Loss Tests, meaning that its net asset value was no longer sufficient compared to the outstanding principal amount of the Mezzanine Capital Notes and Junior Notes. On August 28, 2007, the Cheyne SIV breached its Major Capital Loss Test and triggered enforcement. Accordingly, a receiver had to be appointed to sell the SIV's assets and repay maturing liabilities of its outstanding Senior Notes. Because of the low quality of the assets in the portfolio, the Cheyne SIV had to sell assets at substantial "fire sale" discounts. Due to the involuntary nature of the sales, these discounts were far greater than

the haircuts calculated in the capital matrices. As a result, Senior Note holders such as PERS suffered massive losses.

255. At the same time, S&P downgraded the Cheyne SIV's Commercial Paper two levels to A-2, its Medium Term Notes six levels to A-, and its Mezzanine Capital Notes ten levels to B- (below investment grade). A week later, Moody's downgraded the Cheyne SIV's Mezzanine Capital Notes eleven levels to Caa2 and put the Senior Notes on review for possible downgrade.

256. On October 17, 2007, the Cheyne SIV's receivers declared an "insolvency event," meaning that the SIV was unable to pay its debts to senior creditors and that all assets were to be sold. S&P then downgraded the Cheyne SIV's Commercial Paper and Medium Term Notes to D (Default), and Moody's dropped the Cheyne SIV's Senior Notes to Ca (one level above Default). One month later, Moody's dropped that rating again to C (Default).

257. The Cheyne SIV's assets were auctioned and ultimately sold for roughly 44 cents on the dollar. The Cheyne SIV Senior Note holders incurred substantial losses, and the Mezzanine Capital Note and Junior Note investors lost everything.

D. Morgan Stanley's Offering and Marketing Materials Were Material to Decisions by PERS and Other Investors to Purchase Cheyne SIV Notes

258. PERS was among the largest institutional investors in the Cheyne SIV notes. PERS was a regular Morgan Stanley client and, because the Cheyne SIV notes targeted qualified institutional investors, Morgan Stanley directly marketed the Cheyne SIV notes to PERS at the latest in January 2006, for the purpose of selling the Cheyne SIV notes to PERS. The natural and foreseeable consequence of directly marketing the Cheyne SIV notes to PERS was the purchase of these notes by PERS.

259. PERS utilizes outside investment managers as its authorized agents to invest a portion of its cash collateral. In this case, the outside investment managers that purchased the Cheyne SIV notes on behalf of PERS were eSecLending ("eSec") and Credit Suisse First Boston ("Credit Suisse").

260. PERS suffered massive losses on its purchases of Cheyne SIV Senior Notes.

STATUTES OF LIMITATIONS

261. The People, by and through Attorney General Kamala D. Harris, entered into an agreement with Morgan Stanley tolling the statute of limitations applicable to the People's claims stated herein with an effective date of September 29, 2011. The pertinent statutes of limitations are as follows: three years from the Attorney General's discovery or six years from the date of the violation for the False Claims Act claims, whichever is later; four years for the Unfair Competition Law claims; three years from the Attorney General's discovery for penalties pursuant to the False Advertising Law and four years for other remedies available under the False Advertising Law; and four years from discovery for violations of the Corporate Securities Law of 1968.

262. To the extent any of the People's causes of action would have accrued, or an applicable limitations period had begun to run, before the time of the tolling agreement (and the People do not concede that any such predicate occurred)—the People invoke the common law discovery rule, any applicable statutory discovery rule, and any other common law doctrines that may apply, including the doctrines of fraudulent concealment and continuous accrual, and in support thereof allege the following facts.

263. The Attorney General did not discover Morgan Stanley's false, fraudulent, or misleading representations, practices, or advertising (collectively, "fraud") until after September 29, 2008. Neither the People nor the Attorney General knew or should have known of Morgan Stanley's wrongdoing, or of facts material to the wrongdoing, until after September 29, 2008. Prior to September 29, 2008, neither the People nor the Attorney General had any reasonable means of knowledge or notice of any wrongdoing by Morgan Stanley. In particular, the Attorney General did not have knowledge or possession of internal Morgan Stanley communications that reveal the Morgan Stanley Defendant's fraud until well after September 29, 2008. Even after the credit agencies' mass downgrade in Summer 2007, and the RMBS investments described herein and the Cheyne SIV began to fail in 2007 and 2008, Morgan Stanley continued to make statements concealing the true risks associated with these investments and misreporting key facets of the mortgage loan pools and due diligence results, and it continued to

knowingly securitize risky loans with incurable defects and insufficient compensating factors, contrary to the representations Morgan Stanley made in its Offering Documents.

FIRST CAUSE OF ACTION
False Claims Act—Government Code § 12651, subd. (a)(l)
(Against Morgan Stanley; Morgan Stanley & Co. LLC; Morgan Stanley Mortgage Capital Holdings LLC; Morgan Stanley ABS Capital I Inc.; Morgan Stanley Capital I Inc.; Saxon Funding Management LLC; and Saxon Asset Securities Company)

264. The People incorporate herein by reference the allegations in paragraphs 1-263 of this Complaint.

265. This is a claim for treble damages, penalties, and costs brought by the People under the California False Claims Act ("CFCA"), Government Code sections 12650-12656.

266. The terms "knowing" and "knowingly," as set forth in the CFCA, mean that a person, with respect to information, has actual knowledge of the information, acts in deliberate ignorance of the truth or falsity of the information, or acts in reckless disregard of the truth or falsity of the information. Proof of specific intent to defraud is not required.

267. Defendants knowingly presented, or caused to be presented, to PERS and STRS claims for payment of State funds for RMBS certificates, including but not limited to those identified in Appendix A. Defendants knowingly presented or caused to be presented to PERS, STRS, and/or their agents trade tickets and/or settlement instructions demanding payment for the purchase of these securities. These claims were false or fraudulent in that:

a. Defendants knowingly misrepresented key facets of the mortgage loan pools, including, without limitation, the LTV, CLTV, DTI, loans in default, owner occupancy, and loan purpose; and

b. Defendants knowingly securitized risky loans with incurable defects and insufficient compensating factors, contrary to the representations they made in the securities' Offering Documents.

268. Defendants also knowingly caused to be presented to PERS false or fraudulent claims for payment of State funds for the Cheyne SIV notes identified by CUSIPs 16705EAV5, 16705EAX1, 16705EBN2, 16705ECK7 and 16705EDA8. Defendants knowingly caused to be presented to PERS and/or its agent trade tickets and/or settlement instructions demanding

payment for the purchase of these securities. These claims were false or fraudulent in that Defendants knowingly caused the Cheyne SIV securities to be rated as less risky than the securities actually were and Defendants knew the Cheyne SIV was riskier and its assets of lower quality than they represented them to be.

269. Defendants' conduct was a substantial factor in causing the false claims to be presented. Defendants provided their knowing misrepresentations for the purpose of having those misrepresentations included in the securities' Offering Documents, offering materials and offers for sale, which Defendants intended and knew (or were reckless or deliberately ignorant in not knowing) would be offered for sale to PERS and STRS.

270. These claims were paid by PERS and STRS. PERS and STRS purchased the securities using State funds.

271. Defendants' misrepresentations had a natural tendency to influence, or were capable of influencing, decisions by PERS and STRS to purchase RMBS certificates including but not limited to those identified in Appendix A and, in the case of PERS, the Cheyne SIV notes at issue in this action, and to purchase them on the terms offered.

272. As a proximate result of Defendants' actions, the People suffered damages in a specific amount to be determined at trial.

SECOND CAUSE OF ACTION
False Claims Act—Government Code § 12651, subd. (a)(2)
(Against Morgan Stanley; Morgan Stanley & Co. LLC; Morgan Stanley Mortgage Capital Holdings LLC; Morgan Stanley ABS Capital I Inc.; Morgan Stanley Capital I Inc.; Saxon Funding Management LLC; and Saxon Asset Securities Company)

273. The People incorporate herein by reference the allegations in paragraphs 1-272 of this Complaint.

274. This is a claim for treble damages, penalties, and costs brought by the People under the CFCA, Government Code Sections 12650-12656 et seq.

275. By the acts described herein, Defendants knowingly made, used, or caused to be made or used false records or statements to get false claims paid or approved by PERS and STRS,

and knowingly made, used, or caused to be made or used, false records or statements material to false or fraudulent claims.

276. Defendants' misrepresentations, records, or statements had a natural tendency to influence, or were capable of influencing, the decisions of PERS and STRS to purchase RMBS certificates including but not limited to those identified in Appendix A and, in the case of PERS, the Cheyne SIV notes at issue in this action, and to purchase them on the terms offered.

277. As a proximate result of Defendants' actions, the People suffered damages in a specific amount to be determined at trial.

THIRD CAUSE OF ACTION
Securities Fraud, Government Code § 12658 & Corporations Code § 25401
(Against Morgan Stanley and Morgan Stanley & Co. LLC)

278. The People incorporate herein by reference the allegations in paragraphs 1-277 of this Complaint.

279. The Attorney General has authority to bring actions for violations of the Corporate Securities Law, Corporations Code section 25000 *et seq.*, pursuant to Government Code 12657 *et seq.*

280. Pursuant to Corporations Code section 25401, "[i]t is unlawful for any person to offer or sell a security in this state… by means of any written or oral communication that includes an untrue statement of a material fact or omits to state a material fact necessary to make the statements made, in the light of the circumstances under which the statements were made, not misleading."

281. The RMBS certificates and Cheyne SIV notes, as alleged herein, are "securities" as defined in Corporations Code section 25019.

282. Defendants' statements regarding the RMBS certificates and Cheyne SIV notes, as alleged herein, violated Corporations Code section 25401.

283. Defendants' misrepresentations took place within the State within the meaning of Corporations Code section 25008.

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284. In the course of offering for sale and/or selling the RMBS certificates and Cheyne SIV notes, Defendants misrepresented and/or omitted material facts, including, without limitation,

a. with respect to RMBS, misrepresenting key facets of the mortgage loan pools, including, without limitation, misrepresenting the LTV, CLTV, DTI, loans in default, owner occupancy, and loan purpose and omitting material matters about the true nature of the mortgage pools and that the Defendants securitized risky loans with material defects and;

b. with respect to the Cheyne SIV, misrepresenting and omitting key facts about the Cheyne SIV, including that Defendants caused the securities to be rated as less risky than the securities actually were and omitting true facts about the quality of the Cheyne SIV.

285. In making the foregoing misrepresentations and omissions, Defendants violated Corporations Code section 25401.

286. The alleged misstatements and omissions caused losses to the Pension Funds and other investors in RMBS and the Cheyne SIV.

FOURTH CAUSE OF ACTION
Securities Fraud by a Broker-Dealer, Government Code § 12658 & Corporations Code § 25216(a)
(Against Morgan Stanley & Co. LLC)

287. The People incorporate herein by reference the allegations in paragraphs 1-286 of this Complaint.

288. Pursuant to Corporations Code section 25216(a), no broker-dealer or agent shall effect any transaction in, or induce or attempt to induce the purchase or sale of, any security in this state by means of any manipulative, deceptive or other fraudulent scheme, device, or contrivance, including any act, practice, or course of business which operates or would operate as a fraud or deceit upon any person; and any untrue statement of a material fact and any omission to state a material fact necessary in order to make the statements made, in the light of the

circumstances under which they are made, not misleading, if the person making the statement or omission knows or has reasonable grounds to believe that it is untrue or misleading.

289. In the course of offering for sale and/or selling the RMBS certificates and Cheyne SIV notes, Defendants misrepresented and/or omitted material facts, including, without limitation,

a. with respect to RMBS, misrepresenting key facets of the mortgage loan pools, including, without limitation, misrepresenting the LTV, CLTV, DTI, loans in default, owner occupancy, and loan purpose and omitting material matters about the true nature of the mortgage pools and that the Defendants securitized risky loans with material defects and;

b. with respect to the Cheyne SIV, misrepresenting and omitting key facts about the Cheyne SIV, including that Defendants caused the securities to be rated as less risky than the securities actually were and omitting true facts about the quality of the Cheyne SIV.

290. Defendants knew or should have known of the foregoing misrepresentations and omissions. Defendants thereby violated Corporations Code section 25216(a).

FIFTH CAUSE OF ACTION
Controlling Person Liability, Government Code § 12658 & Corporations Code § 25403(a)
(Against Morgan Stanley)

291. The People incorporate by reference the allegations in paragraphs 1-290 of this Complaint.

292. Under California Corporations Code section 25403(a), "[e]very person who with knowledge directly or indirectly controls and induces any person to violate any provision of this division or any rule or order thereunder shall be deemed to be in violation of that provision, rule, or order to the same extent as the controlled and induced person."

293. As the parent company of Morgan Stanley & Co. LLC f/k/a Morgan Stanley & Co Incorporated, Morgan Stanley Mortgage Capital Holdings LLC f/k/a Morgan Stanley Mortgage Capital, Inc.; Morgan Stanley ABS Capital I Inc.; Morgan Stanley Capital I Inc.; Saxon Funding Management LLC and Saxon Asset Securities Company (collectively, the "Controllees"), Morgan

Stanley owns and controls the businesses of each of the Controllees. Morgan Stanley with knowledge directly or indirectly controlled and induced the Controllees to violate one or more provisions of the Corporate Securities Law of 1968 and/or rules and orders promulgated thereunder. Accordingly, Morgan Stanley is liable for the illegal conduct of the Controllees, and each of them, pursuant to California Corporations Code section 25403(a).

SIXTH CAUSE OF ACTION
Aiding and Abetting Liability, Government Code § 12658 & Corporations Code § 25403(b)
(Against Morgan Stanley; Morgan Stanley & Co. LLC; Morgan Stanley Mortgage Capital Holdings LLC; Morgan Stanley ABS Capital I Inc.; Morgan Stanley Capital I Inc.; Saxon Funding Management LLC; and Saxon Asset Securities Company)

294. The People incorporate by reference the allegations in paragraphs 1-293 of this Complaint.

295. Under California Corporations Code section 25403(b), "[a]ny person that knowingly provides substantial assistance to another person in violation of any provision of this division or any rule or order thereunder shall be deemed to be in violation of that provision, rule, or order to the same extent as the person to whom the assistance was provided."

296. Defendants, and each of them, knowingly provided substantial assistance to other Defendants in the violations of Corporations Code sections 25401 and 25216 as alleged *supra*. Accordingly, each Defendant is liable for the illegal conduct of the other Defendants for their knowing provision of substantial assistance in the violations of Corporations Code sections 25401 and 25216, pursuant to California Corporations Code section 25403(b).

SEVENTH CAUSE OF ACTION
Business & Professions Code § 17500
(Against Morgan Stanley; Morgan Stanley & Co. LLC; Morgan Stanley Mortgage Capital Holdings LLC; Morgan Stanley ABS Capital I Inc.; Morgan Stanley Capital I Inc.; Saxon Funding Management LLC; and Saxon Asset Securities Company)

297. The People incorporate herein by reference the allegations in paragraphs 1-296 of this Complaint.

298. Defendants violated Business & Professions Code section 17500 by publicly making or disseminating untrue or misleading statements, or by causing untrue or misleading statements to be made or disseminated to the public, in or from California, with the intent to induce members of the public and investors to purchase the RMBS at issue in this action. This

cause of action does not arise from any actual securities transactions between Morgan Stanley and any California consumer. Defendants' untrue and misleading statements include but are not necessarily limited to:

a. Key facets of the mortgage loan pools, including, without limitation, the LTV, CLTV, DTI, loans in default, owner occupancy, and loan purpose; and

b. Statements regarding the riskiness of the securities.

299. Defendants also violated Business & Professions Code section 17500 by publicly making or disseminating untrue or misleading statements, or by causing untrue or misleading statements to be made or disseminated to the public, in or from California, with the intent to induce members of the public and investors to purchase Cheyne SIV notes. These untrue and misleading statements include but are not necessarily limited to statements regarding the riskiness and asset quality of the Cheyne SIV.

300. Defendants knew, or by the exercise of reasonable care should have known, that their statements were untrue or misleading at the time they made them and during the relevant period alleged in this complaint.

EIGHTH CAUSE OF ACTION
Unfair Competition—Business and Professions Code § 17200
(Against Morgan Stanley; Morgan Stanley & Co. LLC; Morgan Stanley Mortgage Capital Holdings LLC; Morgan Stanley ABS Capital I Inc.; Morgan Stanley Capital I Inc.; Saxon Funding Management LLC; and Saxon Asset Securities Company)

301. The People incorporate herein by reference the allegations in paragraphs 1-300 of this Complaint.

302. Defendants have engaged in, and continue to engage in, unlawful, fraudulent, or unfair acts or practices in the conduct of a business, which acts or practices constitute unfair competition, as that term is defined in Business and Professions Code section 17200. This cause of action does not arise from any actual securities transactions between Morgan Stanley and any California consumer. Defendants' acts or practices include, but are not limited to, the following:

a. Knowingly misrepresenting key characteristics of the mortgage loan pools, including, without limitation, the LTV, CLTV, DTI, number of loans in default, owner occupancy, and loan purpose;

b. Knowingly securitizing risky loans known to be out of compliance with applicable underwriting guidelines and/or lending laws;

c. Knowingly causing the Cheyne SIV and its notes to be rated as less risky than they actually were;

d. Knowingly misrepresenting the asset quality, strength, and riskiness of the Cheyne SIV and its notes;

e. Violating Government Code section 12651 et seq., as described in the First and Second Causes of Action, herein;

f. Violating Corporations Code section 25401, as described in the Third Cause of Action, herein;

g. Violating Corporations Code section 25216, as described in the Fourth Cause of Action, herein;

h. Violating Corporations Code section 25403, as described in the Fifth and Sixth Causes of Action, herein, and;

i. Violating Business and Professions Code section 17500, as described in the Seventh Cause of Action, herein.

PRAYER FOR RELIEF

Wherefore, Plaintiff, the People of the State of California, pray for relief against all Defendants as follows:

1. Pursuant to Government Code section 12651 subdivision (a), three times the damages that the Pension Funds sustained as a result of Defendants' acts, in an amount to be determined;

2. Pursuant to Government Code section 12651, subdivision (a), the maximum allowable civil penalties for each false claim;

3. Pursuant to Business and Professions Code section 17536, that Defendants, and each of them, be ordered to pay a civil penalty in the amount of $2,500 for each violation of Business and Professions Code section 17500 by Defendants, in an amount according to proof;

4. Pursuant to Business and Professions Code section 17206, that Defendants, and each of them, be ordered to pay a civil penalty in the amount of $2,500 for each violation of Business

and Professions Code section 17200 by Defendants, in an amount according to proof;

5. Pursuant to Business and Professions Code sections 17203 and 17535, that Defendants, and each of them, be enjoined from engaging in violations of the California Unfair Competition Law and the California False Advertising Law, including without limitation the unfair, unlawful, and deceptive practices alleged herein;

6. Pursuant to Government Code section 12658(a), for a permanent and preliminary injunction, enjoining Defendants and their agents, servants, and employees, and all persons acting under, in concert with, or for it, from directly or indirectly or in any other manner engaging in the conduct as above alleged in violation of Corporations Code sections 25401, 25403, and 25216;

7. Pursuant to Government Code section 12660(a), for an order that Defendants pay a civil penalty in the maximum sum of $25,000 for each violation of Corporations Code sections 25401, 25403 and 25216;

8. Pursuant to Government Code section 12658(b), for an order disgorging all profits and compensation obtained by Defendants as a result of their violations of Corporations Code sections 25401, 25403, and 25216;

9. Pursuant to Government Code section 12658(b) and (c), for an order requiring Defendants to make restitution to the purchasers of RMBS and SIV notes in the principal amount paid by each purchaser by means of the unlawful conduct alleged herein, with interest from the date of purchase;

10. Pursuant to Government Code section 12658(b), for an order awarding damages to the purchasers of RMBS and SIV notes in an amount sufficient to compensate the purchasers for loss suffered as a result of Defendants' violations of Corporations Code sections 25401, 25403, and 25216;

11. Pursuant to Code of Civil Procedure section 1021.8(a), that the People recover their costs of investigation and suit, including expert fees, attorney's fees, and costs; and

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12. Such further or additional relief as the Court deems proper.

Dated: April 1, 2016

Respectfully Submitted,

KAMALA D. HARRIS
Attorney General of California
MARTIN GOYETTE
Senior Assistant Attorney General

HEATHER B. HOESTEREY
Deputy Attorney General
Attorneys for the People of the State of California

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APPENDIX A
RMBS Sponsored, Underwritten, or Brokered by Morgan Stanley and Purchased by PERS and STRS

	SECURITY DESCRIPTION AND TRANCHE	CUSIP
1.	ACCR 2004-3 1A3	004375BA8
2.	ACCR 2004-3 1A5	004375BC4
3.	ARSI 2005-R9 AF3	03072SP74
4.	ARSI 2005-R9 AF4	03072SP82
5.	ARSI 2004-FR1 A6	03072SQP3
6.	CWL 2005-11 AF4	126670CJ5
7.	CWABS 2004-4 3A1	1266715G7
8.	AAMES 2005-2 1A1	126673K43
9.	ELAT 2007-2 A2A	288547AB8
10.	HFCHC 2006-4 A-1F	40430VAA5
11.	HFCHC 2006-3 A-1F	40430XAA1
12.	IXIS 2006-HE2 A3	46602WAC8
13.	MSHLC 2007-1_A	55352RAA6
14.	MSAC 2004-HE8 A7	61744CGZ3
15.	MSAC 2006-NC1 A4	61744CYA8
16.	MSM 2005-3AR 3A	61745M4R1
17.	MSM 2004-8AR 2A	61748HED9
18.	MSM 2006-15XS A1	61750YAA7
19.	MSM 2007-6XS 2A1SS	61751JAF8

	SECURITY DESCRIPTION AND TRANCHE	CUSIP
20.	MSAC 2007-NC2 M4	61753NAK6
21.	MSAC 2007-NC4 A2A	61755EAB4
22.	SAST 2004-2 AF3	805564PX3
23.	SAST 2007-2 A2A	80556YAB1
24.	SAST 2007-3 2A1	80557BAB0
25.	SEMT 2004-10 A1A	81744FET0
26.	SEMT 2004-12 A1	81744FFY8
27.	SEMT 2007-1 2A1	81744HAD5
28.	SEMT 2007-3 2AA1	81744MAM4