IN THE CIRCUIT COURT OF COOK COUNTY
COUNTY DEPARTMENT, CHANCERY DIVISION

PEOPLE OF THE STATE OF ILLINOIS	)	
	)	
Plaintiff,	)	
	)	
vs.	)	**No. 12 CH 02535**
	)	
THE MCGRAW-HILL COMPANIES, INC. and STANDARD & POOR'S FINANCIAL SERVICES, LLC,	)	
Defendants.	)	

MEMORANDUM OPINION AND ORDER

On January 12, 2012, the Attorney General of the State of Illinois commenced this action under the Illinois Consumer Fraud and Deceptive Business Practices Act, 815 ILCS 505/1-1, *et seq.* ("ICFA"), and the Uniform Deceptive Trade Practices Act, 815 ILCS 510/1-1, *et seq.*("UDTPA"), against The McGraw-Hill Companies, Inc. and Standard & Poor's Financial Services LLC. McGraw-Hill is the parent company of S&P, which is a "Nationally Recognized Statistical Rating Organization" ("NRSRO") that analyzes the risk of and assigns risk ratings to a broad range of securities. S&P issues letter ratings to securities from "AAA" to "D", with "AAA" being the rating assigned to those securities with the lowest risk of default and the highest liquidity.

The State summarizes the complaint as follows:

> This lawsuit seeks redress for S&P's unfair, deceptive, and illegal business practice of systematically misrepresenting that its credit analysis of structured finance securities was objective, independent and not influenced by either S&P's or its clients' financial interest. These representations were untrue.

(Comp. ¶ 1). According to the complaint, from 2001 until 2008, defendants, in a variety of public statements, assured the investing public that the process by which S&P rated various securities was independent, objective, and unbiased. The complaint further

claims that based upon information disclosed following the 2008 collapse of the residential real estate market and the ensuing implosion of financial markets around the world, defendants' repeated representations regarding S&P's independence and objectivity were demonstrably false.

The structured finance securities at issue in this case are complex financial products that have as their base, either directly or indirectly, a stream of income generated by a pool of residential mortgages. For purposes of this opinion, it is unnecessary to discuss the variety of such products or the process by which they are created except to note that they are described in the investment community as "opaque" as opposed to "transparent." A "transparent" investment is one for which the risk associated with the investment can be independently investigated through publicly disclosed information such as annual shareholder reports or required SEC filings. In contrast, an investor considering the purchase of structured finance securities often has available no ready source of information by which to gauge the risk of the investment because the details of the underlying asset pool and the structure of the transaction are not publicly available. In this context, the State contends that S&P's ratings reached as the result of an "independent, objective, and unbiased" process are of enhanced importance to investors.

A further layer of complexity results from S&P's publicly disclosed "issuer pays" business model. S&P is compensated for its rating services by issuers of the securities it rates, a structure that inherently entails a conflict between S&P's status as an "independent" and "objective" rating agency and its desire to maximize profits by catering to those issuers whose repeat business drives those profits. While S&P disclosed

this potential conflict in its public pronouncements, the complaint cites defendants' repeated assurances to the investment community that S&P had adopted and adhered to specifically identified business practices and codes of conduct that would prevent it from giving in to "market capture."[1] The complaint further alleges that with respect to structured finance securities, S&P, contrary to its public pronouncements, allowed its profit motive to override its objectivity and independence.

Defendants move to dismiss the complaint pursuant to 735 ILCS 5/2-615 on a variety of grounds. The standards applicable to defendants' motion are well-established. A section 2-615 motion to dismiss challenges a complaint's legal sufficiency based on facially apparent defects. *K. Miller Constr. Co. v. McGinnis*, 238 Ill. 2d 284, 291 (2010) (*citing Pooh-Bah Enter., Inc. v. County of Cook*, 232 Ill. 2d 463, 473 (2009)). Defendants' motion presents the question of whether the allegations of the complaint, when construed in the light most favorable to the plaintiff, are sufficient to set forth a cause of action. *Iseberg v. Gross*, 366 Ill. App. 3d 857, 860 (1st Dist. 2006). "The complaint is to be construed liberally and should only be dismissed when it appears that plaintiff could not recover under any set of facts." *Id.* at 861.

The court will address the issues presented in defendants' motion in the order in which they are raised. References in this opinion to the allegations of the complaint are made in light of the standards applicable to defendants' motion and should not be construed as findings of fact.

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[1] In its June 2008 Annual Report to Congress on Nationally Recognized Statistical Rating Organizations, the SEC reported that S&P, together with Moody's and Fitch & Co. issued over 99% of all outstanding ratings for asset backed securities. In that category, S&P rated nearly 78% of the securities issued. The report is found at www.sec.gov/divisions/marketreg/ratingagency/nrsroannrep0608.pdf.

Defendants' *Avery* Argument

Defendants first argue that under *Avery v. State Farm Mutual Ins. Co.*, 216 Ill. 2d 100 (2005), a complaint purporting to state a claim under the ICFA must allege facts demonstrating that the challenged conduct occurred "primarily and substantially" in Illinois. The complaint here fails, according to defendants, because it does not allege that the majority of S&P's alleged misconduct occurred in Illinois.

Defendants' argument takes *Avery* out of context. The requirement that a plaintiff invoking the ICFA establish that challenged deceptive conduct occurred "primarily and substantially" in Illinois was articulated by the Supreme Court in the context of claims by non-Illinois residents whose dealings with State Farm took place entirely outside of Illinois. *Id.* at 188 ("Avery resides in Louisiana.... His car was garaged in Louisiana and his accident occurred there.... The repair of Avery's car took place in Louisiana... [and] there is no evidence that Avery ever met or talked to a State Farm employee who works in Illinois.") Thus, non-Illinois residents were attempting to give the ICFA extraterritorial effect.

Here, the complaint alleges that:

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

(Comp. ¶ 11). The fact that the State purports to invoke the ICFA for harm to Illinois residents as a result of alleged misrepresentations disseminated in Illinois is sufficient. To the extent that *Avery* requires an Illinois resident to allege that a defendant's conduct

occurred "primarily and substantially" in Illinois, the foregoing allegations of the complaint suffice. No further nexus between defendants' alleged conduct and Illinois need be alleged.

Defendants' Statements as Actionable Representations of Fact

Defendants next argue that the ICFA does not apply to the conduct alleged in the complaint because S&P's ratings are not misrepresentations of fact, but rather non-actionable expressions of opinion. However, it is only by re-casting the allegations of the complaint that defendants are able to advance this argument. Fairly read, the complaint challenges defendants' repeated statements of fact regarding S&P's independence and objectivity and its internal conflict controls; it is not based upon S&P's rating opinions regarding various securities. Thus, defendants' effort to dismiss the complaint on this ground must fail.

Turning to the allegations of the complaint regarding S&P's independence, defendants argue that these representations cannot form the basis of an ICFA claim because 1) they are generalized observations not capable of being proved true or false and 2) the complaint fails to allege that the statements were "material."

The representations upon which the State relies cannot fairly be characterized as "generalities." For example, in addressing the conflict inherent in the "issuer pays" business model, S&P stated "[w]e are intensely aware that our entire franchise rests on our reputation for independence and integrity. Therefore, giving in to 'market capture' would reduce the very value of the rating, and is not in the interest of the rating agency." (Comp. ¶ 52). The complaint also cites provisions of S&P's publicly available Code of Professional Conduct, which reaffirmed S&P's commitment to independence. (*Id.* ¶ 65:

"Section 2.3 of S&P's Code states: 'The determination of a rating by a rating committee shall be based only on factors known to the rating committee that are believed by it to be relevant to the credit analysis.'"; ¶ 66: "Section 2.3 of S&P's Code states: 'Ratings assigned by [S&P] to an issuer or issue shall not be affected by the existence of, or potential for, a business relationship between [S&P] ... and the Issuer....'"). With respect to the monitoring of issued ratings, the complaint refers to April 2007 testimony before the Senate Committee on Banking in which an S&P Managing Director testified: "After a rating is assigned, S&P monitors or 'surveils' the ratings to adjust for any developments that would impact the original rating. The purpose of this surveillance process is to ensure that the rating continues to reflect our credit opinion based on our assumption of the future performance of the transaction." (*Id.* ¶ 72).[2] These are not generalities or vague assurances; rather, they are verifiable representations regarding the manner in which S&P assures the integrity and independence central to the credibility of its ratings.

The parties have cited four trial court cases from other jurisdictions addressing issues relating to representations made by S&P and Moody's regarding each organization's independence. Defendants cite *Reese v. McGraw-Hill Cos.*, 2012 U.S. Dist. LEXIS 83753 (S.D.N.Y. Mar. 30, 2012), in support of their contention that the statements relied upon in the complaint here are "mere commercial puffery." With little analysis, the district court in *Reese* dismissed a securities fraud action brought on behalf of a putative class of McGraw-Hill shareholders in which it was alleged that McGraw-

[2] While defendants' statements regarding S&P's stature in the rating agency hierarchy might be characterized as "puffery" (*see, e.g., id.* ¶ 54: describing S&P's "preeminent position in the world's financial architecture" and labeling S&P the "world's foremost provider of independent credit ratings and risk evaluation"), it is not these representations that form the basis of the State's claims.

Hill made false and misleading statements about its "true financial circumstances and future business prospects…." *Id.* at *3. With respect to S&P, the *Reese* court found that representations by McGraw-Hill that S&P had "market lead[ing] software" and that it used "transparent and independent decision-making" to produce "independent and objective analysis" were not actionable. *Id.* Other than the passing reference to McGraw-Hill's representations in the opinion, no further detail is provided.

In contrast to *Reese*, several other courts have found statements similar to those relied upon by the State in this case to be actionable misrepresentations of fact. In *In re Moody's Corporation Securities Litigation*, 599 F. Supp. 2d 493 (S.D.N.Y. 2009), an investor class action against Moody's, the court considered whether Moody's public statements regarding its independence were, as Moody's contended, mere "puffery."

> [The statements] were neither 'vague' nor 'non-specific' pronouncements that were incapable of 'objective verification.' [cit. om.] Moody's not only proclaimed its independence; it also listed verifiable actions it was taking to ensure its independence. (AC P 68 ("The determination of a Credit Rating will be influenced only by factors relevant to the credit assessment.")) Rather than being general statements, these were specific steps that Moody's was taking to ensure its independence and ratings integrity.

Id. at 509.

Similarly, the court in *State v. Moody's Corp*, 2012 Conn. Super. LEXIS 1268, *1 (Conn. Super. Ct. May 10, 2012), considered whether Moody's public statements regarding its "objective" ratings of structured finance securities violated Connecticut's Uniform Deceptive Trade Practices Act, C.G.S. §42-110a, *et seq.*, which prohibits any person from engaging in "unfair methods of competition and unfair or deceptive acts or practices in the conduct of any trade or commerce."

Taking the allegations of the complaint as true for purposes of defendants' motion to dismiss, the Connecticut court concluded that the challenged representations were both material ("The State alleges that consumers were not aware that Moody's representations of objectivity and independence were false [and] that 'Moody's understands that its representations of objectivity and independence are material to investors.'" *Id.* at *9), and actionable misrepresentations of fact:

> The State has pled specific representations of independence by Moody's, as well as the specific policies and procedures Moody's claims to employ to protect its independence and objectivity. ... Such specific statements go beyond mere puffery and constitute verifiable representations of the efforts Moody's takes to insure its independence. To the extent Moody's misrepresented those efforts, and those misrepresentations are likely to mislead Connecticut consumers into believing that Moody's was doing more than it was to protect the objectivity and independence of its ratings, then those allegations are actionable.

Id. at *22-23). In an order entered the same day, the same court concluded that "substantively identical" claims made by the State against McGraw-Hill and S&P were likewise sufficient to withstand a motion to dismiss. *State v. McGraw-Hill Co., et al.*, Docket No. HHDCV 106008838S (Conn. Super. Ct. May 10, 2012).

While none of the foregoing opinions is binding on this court, the court finds persuasive the reasoning of the courts in *In re Moody's* and *State v. Moody's*. In this case, the public statements cited in the State's complaint are statements of fact regarding S&P's independence and objectivity and the steps defendants take to preserve those qualities. The State further alleges that those statements were false and known to be false by McGraw-Hill and S&P when made. Particularly given defendants' emphasis on S&P's independence as the "cornerstone" of its business, the court concludes that the State has sufficiently alleged misrepresentations of fact that are actionable under the ICFA. *See Lapin v. Goldman Sachs*, 506 F. Supp. 2d 221, 239-40 (S.D.N.Y. 2006)

("[T]he Second Amended Complaint does more than identify rosy predictions or vague statements about Goldman's integrity. Goldman stated that such integrity 'was at the heart' of its business and attempted to distinguish itself from other institutions based on its 'truly independent investment research' while it allegedly knew the contrary was true.")

Defendants also argue that the complaint fails to allege that the misrepresentations regarding S&P's independence and objectivity were "material" to Illinois investors. As an initial matter, it is debatable whether the language of the Act requires materiality at all in the context of deceptive conduct. The ICFA prohibits "use or employment of any deception, fraud, false pretense, false promise, misrepresentation ***or** the concealment, suppression or omission of any material fact, with the intent that others rely upon the concealment suppression or omission of such material fact*"(emphasis supplied). From a purely grammatical standpoint, the Act refers to materiality only in the context of the "concealment, suppression or omission" of any material fact. Such a construction makes perfect sense. It would not be reasonable to suggest that the ICFA condones deception or fraud by those doing business in Illinois as long as the deception or fraud is "immaterial."[3]

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[3] For example, if a store advertises a special on a name brand product and then substitutes another name brand or store brand product for the one advertised, it is no defense to an ICFA claim that the substituted product was just as good as that advertised and thus the deception was "immaterial." *See, e.g., Williams v. Bruno Appliance and Furniture Mart, Inc.*, 62 Ill. App. 3d 219, 222-23 (1st Dist. 1978) (an illegal "bait and switch" sales tactic is defined by the Federal Trade Commission as an "alluring but insincere offer to sell a product or service which the advertiser in truth does not intend or want to sell" and an Illinois consumer stated a cause of action under ICFA and UDTPA when she alleged a seller advertised a misleading furniture deal, which it did not honor, and the seller then sold unadvertised items to the buyer instead). The quality of the substituted product may, of course, bear on the measure of damages, but it does not constitute a defense to the ICFA claim.

However, in at least one opinion, the Illinois Supreme Court, without analyzing the issue, listed materiality as an element of a claim under the Act involving deception or fraud. *See People v. E & E Hauling, Inc.*, 153 Ill. 2d 473, 492 (1992) ("In order to state a claim under the Consumer Fraud Act, a complaint must set forth specific facts which show that defendants misrepresented a material fact in the conduct of a trade or commerce with the intent that others would rely on such misrepresentation."). So for purposes of this opinion, the court will assume the State must satisfy such a pleading requirement.

To the extent materiality need be alleged, the complaint in this case passes muster. As noted, the complaint alleges that "[b]ased on S&P's public representations, [Illinois investors] depend on S&P to provide independent and objective assessments of the relative credit risk of structured finance securities, unaffected by S&P's or its clients['] interests." (Comp. ¶ 11). Further, after alleging that certain investors (such as pension and mutual funds) are restricted to investing in products receiving a certain rating from S&P (*e.g.*, AAA rated investments) and considering the "opacity" of such investments, the complaint states: "[I]ssuers cannot effectively market structured finance securities without ratings from credit rating agencies. As a result, credit rating agencies play a central role in the market for structured finances securities." (*Id.* ¶ 38). Finally, with respect to the conflict inherent in the "issuer pays" business model, the complaint alleges: "Investors and other market participants depend on S&P to properly manage this conflict and reasonably interpret S&P's representations to understand that S&P does so." (*Id.* ¶ 78). Indeed, when, as the complaint alleges, S&P itself characterizes its

"independence" and "objectivity" as the "cornerstone" of its business, it is impossible for S&P to contend that the foregoing representations are not material.

The fact that the complaint does not use the word, "material," is not determinative. Accepting the foregoing allegations as true, the complaint satisfies any requirement that the State allege facts demonstrating the materiality of S&P's representations to Illinois investors.

During the argument on defendants' motion, counsel for defendants raised an additional argument under the ICFA regarding the absence of any identifiable "transaction" within the meaning of ICFA. In their briefs, in the context of defendants' *Avery* argument, defendants commented that there was no direct relationship between S&P and Illinois investors in the sense that investors did not compensate S&P for its rating services, thus underscoring the lack of any "substantial" connection between S&P's ratings and Illinois. However, defendants never argued that the absence of any direct dealings between S&P and Illinois investors *per se* rendered the ICFA inapplicable to their conduct.

If defendants now contend that there must be some direct "transaction" between a rating agency and an Illinois investor in order for the ICFA to apply, the court rejects this position. By its plain terms, the Act applies to deceptive conduct that "directly or indirectly" affects Illinois consumers. 815 ILCS 505/1(f) (defining "trade" and "commerce" to include "the advertising...of any services... and shall include any trade or commerce directly or indirectly affecting the people of this State.") At a minimum, defendants' representations regarding S&P's independence had an indirect effect on Illinois investors.

Furthermore, the logical extension of defendants' argument would be to immunize rating agencies from investor claims based upon misrepresentations clearly intended to influence those same investors. A rating agency's existence depends on the investing public's confidence in the credibility and independence of its ratings. Without that confidence, investors do not make investment decisions predicated upon the rating assigned to a particular security, those ratings lose their value to issuers, and issuers lack motivation to seek out that agency's rating in the future. Thus, defendants' alleged misrepresentations regarding the integrity of the process by which S&P assigned ratings to structured finance securities were part and parcel of the purchase of the security itself and, thus, actionable under the ICFA.

Finally, at least one reported Illinois decision appears to recognize that direct dealings between a defendant and Illinois consumers are not necessary in order to impose liability under the ICFA. In *People v. Maclean Hunter Publishing Corp.*, 119 Ill. App. 3d 1049 (1st Dist. 1983), the State sued the publisher of the "Red Book," a manual of used vehicle pricing information. Defendants advertised the book as containing "official used car valuations" and represented that the information contained in the manual was "impartial", "accurate", and "reliable" and was based on "average" finance, wholesale, and retail values. *Id.* at 1052. The State alleged that defendants' representations were demonstrably false and misleading in that the values assigned to used cars in the Red Book were the product of little, if any, market analysis and were, in fact, subjective estimates. *Id.*

Finding that the Act applied to defendants' conduct, the Appellate Court noted the statute's broad reach and that, notwithstanding that defendants were not, in fact, selling

used cars, the business of publishing a manual of used car values constituted "trade or commerce" within the meaning of the Act. *Id.* at 1054. Importantly, the court found that defendants' failure to inform "subscribers, **users, and the public**" that the Red Book was merely a compilation of subjective estimates stated a claim under the Act. *Id.* at 1059 (emphasis supplied). Thus, the court contemplated that consumers other than those who had purchased the Red Book could be harmed by defendants' misrepresentations. *Id.*

The court cited with approval *FTC v. National Commission on Egg Nutrition*, 517 F.2d 485 (7th Cir. 1975), a case that found actionable representations by a trade association calculated to allay the public's fears about the high cholesterol content of eggs and encourage egg consumption. Reasoning that the association was organized for the benefit of the egg industry, the Seventh Circuit held the association's alleged misrepresentations could be enjoined even though the association's profit was not derived directly from consumers. *Id.* at 1055. Based on the foregoing, it is apparent that the *Maclean* court did not consider the lack of any direct "transaction" between defendants and consumers to constitute a bar to an ICFA claim.

Similarly, defendants' statements here fall into the same category. According to the complaint, in issuing ratings, S&P was guided by its motive to increase profits and encourage repeat business by issuers. Notwithstanding defendants' assurances regarding the integrity of S&P's rating process, the State alleges that S&P allowed its independence and objectivity to be co-opted by desire for market share. Consequently, because S&P's ratings were intended to and allegedly did influence investors in the purchase of rated securities, the lack of any direct transaction between S&P and Illinois consumers does not render the ICFA inapplicable.

Federal Preemption Under CRARA

Defendants next contend the State's claims are preempted by the federal Credit Rating Agency Reform Act (CRARA) of 2006, 15 USCS § 78o-7 *et seq*. As an initial matter, as the State points out, CRARA did not become effective until June 26, 2007. The majority of the misrepresentations cited in the State's complaint precede the Act's effective date. The alleged pre-CRARA misrepresentations as to integrity, objectivity and independence include S&P's 2002, 2003 and 2004 annual reports, S&P's code of professional conduct (starting in 2005), 2006 and 2007 annual reports and testimony of an S&P Managing Director to a Senate Committee in April 2007. (Comp. ¶¶ 51-73).

The SEC has acknowledged that S&P was not subject to CRARA until it registered as an NRSRO in September 2007. *Summary Report of Issues Identified in the Commission Staff's Examination of Select Credit Rating Agencies by the Staff of the Securities and Exchange Commission* (July 2008) at 1; *see also Hearing before the Senate Committee on Banking Housing and Urban Affairs,* 110th Cong. 16 (2007) (statement of Christopher Cox, Chairman, U.S. Securities and Exchange Commission: "Despite the fact that the NRSRO concept was used by the SEC for regulatory purposes prior to the enactment of [CRARA], no legislation had yet given the Commission statutory regulatory authority over credit rating agencies as such."). Certainly, had the SEC commenced an enforcement action against defendants based upon conduct occurring prior to CRARA's effective date, it is not difficult to predict that defendants would prevail on an argument that CRARA cannot be retroactively applied to such conduct. *See Landgraf v. USI Film Products*, 511 U.S. 244, 280 (1994) (statute will not operate retroactively when it would "increase the party's liability for past conduct [ ] or impose

new duties with respect to transactions already completed"). Defendants do not articulate how the same statute can be retroactive in one context (to preclude the State's claims against them), but not in another.

There is certainly no expression of Congressional intent in CRARA that its provisions be applied retroactively. *See Commonwealth Edison Co. v. Will County Collector,* 196 Ill. 2d 27, 27 (2001), citing *Plaut v. Spendthrift Farm, Inc.*, 514 U.S. 211, 237 (1995) ("new statutes do not apply retroactively unless Congress expressly states that they do"); *In re Krotzch's Estate*, 60 Ill. 2d 342, 345 (1975) ("Legislative enactments are, in the absence of express language which provides otherwise, construed as prospective and not retrospective."). Thus, at least to the extent that defendants' alleged misrepresentations pre-date CRARA, the court finds that the Act's provisions do not apply.

However, even if the Act could be applied retroactively (and to the extent that certain alleged misstatements were made after the Act's effective date), defendants' preemption argument is nevertheless unavailing.

CRARA was enacted "to improve ratings quality for the protection of investors and in the public interest by fostering accountability, transparency, and competition in the credit rating agency industry." Pub. L. No. 109-291, 120 Stat.1327 (preamble). Federal preemption is the exception, not the rule. *See Medtronic v. Lohr*, 518 U.S. 470, 485 (1996) ("[T]he historic police powers of the States were not to be superseded … unless that was the clear and manifest purpose of Congress."). Furthermore, when the text of a preemption clause can be interpreted in more than one way, the interpretation that disfavors preemption will be adopted. *Altria Group, Inc. v. Good*, 555 U.S. 70, 77

(2008). Given Congress' express purpose to protect investors through the enactment of CRARA, it would be incongruous, to say the least, to conclude that Congress also intended to strip investors (and, by implication, the States) of longstanding remedies for misconduct by rating agencies.[4] *Bates v. Dow Agrosciences LLC*, 544 U.S. 431, 449-50 (2005) ("If Congress had intended to deprive injured parties of a long available form of compensation, it surely would have expressed that intent more clearly.")

Importantly, unlike other federal legislation interpreted to have broad preemptive reach, CRARA was not motivated by Congress' desire to alleviate difficulties experienced by rating agencies in complying with various states' efforts to regulate them. *See S.C. Johnson & Son, Inc. v. Transport Corp. of America, Inc.*, 2012 U.S. App. LEXIS 19835, *11-12 (7th Cir. September 21, 2012) (considering scope of preemption under the Federal Aviation Administration Authorization Act of 1994, the preamble to which recited the deleterious effects of state regulation of interstate transportation of property and prohibited states from enacting or enforcing any "law, regulation, or other provision having the force and effect of law related to a price, route, or service of any motor carrier ... with respect to the transportation of property.").[5]

Indeed, CRARA by its terms merely vests in a federal agency the "exclusive authority" to enforce its provisions against NRSRO's and precludes states, as well as the SEC, from regulating the substance of an NRSRO's ratings. As the State points out, if

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[4] Rating agencies have long faced lawsuits, along with other participants in the securities markets, for violations of state and federal securities laws. *See In re Taxable Mun. Bond Sec. Lit.*, 1993 U.S.Dist. LEXIS 18592 (E.D. La. December 29, 1993).

[5] Notwithstanding the broad preemptive language at issue in *S.C.Johnson*, the Seventh Circuit concluded that certain of the plaintiff's claims against defendants based upon an alleged bribery and kickback scheme were not preempted: "*Morales* [*v. Trans World Airlines, Inc.*, 504 U.S. 374 (1992)] thus demonstrates that we are not looking at a simple all-or-nothing question; instead the court must decide whether the state law at issue falls on the affirmative or negative side of the preemptive line." *Id.* at *15-16.

such "exclusive authority" language was effective to preempt any and all state causes of action, then federal preemption would be the norm given the broad spectrum of federal statutes that vest exclusive enforcement authority in various federal agencies. As this is clearly not the law, defendants' argument that the "exclusive authority" language of CRARA is dispositive on the issue of preemption must fail.

An examination of the language of the provisions relied upon by defendants reinforces this conclusion. Defendants' preemption argument focuses on two subsections of the Act, 15 U.S.C. 78o-7(c)(1) and (c)(2), which read as follows:

> (c) Accountability for ratings procedures.
>
> (1) Authority. The Commission shall have exclusive authority to enforce the provisions of this section in accordance with this title... with respect to any [NRSRO], if such [NRSRO] issues credit ratings in material contravention of those procedures relating to such [NRSRO], including procedures relating to... conflicts of interest...
>
> (2) Limitation. Notwithstanding any other provision of this section, or any other provision of law, neither the Commission nor any State (or political subdivision thereof) may regulate the substance of credit ratings or the procedures and methodologies by which any [NRSRO] determines credit ratings...

15 U.S.C.S. § 78o-7. Defendants contend that the State's attempt to redress injury to Illinois investors resulting from their alleged misrepresentations runs afoul of the foregoing provisions vesting "exclusive" authority in the SEC and prohibiting States (and the SEC for that matter) from regulating the substance of credit ratings.

The latter argument is easily dispensed with. None of the relief sought in the State's complaint seeks to regulate the substance of S&P's ratings or the procedures by which those credit ratings are determined. Rather, the remedies sought in the State's complaint would, if granted, enforce the procedures S&P itself represented governed its

ratings decisions and remedy the consequences of S&P's 1) failure to adhere to those procedures and 2) misrepresentations regarding its own independence and objectivity. Thus, the provisions of subsection (c)(2) are simply not implicated in the context of this case.

Likewise, the State's complaint does not impinge upon the "exclusive authority" vested in the SEC under subsection (c)(1). The authority granted to the SEC under §78o-7 relates to registration of NRSRO's and the suspension or revocation of those registrations. The State's complaint does not seek to suspend, revoke or otherwise affect S&P's registration as an NRSRO and thus does not contravene the SEC's exclusive authority to regulate such matters.

As in the case of defendants' arguments regarding whether their representations as to S&P's independence and objectivity are actionable, several trial court opinions from other jurisdictions have addressed the effects of CRARA's preemption provisions. In *California Public Employee's Retirement System v. Moody's Corp.*, No. CGC-09-490241, Slip Op. at 3 (Cal. Super. Ct. June 1, 2010) (*"CALPERS"*), a state retirement system alleged ratings agencies, including McGraw-Hill, employed "increasingly lax [ratings] standards" and negligently misrepresented that certain structured finance securities in which it invested $1.3 billion, were rated as AAA. The *CALPERS* court rejected the ratings agency defendants' argument that the negligence claim was preempted by CRARA, finding that CRARA's limited purpose was the registration of NRSROs. *Id.* at 9, citing 15 U.S.C. § 78o-7. The court held that a claim for negligence did not interfere with Congress' power to determine standards for ratings agencies. *Id.* The court also rejected the ratings agencies' argument that they were invulnerable to any

state actions that would impose liability related to ratings decisions, reasoning "[i]f that were true, the Rating Agencies would be immune from liability for actions between both ends of the spectrum – ...pure negligence...and intentional torts (such as deceit)." *Id.*

Genesee Cnty. Empl. Ret. Sys. v. Thornburg Mtg. Secur. Trust, 825 F. Supp. 2d 1082, 1252 (D. N.M. 2011), also addressed the same two provisions relied on by defendants here. Regarding the SEC's "exclusive authority" under subsection (c)(1), the court held the scope of that authority was not all-encompassing, but was specifically restricted to "the provisions of [that] section." *Id.* With respect to subsection (c)(2), the court concluded that its prohibition on the regulation of the substance of credit ratings not only by states, but also the SEC, counseled a more narrow interpretation of its scope than that advocated by the rating agencies. *Id.* The court concluded CRARA's preemption provisions are intended to prevent states from (1) creating and enforcing comparable regulatory schemes requiring the registration of NRSROs; (2) prescribing rules regarding the form and content of credit ratings; (3) specifying procedures that NRSROs must follow regarding conflicts of interest, the exercise of due diligence, and other specified matters addressed in 15 U.S.C. § 78o-7; and (4) regulating the substance of credit ratings or the procedures and methodologies by which any NRSRO determines credit ratings. *Id.*

Rejecting a broad interpretation of CRARA's preemption provisions, the court concluded that "CRARA is susceptible to a construction that avoids the preemption of traditional state law causes of action against credit rating agencies, such as breach of contract claims, defamation claims, and securities fraud claims, assuming those claims do not rely on theories that would run afoul of CRARA's preemptive provisions." *Id.* at 1252-53. While the court concluded that certain of plaintiff's theories would require the

rating agencies to change or update their evaluation models or conduct additional due diligence and thus were subsumed in the SEC's exclusive authority under CRARA, it determined that theories premised on the rating agencies' general duty under the securities laws not to deceive were not preempted. Thus, causes of action based upon the rating agencies' alleged misrepresentations were not preempted because they would "not purport to require the Rating Agency Defendants to follow specific practices in issuing ratings, but only to issue ratings in a non-misleading manner." *Id.* at 1256.

Another motion to dismiss based on CRARA's preemption provisions was rejected in *The Anschutz Corp. v. Merrill Lynch and Co. Inc.*, 785 F. Supp. 2d 799 (N.D. Cal. 2011). The *Anschutz* court found that there was nothing in either the text of the statute or its legislative history to suggest Congress intended to bar all state actions against ratings agencies. *Id.* at 829. Like *CALPERS* and *Genesee*, *Anschutz* concluded that the preemption provisions of subsections (c)(1) and (c)(2) did not bar plaintiff's state law claims:

> [E]ven if CRARA could be read to preempt common law causes of action based on allegations that NRSRO's *apply* deficient standards or inadequate procedures and methodologies in their credit ratings – and this court does not conclude that it does – that is not what plaintiff seeks to do here. Instead, plaintiff seeks to hold the Rating Agencies liable for purported misrepresentations that allegedly would not have occurred if the Agencies had followed their own published procedures and methodologies.

Id. at 830 (emphasis in the original; footnote omitted).

State v. Moody's Corp. and *State of Conn. v. McGraw-Hill Co., supra*, likewise rejected defendants' preemption arguments. In *State v. Moody's*, in addition to the preemption arguments addressed above, the rating agencies raised the so-called "carve-

out" provisions found in subsections (i)(1) and (i)(2) of §78o-7. Section 78o-7(i) provides:

> (i) Prohibited conduct.
>
> (1) Prohibited acts and practices. The Commission shall issue final rules... to prohibit any act or practice relating to the issuance of credit ratings by a[n] [NRSRO] that the Commission determines to be unfair, coercive, or abusive, including...
>
> (A) conditioning or threatening to condition the issuance of a credit rating on the purchase by the obligor... of other services or products including pre-credit rating assessment products...;
>
> (B) lowering or threatening to lower a credit rating on, or refusing to rate, securities or money market instruments issued by an asset pool or as part of any asset-backed or mortgage-backed securities transaction, unless a portion of the assets within such pool... also is rated by the [NRSRO]; or
>
> (C) modifying or threatening to modify a credit rating or otherwise departing from...procedures and methodologies in determining credit ratings, based on whether the obligor... purchases...the credit rating or any other service or product... .
>
> (2) Rule of construction. Nothing in paragraph (1), or in any rules or regulations adopted thereunder, may be construed to modify, impair, or supersede the operation of any of the antitrust laws (as defined in the first section of the Clayton Act, except that such term includes section 5 of the Federal Trade Commission Act [15 USCS § 45], to the extent that such section 5 applies to unfair methods of competition).

15 USCS § 78o-7(i). In that case, as here, defendants argued that the limitation in subsection (i)(2) that "carved out" claims under §5 of the Federal Trade Commission Act "to the extent that such section 5 applies to unfair methods of competition" should be interpreted to preclude claims for deceptive trade practices, which are also prohibited in §5 of the FTC Act, but are not carved out under subsection (i)(2).[6]

[6] Effectively, defendants interpret subsection (c)(2) as if it read "**but only** to the extent that such section 5 applies to unfair methods of competition," which, of course, it does not.

State v. Moody's rejected this argument reasoning that subsection (i)(2)'s reference to §5 of the FTC Act included the entirety of that section so that despite subsection (i)(2)'s specific mention of unfair methods of competition, claims based upon deceptive trade practices were likewise permitted. "In adopting an otherwise comprehensive statutory scheme for rating agencies under CRARA, Congress explicitly preserved the right to pursue claims against such agencies for violation of the FTC Act." 2012 Conn. Super. LEXIS 1268, at *15. Because Connecticut's Unfair and Deceptive Trade Practices Act (like the ICFA) is expressly modeled on §5 of the FTC Act, the court concluded that state consumer fraud claims were preserved as well.[7]

Defendants cite two cases in which courts have concluded that CRARA preempts, in whole or in part, claims against rating agencies. The first is an oral ruling from the Tennessee Circuit Court in *First Community Bank v. First Tennessee Bank*, No. 3-475-11 (Tenn. Cir. Ct. May 25, 2012). The entirety of the court's reasoning on preemption is as follows: "I think our law on [preemption] is pretty much in its infancy, but I cannot read [CRARA] in any way to conclude that, insofar as a claim is based upon negligence against a rating agency, ... that act is designed by Congress to preempt such litigation." *Id.* at 21. Defendants also point to the fact that the court in *Genesee*, as discussed above, found that some of plaintiff's theories of recovery against the rating agencies were preempted by CRARA.

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[7] This court agrees with the result reached on this issue in *State v. Moody's*, but for a slightly different reason. The practices prohibited in subsection (i)(1)(A)-(C) (*inter alia,* modifying or conditioning the issuance of a credit rating on the issuer's purchase of pre-credit rating services or the credit rating itself) are properly characterized as unfair methods of competition. It is conduct aimed at S&P's own clients. Such practices do not constitute deceptive trade practices because the focus is not on deception, but on forcing the issuer to do business with S&P in order to obtain a favorable rating. Thus, in clarifying that claims for unfair competition under §5 of the FTC Act are unaffected by the authority vested in the SEC under subsection (c)(1), Congress did not need to "carve out" claims based upon deceptive trade practices under §5 because subsection (i)(1) does not implicate such claims at all.

The ruling in *First Tennessee Bank* is unenlightening given the lack of any discussion of the basis for the court's preemption ruling. Likewise, *Genesee's* finding that certain causes of action were preempted does not help defendants here because the State's complaint in this case is premised on the general duty not to deceive imposed on all who engage in trade or commerce affecting Illinois citizens, precisely the type of claim *Genesee* found was not preempted.

For all of the reasons set out at the beginning of the discussion of this issue, the court agrees with those trial courts that have rejected defendants' preemption arguments. The fact that CRARA vests "exclusive authority" to enforce its provisions in the SEC is unremarkable and, standing alone, insufficient to afford the statute the broad preemptive reach defendants advocate. As the claims asserted by the State in this case do not contravene or in any way impact the SEC's exclusive authority under CRARA, defendants' motion to dismiss on this basis must be denied.

Rating Agencies Are Not "Highly Regulated" Entities Exempt from ICFA Claims

Consistent with their position that CRARA preempts the State's ICFA claim, defendants also contend that because rating agencies like S&P are subject to CRARA's provisions and are thus "highly regulated," they should be excluded from the scope of the ICFA. As a threshold matter, given the court's findings that CRARA does not retroactively apply to defendants' alleged conduct and, even if it did, its provisions would not preempt the State's claims, this argument must be rejected as well. But even if the court reached the opposite conclusion, defendants' argument would be unavailing.

In Illinois, a narrow exemption from claims under the ICFA has been accorded to professions, such as lawyers, dentists, and doctors that are subject to comprehensive

regulatory schemes governing relationships with clients. *See Cripe v. Leiter*, 184 Ill. 2d 185, 192 (1998) (fee dispute with lawyer not amenable to a claim under the Act because the statute should not "impose liability for misconduct amounting to professional malpractice"). Because such regulatory schemes are designed to maintain the integrity of the regulated professions and protect the public, courts have found that a law designed to apply to ordinary merchant-customer relationships should not supplant claims for professional negligence. *Id.* at 196-97.[8] No case has applied the exception in the absence of a personal confidential relationship between the regulated party and the consumer.

Here S&P issued its ratings to the investment community at large. It has no personal relationship with any particular investor. Defendants point to no SEC regulations that govern or otherwise provide redress for claims by investors misled by knowingly false statements made by rating agencies. Consequently, defendants are not entitled to invoke Illinois' narrow exception to the applicability of the Act to their conduct.

The First Amendment Does Not Shield Defendants' Alleged Misrepresentations

Defendants next raise the First Amendment as a bar to liability for their alleged misrepresentations. Characterizing S&P's rating opinions as protected speech, defendants argue that the State's effort to impose liability under the ICFA infringes upon their freedom of expression.

Most commonly, the First Amendment has been successfully invoked by rating organizations to defeat defamation claims by the subject of the rating opinion. *See Compuware Corp. v. Moody's Investors Services, Inc.*, 499 F. 3d 520 (6th Cir. 2007);

[8] One court has refused to include accountants among those professions deemed "highly regulated." *See Lyne v. Arthur Andersen & Co.*, 772 F. Supp. 1064 (N.D. Ill. 1991).

Jefferson County School Dist. No. R-1 v. Moody's Investors Services, Inc., 175 F. 3d 848 (10th Cir. 1999). In pursuing this argument, defendants again focus on S&P's ratings, i.e., its expressions of opinion, regarding the risk involved in various structured finance securities. As noted above, however, the complaint is based upon defendants' representations of fact pertaining to the "cornerstone" of S&P's business.

While even purely "commercial" speech is entitled to a limited degree of First Amendment protection, see, e.g., *Bigelow v. Virginia*, 421 U.S. 809, 818 (1975), and *Bolger v. Youngs Drug Products Corp.*, 463 U.S. 60, 65 (1983), courts have long held that neither the federal nor state constitutions protects false, misleading, or deceptive commercial speech. *Virginia State Bd. Of Pharmacy v. Citizens Consumer Council, Inc.*, 425 U.S. 748, 771-72 (1976) ("Untruthful speech, commercial or otherwise, has never been protected for its own sake."); *Scott v. Ass'n for Childbirth at Home, Int'l*, 88 Ill. 2d 279, 287 (1981) ("Since the [ICFA] prohibits only such speech as amounts to fraudulent or deceptive practices, i.e., false or misleading advertising, it can affect only speech that is by definition outside the ambit of first amendment protection, and within the scope of permissible State regulation."). This is precisely what the State's complaint alleges and, therefore, the First Amendment does not pose a bar to the claims asserted.

ICFA Pleading Requirements

Addressing the substance of the complaint's allegations, defendants argue that the State has failed to plead its ICFA claim with the requisite detail. Allegations in support of claims under the ICFA must be set forth with specificity and particularity. *Sklodowski v. Countrywide Home Loans, Inc.*, 358 Ill. App. 3d 696, 703 (1st Dist. 2005). When the Attorney General pursues an action under the ICFA it is "essentially a law enforcement

action designed to protect the public, not to benefit private parties. *People ex rel. Hartigan v. Lann*, 225 Ill. App. 3d 236, 240 (1st Dist. 1992). In order to state a claim for unfair or deceptive acts under the ICFA, the State must allege that the defendant is engaged in (1) "trade or commerce" within the meaning of the Act and (2) unfair or deceptive acts or practices in the conduct of that trade or commerce. *People ex rel. Hartigan v. All American Aluminum & Constr. Co.*, 171 Ill. App. 3d 27, 34 (1st Dist. 1988).

As they do in the context of several other arguments, defendants focus on the complaint's lack of detail as to particular structured finance security ratings on the assumption that these are the deceptive or misleading statements forming the basis of the claim. As already noted, this focus is misplaced and it is apparent that the complaint sets forth in sufficient detail the precise representations as to S&P's independence and objectivity that the State claims were misleading and deceptive. The State need not identify who was exposed to defendants' public statements, when they heard or saw them, and how those statements were material. Defendants' pronouncements were made to all participants in the financial markets, the complaint identifies when they were made, and for reasons already articulated, they were clearly material.

Defendants also contend that the State must allege that defendants' statements were made with the intent to induce reliance. In the context of this case, the conclusion that defendants intended investors to rely upon their representations regarding the objectivity of S&P's ratings process and its post-rating monitoring activities is self-evident. Without public confidence in the integrity of the process by which S&P reached

its ratings and monitored their continuing validity, the "cornerstone" of S&P's business would not exist.

UDTPA Claim

With respect to the State's claim under the UDTPA, defendants argue that the complaint fails to state a claim because it lacks allegations regarding the likelihood that defendants' conduct will cause harm in the future. Citing *Brooks v. Midas-International Corp.*, 47 Ill. App. 3d 266 (1st Dist. 1977), defendants contend that because the complaint focuses only on past representations, the most recent of which was made four years ago, the State cannot satisfy this element of a UDTPA claim. However, notwithstanding *Brooks'* observation regarding the inability of an individual plaintiff under the UDTPA to establish that he or she will likely be misled in the future by a deceptive trade practice already exposed,[9] because this case is prosecuted by the Attorney General, the court finds that the likelihood of future deception may be addressed via a UDTPA claim, at least in the context of defendants' 2-615 motion to dismiss.

Prayer for Relief

Finally, defendants challenge the prayer for relief in the State's complaint claiming that the State does not specify the violations for which it seeks imposition of civil penalties. However, there is no requirement that a prayer for relief under the ICFA identify every transaction for which the imposition of a civil penalty is sought. Therefore, the failure to include such detail provides no basis for dismissal.

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[9] "The problem inherent in such consumer actions is the inability to allege facts which would indicate that the plaintiff is 'likely to be damaged.' Ordinarily, the harm has already occurred, thus precluding a suit for injunctive relief." *Id.* at 275.

WHEREFORE, for the foregoing reasons, IT IS HEREBY ORDERED that

1) defendants' Motion to Dismiss is hereby DENIED;

2) defendants shall answer the complaint on or before December 5, 2012; and

3) this matter is set for further status and case management on December 12, 2012, at 10:00 a.m., without further notice.

November 7, 2012

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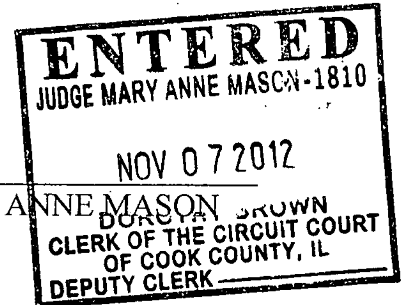

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JUDGE MARY ANNE MASON