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Note

Federal Preemption and the Rating Agencies: Eliminating State Law Liability to Promote Quality Ratings

Timothy M. Sullivan*

In July 2009, the California Public Employees' Retirement System (CalPERS) sued Moody's, Standard & Poor's, and Fitch, the three major credit rating agencies, in California state court for an unstated amount of damages. CalPERS, a multibillion dollar investor, invoked California common law in alleging that the rating agencies acted negligently by stamping inappropriately high ratings on subprime mortgage-backed securities, thereby signaling, falsely, that the securities were safe investments. CalPERS alleged that it purchased these securities in reliance on the ratings. When these securities collapsed, CalPERS suffered a substantial loss—perhaps as much as one

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3. CalPERS Complaint, supra note 1, at 21-22.

4. See id. ("[T]he Rating Agencies owed a duty to CalPERS, which relied on their ratings . . . .").
billion dollars. To recover this loss, CalPERS focused its litigation efforts on the rating agencies.

Meanwhile, Congress is considering various proposals to change the federal regime for regulating the rating agencies. These proposals address perceived problems in the rating industry in various ways. Some would require the rating agencies to adopt specific methodologies prescribed by the Securities and Exchange Commission (SEC). Others would require rating agencies to provide greater disclosure of rating methodologies. Still others would alter the manner in which rating agencies are compensated. Finally, some proposals would make it easier for rating agencies to be sued under federal law. No proposal addresses the normative desirability of allowing the state law claims like those made in the CalPERS suit to go forward.

The CalPERS suit raises important questions that Congress should consider in determining how best to regulate the rating agencies: Should the rating agencies be subject to state law liability for ratings that turn out to be inaccurate? How might state law liability for inaccurate ratings affect the quality, that is, accuracy, of future ratings? To answer these questions, one must consider the purpose of ratings. Credit ratings reduce information asymmetry between investors and investment issuers, thereby promoting efficient markets. More spe-

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5. Id. at 1; Marc Lifsher & Jerry Hirsch, CalPERS Sues 3 Rating Firms over Its Losses, L.A. TIMES, July 16, 2009, at B2.
6. CalPERS Complaint, supra note 1, at 2; see also Lifsher & Hirsch, supra note 5 (describing both the “plaudits and skepticism” surrounding the lawsuit).
8. H.R. 3890 § 2(11) (setting forth methodologies and minimum disclosure requirements the SEC would be required to impose on the rating agencies).
9. H.R. 2549 § 2(2) (suggesting that the rating agencies engage in procedures to be more clear, consistent, and reliable).
10. H.R. 3890 § 2(6) (stating that compensation should ensure independence of the director’s judgment).
11. H.R. 3214 § 4 (easing the pleading requirements for federal securities claims against rating agencies); S. 1073 § 4 (same).
12. See Amy K. Rhodes, The Role of the SEC in the Regulation of the Rating Agencies: Well-Placed Reliance or Free-Market Interference?, 20 SETON HALL LEGIS. J. 293, 294 (1996) (“Efficient capital markets need accurate information to insure optimal choices by investors and to assure that money flows to those who are able to use it most effectively.”); Stéphane Rousseau, Enhancing the Accountability of Credit Rating Agencies: The Case for a Disclosure-Based Approach, 51 MCGILL L.J. 617, 620 (2006) (“[Rating Agencies] have
cifically, credit ratings provide investors with a succinct opinion of the creditworthiness of a particular company, government entity, security, or other financial product. Discerning the optimal liability regime for rating agencies requires consideration of such a regime’s likely effect on ratings quality.

Over the past century, the credit rating industry grew exponentially. Aided by the incorporation of privately issued ratings into government securities regulations, the industry that began by rating railroad bonds now stands as a central facet of the world financial system. Despite the tremendous influence of credit ratings in the modern financial system, the agencies that produce these ratings enjoy minimal government regulation and little exposure to liability. This could soon change. The bursting of the real estate market bubble precipitated a collapse of financial products collateralized by residential mortgages. Virtually all of these products bore ratings that emerged as informational intermediaries specializing in the appraisal of the creditworthiness of corporations.


14. See U.S. SEC. & EXCH. COMM’N, supra note 13, at 5 (finding that rating agencies increased their market because of the growing reliance on their reports and the globalization of financial markets).

15. See Rhodes, supra note 12, at 294; Op-Ed., The Moody’s Blues, WALL ST. J., Feb. 15, 2008, at A14 (noting that one major rating agency’s twenty percent annual growth until recently was due to “government help”).


17. See Kenneth S. Kettering, Securitization and Its Discontents: The Dynamics of Financial Product Development, 29 CARDOZO L. REV. 1553, 1674 (2008) (“[I]n 2006 federal legislation imposed a small measure of regulatory oversight on rating agencies, which until then were essentially unregulated.”).

18. See id. at 1687 ("[R]ating agencies have been eminently successful in avoiding liability on account of allegedly incorrect ratings they issue."); Arthur R. Pinto, Control and Responsibility of Credit Rating Agencies in the United States, 54 AM. J. COMP. L. 341, 352 (2006) ("[C]redit rating agencies have generally been able to avoid liabilities . . . .").

19. See CDOh No!, ECONOMIST, Nov. 10, 2007, at 90 (noting that mortgage-backed investment losses in late 2007 were “set to rise sharply as mortgage defaults in America climb”).
produced by one of the major agencies. In many instances, the agencies gave these now-illiquid products their highest rating, indicating a very low risk of default and corresponding loss of value. Many of these ratings turned out to be incorrect. As foreclosure rates skyrocketed throughout the country, the value of mortgage-backed securities nose-dived. Numerous investors, perhaps having relied on credit rating assurances that mortgage-backed products were safe, suffered substantial losses.

Not surprisingly, rating agencies face increased scrutiny resulting from the collapse of mortgage-backed investments. Congress is considering new legislation regarding the rating agencies, and aggrieved investors, most notably CalPERS, have commenced major litigation stemming from losses allegedly caused by inaccurate ratings. Historically, lawsuits against rating agencies have been unsuccessful, with few exceptions.

Rating agencies traditionally rely on the First Amendment.
and various other defenses to avoid liability for issuing ratings that later prove to be incorrect. Congress's most recent attempt to regulate the rating agencies arguably provides another defense to claims rooted in state law: federal preemption.

The Credit Rating Agency Reform Act of 2006 gives the SEC authority to compel rating agencies to publicly disclose rating methodologies and any conflicts of interest that may give agencies an incentive to overrate certain securities. The Act also contains a preemption provision, which states that "[n]otwithstanding 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 nationally recognized statistical rating organization determines credit ratings." The preemptive effect of this provision is uncertain, but a growing number of litigants and commentators argue that it prevents most state claims against rating agencies.

suit against Moody's and reasoning that the First Amendment protects the rating agency's opinion.

30. See, e.g., Quinn v. McGraw-Hill Cos., 168 F.3d 331, 336 (7th Cir. 1999) (holding that a rating agency's letter to the plaintiff-investor that explained that ratings are not intended to be relied upon for investment advice made such reliance by the plaintiff unreasonable as a matter of law); First Equity Corp. v. Standard & Poor's Corp., 869 F.2d 175, 179-80 (2d Cir. 1989) (finding that Standard & Poor's was not in privity with consumers of the agency's opinions).

31. Credit Rating Agency Reform Act of 2006, 15 U.S.C. § 78o-7(c)(2) (2006) ("Notwithstanding any other provision of law, neither the [SEC] nor any State . . . may regulate the substance of credit ratings or the procedures and methodologies by which any nationally recognized statistical rating organization determines credit ratings.").

32. Id. § 78o-7(a)(1)(B)(ii) (methodologies); id. § 78o-7(a)(1)(B)(vi) (conflicts of interest).

33. Id. § 78o-7(c)(2).

34. See Suggestion of Additional Authorities at 9–14, In re Nat'l Century Fin. Enters., Inc., No. 2:03-MD-01565 (S.D. Ohio June 28, 2007) (claiming that the Reform Act preempts state authority to regulate rating agencies); John Patrick Hunt, Credit Rating Agencies and the "Worldwide Credit Crisis": The Limits of Reputation, the Insufficiency of Reform, and a Proposal for Improvement, 2009 COLUM. BUS. L. REV. 109, 196 ("[T]he 2006 Act prohibits states from regulating the 'substance' of credit ratings. State tort liability relating to a subject typically is considered state regulation of that subject, so it probably is preempted under current law."); Larry P. Ellsworth & Keith V. Porapairoon, Credit Rating Agencies in the Spotlight: A New Casualty of the Mortgage Meltdown, BUS. L. TODAY, Mar.–Apr. 2009, at 35, 36 ("A preemption defense may come into play where a state government or private plaintiff challenges the methods by which credit rating agencies operate or determine their credit ratings for securities."). But see Kettering, supra note 17, at 1689 ("It would be ironic for preemption of tort liability to be the result of
This Note evaluates the preemptive effect of the Credit Rating Agency Reform Act of 2006 and analyzes the normative desirability of preemption. Part I describes the history of the rating industry and the role of rating agencies in the subprime mortgage crisis. Part II analyzes the preemption provision of the 2006 Act and explains why it likely preempts most species of state law claims against rating agencies. Finally, Part III argues to the extent that the 2006 Act does not preempt most state claims against rating agencies, the Act should be amended to make this preemption provision clearer. Rating agencies should not face substantial state law liability for ratings that turn out to be inaccurate because such liability would tend to diminish ratings quality. To create a coherent, national regime for promoting ratings quality, Congress should ensure that plaintiff-investors cannot assert state law claims against rating agencies.

I. THE EVOLUTION OF THE RATING INDUSTRY AND THE RATING AGENCIES' ROLE IN THE SUBPRIME MORTGAGE CRISIS

This Part traces the history of rating agencies from their inception through their role in the recent financial crisis and provides an overview of past attempts at pinning liability to rating agencies for allegedly false ratings. First, this Part provides a history of the rating agencies up to the collapse of Enron and describes the federal government's corresponding regulation of the agencies. Second, it explains the role of the rating agencies in the recent subprime mortgage crisis. This Part concludes by summarizing traditional defenses to lawsuits filed by investors claiming to have suffered financial loss because of inaccurate ratings.

A. HISTORICAL BACKGROUND

Rating agencies began issuing securities ratings nearly a hundred years ago.35 Although the essential role of rating

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34. The legislation, for the hearings held and reports written leading up to it . . . never broached the notion that the general welfare would be promoted by awarding the rating agencies immunity from any risk of tort liability on account of their ratings.

agencies has always been to evaluate investment risk, the scope, importance, and influence of rating agencies increased dramatically since then. The SEC attributes this trend to an increase in the number of entities issuing securities, the growing complexity of the securities themselves, and the globalization of U.S. financial markets. Perhaps the most significant factor in this expansion is the widespread incorporation of ratings into the SEC's regulatory scheme.

Since the nineteenth century, rating agencies have undergone at least four significant transformations. First, agencies now charge issuers a fee for rating a security. Prior to the 1970s, agencies made money primarily by selling publications containing their ratings. As the demand for ratings increased, the agencies switched business models such that a majority of their income came from issuer fees rather than from subscribers. Indeed, without these fees, it is unlikely that the rating industry could have expanded quickly enough to meet the rising demand for their services.

Second, ratings are now an integral part of SEC regulations, thereby amplifying their importance to both issuers and
consumers. To simplify the SEC's oversight responsibilities, regulators routinely incorporated ratings into financial regulations.

Third, the securities rated by the agencies are more complex than in the past. Whereas rating agencies began by rating only traditional bonds, they now rate highly complex securities, including the mortgage-backed products that collapsed in the wake of the subprime mortgage crisis.

Finally, modern rating agencies aid issuers in structuring bonds to a much greater degree than in the past. While the rating agencies avoid characterizing this assistance as structuring, they assist issuers by making ratings criteria available so that securities can be advantageously structured to achieve a desired rating. Ultimately, the courts and legislators must decide how to interpret this activity, but to the extent that agencies provide issuers with information that helps them gain more favorable ratings, agencies are much more involved in helping issuers create marketable securities than in the past.

These transformations developed in an environment of minimal regulation of the rating agencies. Before 2006, no federal statute directly addressed the credit rating industry.


45. See U.S. SEC. & EXCH. COMM'N, supra note 13, at 6 (noting that ratings were first incorporated into SEC regulations in 1975).

46. See Cantor & Packer, supra note 35, at 5-6 tbl.3 (showing the progression of rules incorporating ratings).


48. See In re Fitch, Inc., 330 F.3d 104, 106 (2d Cir. 2003) (describing the heavy involvement the rating agency in the case had with structuring a bond).

49. See id. at 110 ("Fitch admits that it makes its ratings criteria available to the subjects of its ratings, and that the companies often conform their transactions to those ratings criteria."); Rhodes, supra note 12, at 312.

50. See Rhodes, supra note 12, at 313 ("During the rating process, issuers are in constant contact with the rating agencies, seeking the rating agency's feedback . . . in an attempt to obtain a higher rating.").

51. See In re Fitch, 330 F.3d at 110.

52. See Kettering, supra note 17, at 1675.
This situation changed after the collapse of Enron, when Congress took an exacting look at the credit rating industry. Rating agencies were widely believed to have failed at apprizing investors who held Enron debt of the imminent collapse of those investments. Legislators believed that the rating agencies should have known that Enron was in trouble long before its precipitous collapse.

In response, Congress passed the Credit Rating Agency Reform Act of 2006, which represented the first substantial effort by Congress to directly regulate the rating industry. The Act addressed perceived rating agency shortcomings in two primary ways. First, the Act made it easier for upstart rating agencies to gain the status of Nationally Recognized Statistical Rating Organization (NRSRO), a prerequisite for a particular agency's ratings to satisfy SEC regulations that incorporate such ratings. Second, the Act imposed significant disclosure requirements on all agencies that voluntarily sought NRSRO designation. These disclosure requirements compel NRSROs to publicize their rating methodologies and any conflicts of interest within their business model. The 2006 Act also gives the SEC authority to issue rules effectuating the disclosure and registration requirements of the Act.

Thus, the regulatory environment for rating agencies immediately before the subprime mortgage crisis remained limited.

54. See Pinto, supra note 18, at 343 ("The recent financial scandals involving large publicly traded corporations like Enron where credit rating agencies failed to downgrade debt in a timely manner placed the role of credit rating agencies on the agenda of financial reform.").

55. See id. ("[Credit rating agencies'] failure to reflect the financial condition of troubled issuers raised issues.").

56. Id. at 345.

57. 15 U.S.C. § 78o-7 (2006); see Timothy E. Lynch, Deeply and Persistently Conflicted: Credit Rating Agencies in the Current Regulatory Environment, 59 CASE W. RES. L. REV. 227, 248 (2009) ("Prior to the enactment of the Credit Rating Agency Reform Act of 2006, the credit rating industry was largely unregulated.").

58. See Lynch, supra note 57, at 268 ("The Act establishes an express process by which a credit rating agency can be deemed to be a 'nationally recognized statistical rating organization' (NSRO). Hence, it is designed to reduce the barriers to entry into the industry and, thus, increase competition among rating agencies.").

59. Id. at 268–69 (listing the information that an NRSRO application requires and stating that much of it must be publicly available and regularly updated).

60. Id. at 269–71.

61. Id. at 267–75.
The 2006 Act increased disclosure requirements but did not direct rating agencies to adopt any particular rating methodologies. The onset of the current financial crisis shortly after its enactment makes it difficult to evaluate the efficacy of the Act’s disclosure requirements.

B. THE ROLE OF THE RATING AGENCIES IN THE SUBPRIME MORTGAGE CRISIS

Shortly after the 2006 Act became law, the early stages of the recent financial crisis materialized. Investor confidence in U.S. financial institutions plummeted following the collapse of the mortgage-backed securities market. The bursting of the subprime mortgage bubble precipitated a market collapse. Leading up to 2006, an increasing number of subprime borrowers found willing lenders. During this period, subprime mortgages accounted for twenty percent of all mortgage debt.

An unprecedented frenzy for securities collateralized by mortgages fueled a surge in subprime lending. Large scale investors such as banks, insurance companies, and pension funds invested heavily in mortgage-backed securities. These securities relied on steady principle and interest payments on the underlying mortgage debt. Typically, these securities, especially those rated investment grade, were insulated from loss by overcollateralization of the investment pool and subordination of riskier tranches. With these protections in place, the entire

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63. See CDOh No!, supra note 19.

64. See Forte, supra note 24, at 11.

65. Lowenstein, supra note 16, at 40.

66. See id. at 38 (“Almost all . . . subprime loans ended up in securitized pools . . . .”).


68. See id.

69. See CDOh No!, supra note 19, at 90.
financial community seemed convinced that these products would perform well indefinitely.\footnote{70}{See, e.g., Forte, supra note 24, at 11 (discussing former Federal Reserve Chair Alan Greenspan’s confidence in the growth process of mortgage-backed products).}

But conditions changed.\footnote{71}{See Faten Sabry & Thomas Schopflocher, The Subprime Meltdown: Not Again!, 26 Am. Bankr. Inst. J. 1, 42 (2007).} Many subprime borrowers, faced with substantially higher monthly mortgage payments after the initial “teaser” period, began to default.\footnote{72}{See id. at 45.} As defaults and foreclosures mounted, mortgage-backed securities became distressed.\footnote{73}{See Forte, supra note 24, at 11 (“The subprime business began to unravel in early 2007 . . . as subprime loan defaults began to increase and investors began to distrust the AAA rating of [mortgage-backed securities].”).} These securities were designed such that there was a margin of error protecting them.\footnote{74}{See CDOh No!, supra note 19, at 90.} But the sheer number of borrower defaults surpassed this margin of error beyond prevailing expectations.\footnote{75}{See, e.g., id. at 90, 92.}

Once this margin of error vanished, investment-grade mortgage-backed securities looked far riskier than previously thought. All three of the major rating agencies quickly lowered their ratings for large swaths of mortgage-backed securities.\footnote{76}{See Lowenstein, supra note 16, at 41.} Many criticized the rating agencies for giving these securities such a high initial rating.\footnote{77}{See, e.g., id. at 40; Waxman Grills Rating Agencies, DIRECTORSHIP, Oct. 23, 2008, http://www.directorship.com/waxman-grills-rating-agencies/} Finding it unjustifiable that the rating agencies could give top ratings to securities in 2006 when the same investments fell below investment grade in 2007, investors, politicians, and others began to clamor for increased rating agency liability. The next section describes traditional theories of liability leveled against rating agencies and explains the often successful defenses the agencies typically use.

\section*{C. THEORIES OF RATING AGENCY LIABILITY AND TRADITIONAL DEFENSES}

Some believe the rating agencies knew mortgage-backed investments were far riskier than their ratings indicated, but acted on the perverse incentive to please their issuer-clients at
the expense of accuracy.\textsuperscript{78} Others argue that the rating agencies are not suited to predict systemic market failures like the one that occurred, and that the agencies are motivated primarily by the incentive to protect their reputation for accuracy.\textsuperscript{79} These divergent opinions preview the arguments that litigants are likely to make in litigation involving the rating agencies.\textsuperscript{80} Historically, rating agencies have had overwhelming success at defending themselves in court.\textsuperscript{81} Investors have deployed a variety of theories in lawsuits against rating agencies; to fend them off, the rating agencies have relied on an array of traditional defenses.

1. Theories of Liability

Common law theories of rating agency liability to investors for inaccurate investment information include claims of negligent misrepresentation, fraud, and breach of contract.\textsuperscript{82} For negligent misrepresentation claims, investors argue that rating agencies negligently issued inaccurate ratings, thereby breaching a duty of care owed to investors to give accurate information.\textsuperscript{83} Fraud claims allege that rating agencies knowingly issued false or misleading ratings.\textsuperscript{84} Breach of contract claims allege that investors are the intended beneficiaries of ratings pursuant to a contract with the issuer.\textsuperscript{85} As third-party beneficiaries, investors sue for breach of contract when the rating

\textsuperscript{78} See, e.g., Lynch, supra note 57, at 266 ("The subprime episode seems to paint a picture in which the rating agencies, captured by the issuers, were more than willing to accept that they lacked the resources to perform credible and accurate analyses. Moreover, any inclination to conduct lax diligence . . . is exacerbated by the issuer-pays conflict of interest. The desire to generate revenues and the explicit or implicit pressure from issuers increases rating inaccuracies.").

\textsuperscript{79} See Rhodes, supra note 12, at 296. See generally Steven L. Schwarcz, Private Ordering of Public Markets: The Rating Agency Paradox, 2002 U. ILL. L. REV. 1, 6–9 (developing the reputational capital view of the credit rating industry).

\textsuperscript{80} See, e.g., CalPERS Complaint, supra note 1, at 12–13.

\textsuperscript{81} See Kettering, supra note 17, at 1688–89.


\textsuperscript{83} See Quinn, 168 F.3d at 335.

\textsuperscript{84} See First Equity Corp., 869 F.2d at 179.

\textsuperscript{85} See Quinn, 168 F.3d at 334–35.
agencies fail to perform as promised, for example, by failing to issue and monitor accurate ratings for the sake of investors. 86

Federal securities law arguably creates a private cause of action against rating agencies when securities issuers make material misrepresentations or omissions in information furnished to potential investors. 87 Entities that participate in these material misrepresentations—such as accountants and credit rating agencies—can conceivably be held liable under these laws even though they do not issue securities. 88 The particular statutory locus for these claims depends on the specific type of and context surrounding the information provided by issuers to prospective investors. 89 All of these potential causes of action require the same essential elements: a misstatement or omission of a material fact, made with scienter, justifiably relied on by the plaintiffs, and proximately causing plaintiffs’ injuries. 90

Plaintiffs are already asserting federal securities claims against the rating agencies. New Jersey Carpenters Vacation Fund v. HarborView Mortgage Loan Trust, a major subprime-investor lawsuit against a rating agency, alleges that the rating agencies knowingly issued overly high ratings for mortgage-backed products in violation of federal securities law. 91 The plaintiffs argue that they relied on these alleged material misstatements, which were incorporated into the offering materials provided to the investors, in their decision to purchase HarborView’s mortgage-backed products. 92 Thus, the plaintiffs allege that they suffered damage proximately caused by the rating agencies when the mortgage-backed investment market collapsed and these securities dropped precipitously in value. 93

State securities laws may have lower scienter requirements than federal securities law for claims alleging that participants in the purchase or sale of a security made false or mis-

86. See id.
88. Id.
90. Id.
91. See Complaint, supra note 87, at 43–44.
92. Id.
93. Id.
leading statements or omissions. For example, Ohio law imposes liability on any party who aided an issuer in the making of false or misleading statements "in any way." Ohio courts have noted that the standard is very liberal. Ohio's lower scienter requirement demonstrates that the rating agencies could face more exposure to liability under state law than under federal securities law. Damaged investors will argue that the rating agencies aided issuers in making false or misleading statements by providing inaccurate ratings for mortgage-backed securities even though the agencies had modernized risk modeling tools that, if implemented, would have revealed the securities' true risk. Whether this argument is persuasive remains to be seen, but as a general matter, the risk of liability for the rating agencies may be greater under state securities laws than under federal securities law.

2. Traditional Rating Agency Defenses

Perhaps the greatest barrier to liability for investors who sue rating agencies is the First Amendment. Though not universally successful, rating agencies have consistently argued that they are in the business of writing "editorials," and that they are members of the financial press. The Supreme Court has yet to take up the issue of the rating agencies' First Amendment argument, but many commentators believe that the First Amendment is not an absolute bar to rating agency liability. Though the rating agencies' First Amendment defense may be

95. OHIO REV. CODE ANN. § 1707.43(A) (LexisNexis 2009).
96. E.g., Federated Mgmt. Co. v. Coopers & Lybrand, 738 N.E.2d 842, 860-61 (Ohio Ct. App. 2000) ("[T]he language in [§ 1707.43] is liberal. . . . [T]he language is very broad, and participating in a sale or aiding the seller in any way is sufficient to form a basis for liability . . . .")
97. Compare Complaint, supra note 87, at 34–35, with In re Nat'1 Century, 580 F. Supp. 2d at 650–51 (outlining the Credit Rating Agency Reform Act's requirement that agencies provide information about methodologies used to formulate ratings).
98. U.S. CONST. amend. I ("Congress shall make no law . . . abridging the freedom of speech, or of the press . . . ."); see Pinto, supra note 18, at 352.
100. See, e.g., id.
problematic for several reasons, past experience demonstrates that this defense will prevail in some, if not all, subprime-inspired investor lawsuits against rating agencies.

In addition to First Amendment defenses, rating agencies often have prevailed by arguing either that they owe no duty of care to investors, or that investor reliance on credit ratings is unreasonable. To bolster these defenses, rating agencies consistently state that ratings are merely opinions and not intended to be used as investment advice. At least one recent case demonstrates the ongoing vitality of this argument. Rating agencies admit that investors do, in fact, rely on investment decisions when purchasing subprime mortgage-backed investments, but claim that the agencies counsel against this reliance. Agency disclaimers counseling against investor reliance are typically found in small print. Whether the defense of unreasonable reliance survives subprime-inspired litigation against credit ratings is unclear, especially given that


102. Compare, e.g., In re Fitch, Inc., 330 F.3d 104, 111 (2d Cir. 2003) (affirming a lower court's determination that a credit rating agency could not assert a state journalist's privilege), with Jefferson County Sch. Dist. No. R-1 v. Moody's Investor's Servs., Inc., 175 F.3d 848, 856 (10th Cir. 1999) (affirming dismissal of a defamation suit against Moody's by reasoning that the First Amendment protects the rating agency's opinion).

103. See, e.g., First Equity Corp. v. Standard & Poor's Corp., 869 F.2d 175, 179–80 (2d Cir. 1989) (finding that Standard & Poor's was not in privity with consumers of their opinions).

104. See, e.g., Quinn v. McGraw-Hill Cos., 168 F.3d 331, 336 (7th Cir. 1999) (holding that a rating agency's letter to the plaintiff-investor which explained that he should not rely on ratings for investment advice made such reliance by the plaintiff unreasonable as a matter of law).

105. See Stephen J. Crimmins et al., Subprime Mortgage Lending: Possible Securities Litigation Exposure, 39 Sec. Reg. & L. Rep. (BNA) 1455, 1459 (Sept. 24, 2007) (“Credit rating agencies have historically escaped blame by stressing that their ratings are simply opinions and thus not actionable.”).

106. Compuware Corp. v. Moody's Investors Servs., Inc., 499 F.3d 520, 529 (6th Cir. 2007) (holding, in a defamation action, that a credit rating is “a predictive opinion, dependent on a subjective and discretionary weighing of complex factors”).

107. See Tomlinson & Evans, supra note 67 (quoting a Moody's executive as saying that “many people have the tendency to rely on [ratings]” and adding that “we want to make sure that they don't”).

108. Id.
the agencies are aware of widespread investor reliance on rat-

ings.\textsuperscript{10}

If history is a guide, the rating agencies will assert the
First Amendment and other traditional defenses to avoid liabil-
ity for inaccurate ratings of mortgage-backed securities. In ad-
dition, Congress may have added another barrier to relief for
investors: federal preemption. The next Part analyzes federal
preemption issues arising from Congress's recent attempt to
regulate the rating industry.

II. A NOVEL RATING AGENCY DEFENSE: FEDERAL
PREEMPTION UNDER THE CREDIT RATING AGENCY
REFORM ACT OF 2006

The Credit Rating Agency Reform Act of 2006 represents
Congress's most significant effort to regulate the activities of
the rating agencies.\textsuperscript{11} The agencies' failure to give investors
timely warning of the imminent collapse of investments in
Enron's debt provided a major impetus for this Act.\textsuperscript{11} This Part
analyzes the preemptive reach of the 2006 Act by applying a
traditional express preemption analysis. Additionally, this Part
analyzes, in the absence of helpful legislative history, the prac-
tical considerations that militate toward treating credit ratings
as an exclusively national interest for purposes of preemption
analysis. Finally, this Part concludes that the 2006 Act, though
not entirely clear with regard to preemption, should be read to
preempt most state law claims against rating agencies.

A. PREEMPTION ANALYSIS

Rather than establishing government oversight and direct
influence over the methodologies used by rating agencies to
rate securities, the 2006 Act focuses primarily on compelling
the rating agencies to disclose material conflicts of interest and
rating methodologies to the SEC.\textsuperscript{11} In fact, the 2006 Act con-
tains a provision that demonstrates that Congress made a pur-

\begin{itemize}
\item \textsuperscript{10} See \textit{id.}
Act the SEC had been criticized for failing to regulate agencies designated as
NRSROs).
\item \textsuperscript{11} See S. REP. No. 109-326, at 1, 2006 U.S.C.C.A.N. at 865; Claire A. Hill,
\textit{Rating Agencies Behaving Badly: The Case of Enron}, 35 CONN. L. REV. 1145,
1152 (2003) (noting that "rating agencies were . . . very late to downgrade"
investments in Enron's debt).
\item \textsuperscript{11} See S. REP. No. 109-326, at 7, 2006 U.S.C.C.A.N. at 872.
\end{itemize}
poseful decision not to regulate the methodologies or substance of ratings.\textsuperscript{113} In at least one case, a rating agency argued that this provision expressly preempts state statutory claims, and possibly common law claims, brought against rating agencies by investors.\textsuperscript{114} So far, no court has construed this provision to determine the extent of preemption.\textsuperscript{115}

A constitutionally valid act of Congress preempts state law when the act states in express terms that it intends to do so.\textsuperscript{116} The 2006 Act contains an express preemption provision prohibiting the SEC or any other state or federal entity from regulating the substance or methodology of credit ratings.\textsuperscript{117} The preemption provision states that "[n]otwithstanding any other provision of law, neither the [SEC] nor any state . . . may regulate the substance of credit ratings or the procedures and methodologies by which any [NRSRO] determines credit ratings."\textsuperscript{118} To determine the scope of this provision a court would look first to the text, and, if necessary, to the purpose and structure of the

\begin{footnotesize}
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\item[113.] See 15 U.S.C. § 78o-7(c)(2).
\item[115.] See, e.g., id. at 651–52; Kia Dennis, \textit{The Ratings Game: Explaining Rating Agency Failures in the Build Up to the Financial Crisis}, 63 U. MIAMI L. REV. 1111, 1143 (2009) (discussing \textit{National Century} and concluding that the validity of the rating agencies' preemption defense is an open question).
\item[116.] See Pac. Gas \& Elec. Co. v. State Energy Res. Conservation \& Dev. Comm'n, 461 U.S. 190, 203 (1983). If no express provision exists, the Act may preempt state law by implication where it is reasonable to infer that federal law in the regulated area is "so pervasive" that Congress left no room for states to regulate. \textit{Id.} at 203–04. Implied preemption might also exist where "the Act of Congress . . . touch[es on] a field in which the federal interest is so dominant that the federal system will be assumed to preclude enforcement of state laws on the same subject." \textit{Id.} at 204. Because the 2006 Act contains an express preemption provision, see 15 U.S.C. § 78o-7(c)(2), this Note focuses on an express preemption analysis and takes no position on the 2006 Act's implied preemptive effect.
\item[117.] 15 U.S.C. § 78o-7(c)(2).
\item[118.] In its entirety, the preemption provision reads as follows:

\textbf{LIMITATION.—}The rules and regulations that the [SEC] may prescribe pursuant to [this Act], as they apply to nationally recognized statistical rating organizations, shall be narrowly tailored to meet the requirements of this title applicable to nationally recognized statistical rating organizations. Notwithstanding any other provision of law, neither the SEC nor any State (or political subdivision thereof) may regulate the substance of credit ratings or the procedures and methodologies by which any nationally recognized statistical rating organization determines credit ratings.

\textit{Id.}
\end{enumerate}
\end{footnotesize}
A plain reading of the preemption provision indicates that Congress meant to limit both federal and state authority to regulate rating agencies. The scope of this preemption ultimately hinges on the meaning of “regulate” as the term is used in the Act.120

“Regulate” is not defined in the 2006 Act. Therefore, it is not immediately clear whether Congress meant “regulate” to mean only affirmative, explicit regulation of ratings substance or methodology or, conversely, whether Congress intended to prevent states from conferring private causes of action aimed at allegedly inaccurate ratings. Both Supreme Court jurisprudence and the ordinary meaning of “regulate” point toward construing that word to include private causes of action.

The Supreme Court has said that providing remedies to private litigants is a “potent method” of regulating conduct.121 The Court’s view resonates with the ordinary meaning of “regulate”: Black’s Law Dictionary defines “regulation” as “the act or process of controlling by rule or restriction.”122 Because a judicial ruling usually controls and restricts the behavior of parties involved in litigation,123 the 2006 Act can plausibly be read to prohibit private rights of action against rating agencies if re-

119. See, e.g., N.Y. State Conference of Blue Cross & Blue Shield Plans v. Travelers Ins. Co., 514 U.S. 645, 655 (1995) (“Since pre-emption claims turn on Congress’s intent, we begin as we do in any exercise of statutory construction with the text of the provision in question, and move on, as need be, to the structure and purpose of the Act in which it occurs.” (citation omitted)).

120. See Kettering, supra note 17, at 1688–89.


122. BLACK’S LAW DICTIONARY 1311 (8th ed. 2004); see, e.g., Noe v. Henderson, 456 F.3d 868, 870 (8th Cir. 2006) (adopting the Black’s Law Dictionary definition of “regulation”); In re Katrina Canal Breaches Consol. Litig., No. 05-4182, slip op. at 5 (E.D. La. Jan. 26, 2009) (adopting the Black’s Law Dictionary definition of “regulation” and holding that “[t]he application of state law negligence principles to assess and evaluate the suitability of the design and construction of a railroad crossing, railroad tracks, and roadbed for railroad tracks qualifies as an attempt at state law ‘regulation’ in respect to rail transportation”); In re Bankr. Estate of Midland Euro Exch. Inc., 347 B.R. 708, 716 (Bankr. C.D. Cal. 2006) (adopting the Black’s definition and inferring that “regulated conduct” is . . . controlled by either judicial or administrative rule or restriction”).

123. See, e.g., In re Enron Corp. Sec., Derivative & ERISA Litig., No. MDL-1446, 2007 WL 1662658, at *4 (S.D. Tex. June 5, 2007) (“Imposing [liability for negligence against the rating agencies] would . . . chill the agencies from vital and vigorous participation in the rating process and the marketplace, where the free flow of information and conflicting views ideally establish reliability.”).
resulting judgments have the effect of regulating (i.e., controlling or restricting) ratings substance or methodology.

Subprime plaintiff-investors may assert that express preemption analysis initially presumes that Congress did not intend to preempt state law absent "clear and manifest" language to the contrary.\footnote{124} This presumption, however, loses strength when legislation addresses a matter under federal control.\footnote{125} Indeed, the current Supreme Court tends to read express preemption provisions broadly, especially when legislation addresses a significant national interest.\footnote{126} Because the term "regulate" is not defined in the 2006 Act, and it is unclear whether Supreme Court jurisprudence requires a presumption in favor of or against preemption, one must go beyond the text of the 2006 Act to construe its preemptive effect.

Supreme Court jurisprudence dictates that one should look to the purpose and structure of legislation to determine the extent of an express preemption provision when the text is inconclusive.\footnote{127} Courts often look to legislative history to determine the purpose of legislation.\footnote{128} Unfortunately, the legislative history focusing on the preemption provision of the 2006 Act is scarce and unhelpful.\footnote{129}

Despite the lack of legislative history focusing narrowly on the preemption provision, existing legislative history surrounding the 2006 Act as a whole indicates that Congress determined regulating the substance or methodology of credit ratings would not improve ratings quality. The stated purpose of the 2006 Act

\footnote{124} Bates v. Dow Agrosciences LLC, 544 U.S. 431, 449 (2005) ("In areas of traditional state regulation, we assume that a federal statute has not supplanted state law unless Congress has made such an intention 'clear and manifest.'" (internal citations omitted)).

\footnote{125} See United States v. Locke, 529 U.S. 89, 108 (2000) ("[A]n 'assumption' of nonpre-emption is not triggered when the State regulates in an area where there has been a history of significant federal presence.").


\footnote{129} See Kettering, supra note 17, at 1688 n.447 ("Legislative commentary on [the preemption provision] appears to consist of one brief vague paragraph in the floor debates that contains no interpretative grist.").
is "[t]o improve ratings quality for the protection of investors and in the public interest by fostering accountability, transparency, and competition in the credit rating industry." The only significant congressional report accompanying the 2006 Act declared that rating agencies "have been criticized by a broad array of interested parties . . . [for] ratings that significantly lag the markets." Congress chose not to address these criticisms by directly regulating the substance and methodology of ratings. Instead, the 2006 Act addresses its primary goal of "improv[ing] ratings quality" by compelling rating agencies to disclose rating methodologies and conflicts of interest (accountability and transparency) and clarifying and simplifying the process through which a new rating agency can become registered as an NRSRO (transparency and increased competition). Apparently to cement its decision to avoid directly regulating ratings, Congress attached the preemption provision, which specifically forbids both states and the federal government from regulating ratings substance or methodology.

The structure of the 2006 Act further supports a reading of the preemption provision that would preclude private rights of action in all but a narrow set of circumstances. A provision subsequent to the preemption clause clarifies that "[n]othing in [this Act] may be construed as creating any private right of action against rating agencies registered as NRSROs under the Act." A later provision mandates that "[n]o provision of the laws of any State or political subdivision thereof requiring the registration, licensing, or qualification as a credit rating agency of a nationally recognized statistical rating organization shall apply to any nationally recognized statistical rating organization." The Act clarifies this last provision by stating that "[n]othing in this subsection prohibits the securities commission . . . of any State from investigating and bringing an enforcement action with respect to fraud or deceit against any nationally recognized statistical rating organization." These additional provisions, read together with the express preemption

133. Id. § 78o-7(c)(2).
134. Id. § 78o-7(m)(2).
135. Id. § 78o-7(o)(1).
136. Id. § 78o-7(o)(2) (emphasis added).
provision, create a strong inference that Congress meant to limit litigation involving rating agencies to suits brought by public agencies to prosecute fraud. Congress easily could have included language permitting a wider variety of claims against rating agencies, making the interpretive canon of *expressio unius est exclusio alterius* appropriate here.

The scope of the 2006 Act's preemption provision has not been fully litigated and has been raised in only one known case. Ultimately, reasonable minds can differ in assessing the Act's intended preemptive scope. A dearth of legislative history surrounding the Act's preemption provision adds uncertainty to the inquiry. Normally, courts construe preemption provisions narrowly, but this presumption applies with less force when a distinctly national interest is at stake. Presumptions aside, the purpose and structure of the 2006 Act indicate a likelihood that Congress intended to preempt all claims against rating agencies registered as NRSROs except enforcement actions brought by regulatory agencies on theories of rating agency fraud or deceit. The next section argues that, because ratings quality is a matter of important national concern, the correct presumption is the one favoring preemption.

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137. "[T]o express or include one thing implies the exclusion of the other, or of the alternative." BLACK'S LAW DICTIONARY 620 (8th ed. 2004). Congress specifically allowed suits based on fraud or deceit, creating the inference that if Congress had wanted to allow suits based on something else, such as negligence, it would have.


139. See Kettering, supra note 17, at 1688–89 (acknowledging the merit of opposite interpretations on whether the Act's preemptive scope extends to tort law for allegedly inaccurate ratings).

140. See id.

141. Compare N.Y. State Conference of Blue Cross & Blue Shield Plans v. Travelers Ins. Co., 514 U.S. 645, 654–55 (1995) ("[W]e have addressed claims of pre-emption with the starting presumption that Congress does not intend to supplant state law."); with United States v. Locke, 529 U.S. 89, 108 (2000) (explaining that when a national interest is at stake, there is no presumption that the "concurrent regulation by the State is a valid exercise of its police powers").

B. CONSIDERATIONS FAVORING THE TREATMENT OF RATINGS QUALITY AS A MATTER OF NATIONAL INTEREST

Despite the frequent incorporation of NRSRO ratings into SEC regulations since the 1970s, neither Congress nor the SEC has ever regulated rating agency methodologies. Even in the context of the Enron collapse, Congress chose not to give the SEC the authority to regulate the substance or methodologies of ratings. This trend arguably represents a collective judgment made by Congress and the SEC that the goal of promoting ratings quality is best served by the federal government remaining neutral as to the substance and methodologies behind credit ratings. Whether this longstanding federal policy of neutrality toward rating methodologies requires courts to abandon the normal presumption against preemption of state law depends on whether one characterizes the goal of ratings quality as a decidedly national interest.

Practical considerations counsel in favor of viewing the goal of improved ratings quality as a matter of national interest for the purposes of preemption analysis. If the goal of regulating nationally recognized statistical rating organizations is to promote ratings quality, and part of ratings quality is ratings uniformity across jurisdictions, the 2006 Act should be viewed as addressing a national interest. Faced with the threat of liability, rating agencies may alter ratings substance or methodologies; therefore, lawsuits based on state law may “regulate” the substance of credit ratings just as effectively as agency-enforced state securities regulations.

To illustrate, assume that rating agencies can be held liable under Ohio’s “in any way” standard for their alleged

143. U.S. SEC. & EXCH. COMM’N, supra note 13, at 5.
144. Cf. id. at 9–10 (detailing the SEC’s criteria for determining which agencies deserve NRSRO status and including in this list no factor requiring particular methodologies).
146. For an explanation of why regulating the substance and methodologies behind credit ratings is best left to the rating agencies themselves, see generally Schwarz, supra note 79.
150. OHIO REV. CODE ANN. § 1707.43(A) (LexisNexis 2009); see also Federated Mgmt. Co. v. Coopers & Lybrand, 738 N.E.2d 842, 861 (Ohio Ct. App. 2000) (“[T]he language [in § 1707.43] is very broad, and participating in the
complicity in helping issuers make false or misleading statements in offering materials. Assume also, as some have, that rating agencies could have implemented a model as early as 2002 to capture the true risk of subprime mortgage-backed investments, but failed to do so. 151 At least some juries—probably many—would find the rating agencies liable under Ohio's standard and similar state securities laws. Investors in subprime mortgage-backed products have lost billions of dollars. 152 If rating agencies can be held liable for these losses under theories other than fraud, rating agencies likely would alter their methodologies to avoid future liability, a result that amounts to functional regulation of ratings substance and methodology. 153

The 2006 Act is an effort to improve ratings quality and rating industry accountability by increasing competition and by compelling rating agencies to disclose information regarding conflicts of interest and rating methodologies. 154 The Act contains explicit language indicating that Congress chose not to address ratings quality through regulation aimed directly at ratings substance or methodology. 155 Substantial rating agency liability through private regulation would disrupt the balance struck by Congress. Thus, the goal of improving ratings quality is best viewed as a matter of national interest sufficient to defeat the normal presumption 156 against preemption of state law. Therefore, courts should find as a matter of law that the 2006 Act preempts state claims against the rating agencies. In

sale or aiding the seller in any way is sufficient to form a basis for liability . . . .

151. See Lowenstein, supra note 16 (noting that Moody's first introduced a revised model to evaluate subprime mortgages in 2002).
152. See Tomlinson & Evans, supra note 67 (noting the value of collateralized debt obligation holdings declined in value between $18 billion and $25 billion due to a lack of repayment by subprime mortgage holders).
153. Cf. In re Enron, 2007 WL 1662658, at *4 (arguing that imposing liability against rating agencies for negligence would "chill the agencies from vital and vigorous participation in the ratings process . . . where the free flow of information and conflicting views ideally establish reliability").
156. See, e.g., Bates v. Dow Agrosciences LLC, 544 U.S. 431, 449 (2005) (affirming the traditional assumption that a federal statute does not supplant state law unless Congress has expressed the "clear and manifest" intention to do so).
light of this analysis, Part III suggests that preemption of state claims against the rating agencies is normatively desirable.

III. CONGRESS SHOULD STRENGTHEN THE PREEMPTION PROVISION OF THE 2006 ACT

Thus far, this Note has argued that existing federal law likely preempts most state law claims against rating agencies without taking a position on whether federal law should preempt these claims. This Part argues in favor of federal preemption of state law claims against rating agencies, such as CalPERS's common law negligent misrepresentation claim. Substantial liability for rating agencies stemming from the subprime mortgage meltdown would incentivize the agencies to begin underrating securities, a costly result. Conceding that the preemption provision of the 2006 Act is less than perfectly clear, this Part proposes that Congress amend the 2006 Act to leave no doubt that private state law claims against rating agencies are preempted.

A. THE CASE FOR PREEMPTION OF STATE LAW CLAIMS AGAINST RATING AGENCIES

Reliable, accurate ratings promote market efficiency by providing securities information to investors in a cost-effective manner. Ratings save investors from having to independently assess the risk of every security they may wish to purchase, an alternative that would be costly both to individual investors and the entire financial system. In short, ratings reduce transaction costs by substituting the need for each investor to do her own risk analysis of a security by performing the same task once and making the results of this analysis available as a public good.

As demonstrated by the Enron and subprime mortgage crises, ratings are not guarantees that a particular security will

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157. See Steven L. Schwarcz, Protecting Financial Markets: Lessons from the Subprime Mortgage Meltdown, 93 MINN. L. REV. 373, 403–04 (2008) ("One might argue that rating agencies should be more conservative, or that government should mandate more conservative ratings, but overprotection itself has a cost.").
158. See Rhodes, supra note 12, at 294.
159. Id.
160. Id.
Conflicts of interest inherent to the rating agencies' business model may have contributed to inflated ratings that worked against the goal of reducing information asymmetry. Many subprime investors, relying to some extent on the accuracy of ratings, collectively lost billions as a result.

The forward-looking issue is what, if anything, Congress should do to respond to these failures. Various proposals currently before Congress would tweak the federal regime for regulating the rating agencies by mandating greater disclosure of rating methodologies, decreasing regulatory reliance on NRSRO ratings, attempting to alter the issuer-pays model, or expressly creating federal private rights of action through which damaged investors could seek redress. None of these proposals address the potential effect of state law-based litigation on federal efforts to optimize ratings quality.

To develop a coherent regime for regulating the rating agencies, Congress should evaluate the likely effect of claims based on state law. The CalPERS suit sends a strong signal to Congress that any national regime for regulating the rating agencies will be incomplete unless it expressly deals with state law claims. CalPERS is a sophisticated, major investor with over two-hundred billion dollars in assets. Accordingly, the influence of the CalPERS suit against the rating agencies, if successful, could be significant. Furthermore, in the current atmosphere of public anger over the financial crisis, a jury might be predisposed to side with CalPERS, especially since CalPERS provides pension benefits to more than 1.6 million re-

161. See U.S. SEC. & EXCH. COMM’N, supra note 13, at 16 (describing the rating agencies' failure to downgrade Enron's debt until four days before the firm declared bankruptcy).

162. See id. at 40–41 ("The practice of issuers paying for their own ratings creates the potential for a conflict of interest.").

163. See CDOh No!, supra note 19 (noting that banks that underwrote mortgage-backed securities admitted to more than $30 billion in losses).


165. See CalPERS at a Glance, supra note 2 (describing how CalPERS has an investment portfolio of $203 billion in stocks, bonds, real estate, private equity, commodities, and infrastructure investments).

166. See Lifsher & Hirsch, supra note 5 (stating that "markets are paying attention" to the CalPERS lawsuit and quoting a financial analyst who said that CalPERS is "a 600-pound gorilla").
tired California government employees.\textsuperscript{167} Holding the rating agencies accountable for their failure to accurately assess the risk of subprime mortgage-backed securities may comport with notions of fairness and justice, especially when government retirees number among the victims of these failings. However, to improve ratings quality over the long term, Congress should assess whether state liability of this kind is normatively desirable despite its current appeal.

The key question is whether Congress should allow plaintiff-investors to assert state law claims against rating agencies.\textsuperscript{168} Observations regarding the relative superiority of market forces over litigation as a means to altering rating agency conduct provide guidance. Although liability for poorly performing ratings methodology may appease aggrieved investors in the short term, it is unlikely to perform better than the market itself at correcting the failures of the rating agencies.\textsuperscript{169} Of course, this view is not universally accepted,\textsuperscript{170} but the way that events have progressed since the subprime market collapsed strongly supports it.

Once the market learned that the rating agencies assigned overly high ratings to subprime mortgage-backed securities, the agencies suffered immediate economic consequences.\textsuperscript{171} The value of McGraw Hill's stock,\textsuperscript{172} which rose tremendously during the subprime boom, fell so much after the collapse of the subprime mortgage-backed securities market that a major shareholder class action suit was filed against the company for

\textsuperscript{167} See CalPERS at a Glance, supra note 2 ("The California Public Employees' Retirement System is the largest public pension fund in the nation. Based in Sacramento, the fund—known as CalPERS—provides retirement benefits for 1.6 million active and inactive state and local government workers, retirees and their families."); Lifsher & Hirsch, supra note 5 ("CalPERS' chances of collecting any money would improve if it could get the case to a jury trial. . . .").

\textsuperscript{168} Cf. Schwarcz, supra note 79, at 11 ("[I]mproving efficiency should be the rationale for regulating rating agencies.").

\textsuperscript{169} Cf. id. at 13–14 (arguing that increased regulation of rating agencies is unlikely to do better than market forces at improving the reliability of ratings).

\textsuperscript{170} See, e.g., Kettering, supra note 17.


\textsuperscript{172} McGraw Hill is the parent company of Standard & Poor's, one of the three largest rating agencies. See id.
failure to inform shareholders that Standard & Poor's, the rating agency owned by McGraw Hill, routinely issued excessively high ratings. The complaint alleges, essentially, that McGraw Hill should have known and disclosed that its stock price would plummet once the market learned that ratings for mortgage-backed products were flawed. This suit illustrates the market's immediate condemnation of the rating industry for overrating mortgage-backed products.

By contrast, the SEC has instituted only modest new regulation of the rating industry since the implosion of subprime mortgage-backed securities. Congress held hearings and is considering various proposals, but has not taken any definitive action. Private, investor-led litigation is only now beginning to ramp up. Contrasted with the immediate reputational hit that the rating agencies took in 2007, the protracted nature of litigation likely means that the rating agencies will not feel the effect of any substantial liability for years. If the rating agencies do significantly alter their ratings practices in the short term as a result of the subprime mortgage crisis, it seems evident that such a response would be stimulated primarily by the market's condemnation of their failings—a threat to their reputational capital.

In the long term, state law-based investor suits against rating agencies, if widely successful, would undercut federal ef-

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174. See id. at 40–41 (alleging that investors would not have purchased McGraw Hill stocks at the prices they paid, or at all, if they knew the market prices had been artificially inflated).


177. See Schwarcz, supra note 79, at 14 (describing the reputational capital concept).
forts to enact a coherent, national scheme for regulating rating agencies and could result in lower quality ratings.\textsuperscript{178} Faced with liability risks that vary across jurisdictions, rating agencies would have the incentive to underrate securities, a result which itself would hurt ratings quality.\textsuperscript{179} The greater the risk of liability, the more likely agencies are to issue ratings that overestimate the risk of loss for rated securities. Since riskier securities typically pay a higher interest rate to investors, financial institutions would find it more difficult to profit by issuing securities.\textsuperscript{180} Consequently, the entire financial market could suffer, rather than improve. Taken to extremes, financial institutions would become less likely to invest in mortgages and other types of receivables, promoting illiquidity and making credit superficially expensive and difficult to obtain.\textsuperscript{181}

Allowing rating agency liability to investors based on state law is unlikely to improve market efficiency. In fact, there is good reason to believe that such a development would have the opposite effect. To avoid this undesirable result, Congress should act decisively to preempt state law claims against rating agencies. The final section of this Note suggests how Congress can amend the 2006 Act to make state law claims unavailable to aggrieved investors.

B. A SUGGESTION FOR CLARIFYING THE 2006 ACT'S PREEMPTION PROVISION

Part II explained how the 2006 Act likely preempts most state and federal claims against rating agencies. Nonetheless, no court has construed the Act's preemption provision.\textsuperscript{182} Ultimately, the final section of this Note suggests how Congress can amend the 2006 Act to make state law claims unavailable to aggrieved investors.

\textsuperscript{178} See Bo Becker & Todd Milbourn, Reputation and Competition: Evidence from the Credit Rating Industry 11 (Harv. Bus. School, Working Paper No. 09-051, 2009) ("Lower quality ratings mean that ratings will reflect things other than expected repayment, and ratings levels will thus be less correlated with bond yields.").

\textsuperscript{179} See id.

\textsuperscript{180} See Lowenstein, supra note 16, at 40 (noting that the lower rated securities command higher interest rates).

\textsuperscript{181} Cf. Schwarz, supra note 79, at 11 ("[I]f rating agency regulation was based on factors other than economic efficiency, ratings would . . . reflect those other factors. Investors, who typically look for the highest economic return for a given level of safety, then would be misled, undermining their confidence in the rating system and their willingness to invest in rated securities.").

\textsuperscript{182} See In re Nat'l Century Fin. Enters., Inc., 580 F. Supp. 2d 630, 651 (S.D. Ohio 2008) (refusing to dismiss plaintiff's claims against the rating agencies on the grounds that the 2006 Act preempts state blue sky laws because the issue had not been sufficiently briefed).
mately, despite Congress’s probable intent to preempt state law claims, this provision may be construed to afford no protection to rating agencies facing claims based on, for example, Ohio securities law with its low “in any way” standard or California common law.183

The *In re National Century Financial Enterprises* plaintiffs present two arguments against a broad reading of the 2006 Act’s express preemption provision.184 First, the *National Century* plaintiffs argue that the 2006 Act’s silence on the issue of private claims against rating agencies is “proof that Congress did not intend to pre-empt... private claims.”185 Second, the 2006 Act “has nothing to do with the powers of individual or private investors, only those of the state.”186 This second argument contends that, because the 2006 Act focuses on new powers given to the SEC to oversee the registration of NRSROs and says nothing about the rights of individual consumers of credit ratings, the preemption provision is properly construed as a limitation on state securities regulators, but not private individuals. As the *National Century* plaintiffs’ arguments point out, the 2006 Act’s preemption provision is ambiguous enough to create room for disagreement about its scope.

If Congress agrees that increased state law liability would work against improved ratings quality, it should clarify the 2006 Act’s express preemption provision in response to the arguments raised by the *National Century* plaintiffs. Congress is quite capable of drafting clearer preemption provisions than the one found in the 2006 Act.187 To this end, Congress should recast

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183. OHIO REV. CODE ANN. § 1707.43(A) (LexisNexis 2009).
185. *Id.* at 9.
186. *Id.* at 10.
187. One wholly unrelated but instructive example of a clear express preemption provision reads as follows:

   No requirement of any State or territory of the United States, or any subdivision thereof, or the District of Columbia, with respect to bonding of packers or prompt payment by packers for livestock purchases may be enforced upon any packer operating in compliance with the bonding provisions ... of this title, and prompt payment provisions ... of this title, respectively: Provided, That this section shall not preclude a State from enforcing a requirement, with respect to payment for livestock purchased by a packer at a stockyard subject to this chapter, which is not in conflict with this chapter or regulations thereunder.

the express preemption provision of the 2006 Act to read as follows:

Notwithstanding any other provision of law, no legislative, executive, or judicial act of the United States, or of any individual State (or political subdivision thereof), including judicial action taken pursuant to private litigation, that has the purpose or effect of regulating the substance of credit ratings or the procedures and methodologies by which any nationally recognized statistical rating organization determines credit ratings may be enforced against any nationally recognized statistical rating organization acting in compliance with the provisions of this Act. Provided that nothing in this section shall be construed to prohibit the securities commission of any State from investigating and bringing an enforcement action with respect to fraud or deceit against any nationally recognized statistical rating organization or person associated with a nationally recognized statistical rating organization.¹⁸⁸

This model offers at least four advantages over the existing provision. First, judicial acts affecting ratings substance or methodology are clearly preempted, foreclosing the question of whether judgments entered pursuant to private litigation fall within the provision. Second, the proviso to the preemption provision, which excludes state securities agency fraud or deceit actions, appears immediately after the preemption provision. In the current Act, the fraud or deceit exception appears much later in the Act.¹⁸⁹ Third, by adding the language “purpose or effect” to the prohibition against regulating ratings substance or methodology, the model clarifies that preemption extends to any government action that affects ratings quality. Finally, by inserting “including judicial action taken pursuant to private litigation,” the model clarifies that the Act’s preemptive reach extends to state law claims.

Adopting the above model would complement whatever new measures Congress adopts for regulating the rating industry. Even if Congress decides that rating agencies should face an increased threat of liability, the contours of a liability regime should be determined at the federal level. For federal regulation of the rating agencies to be coherent and comprehensive, Congress should close the door on state law claims. During this time of heightened frustration with the rating agencies, Congress should remain focused on improving ratings quality. Over the long term, the goal of ratings quality is better

¹⁸⁹. See id. § 78o-7(c)(2), (o)(2).
advanced in an environment where agencies do not face the uncertain threat of liability from varying state regimes.

CONCLUSION

In the midst of the current financial crisis, it is understandable that aggrieved investors want to hold the rating agencies liable for losses. The major rating agencies have all but admitted that they failed to accurately apprise investors of the risks attendant to subprime mortgage-backed financial products. Investors collectively have lost billions of dollars, partly as a result of overly optimistic ratings for these products. Many of these investors, and the political figures charged with representing their interests, want to avoid a repeat of this crisis. As a means to this end, the prospect of expanded rating agency liability seems appealing. Ultimately, subjecting rating agencies to liability exposure that varies across jurisdictions would be detrimental to the goal of improved ratings quality. Perhaps counterintuitively, the best approach to rating agency liability in the wake of the subprime mortgage meltdown is to strengthen existing federal law to decisively preempt state law claims against rating agencies. Any national regime for regulating the rating industry will be incomplete unless it accounts for state law claims.