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COPY for
Jean-Claude Trichet
European Central Bank

Policy & Enforcement Brief

To: Director of Enforcement -
Eurozone Antitrust and Securities Commissions

Re: Wrongful Actions of the Credit Rating Agencies:

1. SEC Enforcement Failure; Distortion of True Credit Risk; and Propagation of Credit Market Contagion:
 - a) Actions Evidencing Application of Reckless Standard of Care;
 - b) Intentional Violations of Published Metrics and Criteria;
 - c) Intentional Violations of the Investment Advisers Act; and
 - d) Intentional Violations of SEC Published NRSRO Standards.
2. Need for Legislative Remedy & Regulatory Enforcement Action.

Date: October 16, 2007

- Documents:**
1. **Letter to EU Commissioners**
Neelie Kroes and Charlie McCreevy
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October 2, 2007

Honorable Neelie Kroes, European Commissioner for Competition
Honorable Charlie McCreevy, European Commissioner for Internal Market and Services
European Commission
B-1049 Brussels, BELGIUM

Re: Wrongful Actions of the Credit Rating Agencies:

1. SEC Enforcement Failure; Distortion of True Credit Risk; and Propagation of Credit Market Contagion:
 - e) Actions Evidencing the Application of a Reckless Standard of Care;
 - f) Intentional Violations of Published Metrics and Criteria;
 - g) Intentional Violations of the Investment Advisers Act; and
 - h) Intentional Violations of SEC Published NRSRO Standards.
2. Need for Regulatory or Legislative Remedy.

Dear Commissioner Kroes and Commissioner McCreevy:

We respectfully write to your attention in regard to a very serious matter directly pertinent to your position as European Commissioners. We refer to the catastrophic consequences resulting from the egregious abandonment of an appropriate standard of care by the three most prominent nationally recognized statistical rating organizations (“NRSROs”) in pursuit of ever greater issuer-compensated ratings revenue. The failure to regulate the wrongful practices engaged in by Standard & Poor’s, Moody’s Investors Service and Fitch Ratings is directly responsible for causing unprecedented and potentially irreparable damage to the integrity of the U.S. capital markets. The SEC has proven itself complicit in actively encouraging such practices through its adoption of a “zero accountability” policy, implicitly endorsing the continuation of the fraudulent practices engaged in by the three primary NRSROs. In this regard, it is noteworthy that in mid-2005 the SEC refused to investigate such wrongful practices despite a request by the Hon. Jim Saxton, then-Chairman of the Joint Economic Committee of the U.S. Congress (<http://www.globalsecuritieswatch.org/investigation.pdf>).

§1.0 Recurrent Theme: Inflated Ratings Profit the Agencies and Injure Investors

Although the SEC defines the term “NRSRO” as an entity that “uses systematic procedures designed to ensure credible and reliable ratings”, the ratings assigned by the three most prominent NRSROs are neither credible nor reliable as evidenced by the numerous “after the fact” credit events which have occurred over the past few decades (please see Exhibit 1.0 for a summary of several of the major such incidents). Invariably, in the immediate aftermath of a serious credit implosion and resultant market contagion, the credit rating agencies claim that they were deceived by management or that they are just publishing editorial opinions that either should not be relied upon or are protected by the “free speech” provisions afforded by the first amendment. The agencies and, thus far at least, various regulators, conveniently ignore the fact that the credit ratings assigned by the largest NRSROs are empowered with the force of law due to the duopoly franchise enjoyed by Standard and Poor’s and Moody’s Investors Service in conjunction with extensive regulatory and prudential codification of their rating classifications by both the public and private sectors (see, e.g., private pension plan administrative standards, municipal retirement systems policies, and federal banking regulations governing permissible activities of insured depository institutions including investment portfolio allocation criteria). In any event, such arguments fail abjectly in the instance involving the false and artificial sovereign credit rating assigned to the government of China, which has been the subject of explicit notice provided to the NRSROs on numerous occasions throughout the past several years. In regard to the “free speech” claim, we note that the first amendment does not protect actions which are intentional, injurious, and in the instance of China, knowingly false. The wrongful actions of the three primary NRSROs are best explained by their revenue model, which creates an endemic conflict of interest as the credit rating agencies seek to maximize issuer fees. This conflicted model is described at length in the excellent investigative series published as a three-part serial installment by the Washington Post (http://www.globalsecuritieswatch.org/Wrongful_Actions_of_the_International_Credit_Ratings_Agencies) . The NRSROs’ thirst for ever increasing profits is unmasked in China’s instance by the assignment of a phony sovereign credit rating designed to establish an artificial “investment grade” sovereign benchmark which conceals the Chinese government’s defaulted sovereign debt, thereby opening the door to large-scale international debt financing by the many thousands of Chinese corporations and providing the NRSROs with a commensurate windfall in ratings revenue. This motivation is revealed as the proximate driver for the assignment of a false sovereign credit rating which conceals the defaulted sovereign debt of the government of China, and which debt is the repayment obligation of the communist Chinese government which refuses repayment in violation of international law and is able to do so in reliance upon its artificial credit rating.

Exhibit 1.0
Recurrent Theme: Credit Raters' Pattern of Deception¹

2007	Misstated the risk and misled investors re: U.S. sub-prime mortgage meltdown
2002	Misstated the risk and misled investors re: Worldcom collapse
2001	Misstated the risk and misled investors re: Enron collapse
1997	Misstated the risk and misled investors re: Asian debt crisis, including the governments of Thailand and Korea
1994	Misstated the risk and misled investors re: Orange County debt crisis
1992-present	Continue to misstate the risk and mislead investors re: true sovereign credit risk of the Chinese government and its state-owned enterprises by concealing the action of selective default (e.g., the prevailing false rating classifications ignore the "willingness" metric as applied to the Chinese government's evasion of its repayment obligation of its defaulted sovereign debt and its practice of making preferential and discriminatory payments to selected creditors)
1983	Misstated the risk and misled investors re: Washington State Public Power Supply System default
1975	Misstated the risk and misled investors re: New York City financial crisis
1970	Misstated the risk and misled investors re: Penn Central debt default

Despite their published claim that they rate a government's *willingness* to pay its sovereign obligations, the three primary NRSROs continue to maintain an artificial "investment grade" credit rating classification for China and have actually upgraded China's rating six times since disclosure of the Chinese government's refusal to honor repayment of its defaulted sovereign debt was communicated to each of the primary rating agencies in 2002 and previous to that, extensive publication in June 2001 concerning the formation of the American Bondholders Foundation (the "ABF") to represent defaulted U.S. creditors. In fact, we observe that S&P affirmed China's "investment grade" credit rating the very next day (October 22, 2003) following the

¹ Primary source: Article entitled, "Unchecked Power", *Washington Post* (November 22, 2004); article entitled, "Shaping the Wealth of Nations", *Washington Post* (November 23, 2004); article entitled, "Flexing Business Muscle", *Washington Post* (November 24, 2004).

Congressional hearing on the ABF, in order to improve the prospects for the sale of China's sovereign bonds and notes registered in both Europe and the U.S. the same month. It is revealing to note that China reportedly denied seeking a credit rating in 1988, after which it bought and paid for a rating from S&P which concealed China's defaulted sovereign debt (http://www.globalsecuritieswatch.org/China_Denies_Seeking_Sovereign_Credit_Rating). Beyond actively assisting a government in default on its national debt in evading repayment, the wrongful actions of the NRSROs including the deliberate assignment, maintenance, and periodic upgrading of false, artificial and disingenuous sovereign credit ratings of a government in default (and which ratings do not conform to their published definitions) have acted to distort the credit risk endemic to investment in Chinese government securities by banks and pension funds and project yet another concealed risk upon the investing public.

§2.0 Dangerous Focus on Creating Marketable Products for Investor Consumption

As evidenced by the facts, the root cause of ratings inflation and the recurring cyclical credit contagions is the predilection of the agencies for creating marketable investment products which are highly saleable by the prime brokerage community and targeting institutional and retail investor consumption to the enormous profitable benefit of the rating agencies. Such penchant is evocative of the often articulated industry maxim, "brokers are selling machines when backed by agency ratings". In this regard, see also the recent Wall Street Journal article entitled, "Credit and Blame: How Rating Firms' Calls Fueled Subprime Mess --- Benign View of Loans Helped Create Bonds, Led to More Lending" (August 15, 2007) which truthfully states "Underwriters don't just assemble a security out of home loans and ship it off to the credit raters to see what grade it gets. Instead, they work with rating companies while designing a mortgage bond or other security, *making sure it gets high-enough ratings to be marketable*. The result of the rating firms' collaboration and generally benign ratings of securities based on subprime mortgages was that more got marketed." The article further states, "The subprime market has been lucrative for the credit-rating firms. Moreover, through their collaboration with underwriters, the rating companies can actually influence how many such securities get created." According to this same article, Moody's Investors Service admitted to taking in "around \$3 billion" over a four year period just from rating securities built from loans and other debt pools. This amount accounted for less than half of the revenue Moody's earned during this period from rating debt securities. A former Moody's managing director is quoted as stating that, "It was always about shopping around" for higher ratings, although Wall Street and mortgage firms "called the process by other names, like 'best execution' or 'maximizing value'". Ohio Attorney General Marc Dann contends that the rating firms had much to gain by issuing investment-grade

ratings, and is quoted as stating the opinion that the rating agencies have a “symbiotic relationship” with issuers of securities. Mr. Dann’s office is presently investigating the agencies’ practices. The propensity of the rating agencies for adjusting ratings as a marketing consideration is also described, enumerating several specific incidents, in our letter to Mr. David Walker, Comptroller General of the United States, Government Accountability Office (http://www.globalsecuritieswatch.org/GAO_LETTER.pdf). It is unfortunate for participants in the credit markets that the propagation of such unrestrained business practices, coupled with and empowered by the NRSROs’ duopoly franchise and the enforcement failure by the SEC, virtually ensures (in the absence of remedial legislation) the continuation of market debacles on a scale of magnitude similar to the instances comprising Exhibit 1.0.

§3.0 As Registrants Under the Advisers Act (Registered Investment Advisers), the Three Primary NRSROs are Prohibited from Engaging in Fraudulent, Deceptive or Manipulative Business Practices Yet Continue to do so with Impunity

The Advisers Act, under which the three primary NRSROs are registered, prohibits registrants from engaging in unethical business practices including engaging in any act, practice, or course of business which is fraudulent, deceptive or manipulative.² Accordingly, the three primary NRSROs are restrained from applying a reckless standard of care in developing their rating classifications. The rating definitions, as published by the NRSROs themselves, state that such ratings are an evaluation of the rated entity’s willingness and ability to pay financial obligations (http://www.globalsecuritieswatch.org/S&P_Sovereign_Ratings_Methodology). As evidenced by an examination of the factual record in the instance of China, the prevailing rating classifications assigned to the Chinese government by the three primary NRSROs do not conform to their published definitions and so do not meet the required standard and, in the face of constructive notice, evidence foreknowledge of falsity and the application of a reckless standard of care by the NRSROs. The Advisers Act explicitly requires the SEC to investigate allegations of wrongdoing and impose penalties upon registrants whose wrongful actions “directly or indirectly result in substantial losses or create a significant risk of substantial losses to other persons” (Section 209 “Enforcement of Title”). We have prepared a concise summary of the wrongful actions of the three primary credit rating agencies, up to and including the specification of fraud (http://www.globalsecuritieswatch.org/Wrongful_Actions_of_the_International_Credit_Ratings_Agencies). Because their ratings are imbued with the force of law as a function of their NRSRO designation, and the fact that the three primary rating agencies are each Registered Investment Advisers and are therefore subject to the provisions of the

² Investment Advisers Act of 1940, as amended. See specifically Section 206 and Section 209.

Advisers Act, and in consideration of the extensive prudential and regulatory codification of investment policies referencing the rating classifications assigned by the three largest NRSROs and the pervasive influence of their rating classifications, we are concerned regarding the lax enforcement posture adopted by the SEC and particularly the failure of the SEC to enforce the provisions of the Advisers Act as such provisions pertain to the wrongful actions and conflicted business practices engaged in by the three primary NRSROs.

§4.0 Example: Primary NRSROs Continue to Assign China an Artificial Sovereign Benchmark Rating Even as the Chinese Government Continues to Engage in *both Selective Default and Discriminatory Settlement* of Defaulted Sovereign Debt

The three largest NRSROs continue to assign artificial sovereign credit ratings to China despite the Chinese government's continuing practices of both selective default and discriminatory settlement. Exhibit 4.0 presents a comparison of the prevailing artificial sovereign credit rating classifications assigned to China with the appropriate rating classifications as determined by the published definitions contrasted with the factual evidence (i.e., the actions of the Communist Chinese government with respect to evasion of repayment of its defaulted sovereign debt, e.g., the Chinese government's 1960 bond which remains unpaid and in a state of default, and which bond certificates explicitly state that the obligations are intended to be binding upon the government of China and any successor government). The full complement of actions by the Chinese government which are concealed by the prevailing ratings include repudiation of the debt; selective default; rejection of the successor government doctrine of settled international law; discriminatory settlement with Great Britain; and the practice of preferential, exclusionary and discriminatory payments to selected general obligation creditors of the government of China. Standard & Poor's presently maintains an "A" rating for China. Note the definition of this rating classification as published by S&P: "An obligor rated 'A' has STRONG capacity to meet its financial commitments but is somewhat more susceptible to the adverse effects of changes in circumstances and economic conditions than obligors in higher-rated categories." Compare this definition to S&P's published definition of the "Selective Default" rating classification, which is the classification S&P claims to assign to nations with defaulted sovereign debt: "An obligor rated "SD" (Selective Default) has failed to pay one or more of its financial obligations (rated or unrated) when it came due. An "SD" rating is assigned when Standard & Poor's believes that the obligor has selectively defaulted on a specific issue or class of obligations but it will continue to meet its payment obligations on other issues or classes of obligations in a timely manner." A nation rated "Selective Default" is virtually unable to issue international sovereign bonds until it repays its defaulted sovereign debt (<http://globalsecuritieswatch.org/SenatePolicyBrief.pdf>).

Exhibit 4.0

Published Definitions: International Sovereign Credit Rating Classifications

4.1 Prevailing Artificial Sovereign Credit Rating Classifications: Long-Term Foreign Currency Debt of the Chinese Government

Agency	Rating	Definition
Standard & Poor's	A	An obligor rated 'A' has STRONG capacity to meet its financial commitments but is somewhat more susceptible to the adverse effects of changes in circumstances and economic conditions than obligors in higher-rated categories.
Moody's	A1	Bonds which are rated "A" possess many favorable investment attributes and are to be considered as upper medium-grade obligations. Factors giving security to principal and interest are considered adequate, but elements may be present which suggest a susceptibility to impairment some time in the future. The modifier "1" indicates that the obligation ranks in the higher end of its generic rating category.
Fitch	A	High credit quality. 'A' ratings denote expectations of low credit risk. The capacity for payment of financial commitments is considered strong. This capacity may, nevertheless, be more vulnerable to changes in circumstances or in economic conditions than is the case for higher ratings.

Compare the above artificial sovereign credit rating classifications assigned to China with the published definitions maintained by the same agencies appearing below, which definitions truthfully describe the genuine rating classifications in light of the factual evidence (i.e., the actions of the Communist Chinese government with respect to evasion of repayment of its defaulted sovereign debt, including the actions of repudiation; selective default; rejection of the successor government doctrine of settled international law; discriminatory settlement with Great Britain; and the practice of preferential, exclusionary and discriminatory payments to selected general obligation creditors of the government of China).

4.2 Truthful Sovereign Credit Rating Classifications

Long-Term Foreign Currency Debt of the Chinese Government As Determined by Conformance of Agencies' Published Criteria and Definitions to Facts Comprising the Actions of the Communist Chinese Government, Including: [1] **Repudiation**; [2] **Selective Default**; [3] **Rejection of Successor Government Doctrine of International Law**; [4] **Discriminatory Settlement with Great Britain**; [5] **Preferential and Discriminatory Payments to Selected General Obligation Creditors**

Agency	Rating	Definition
Standard & Poor's	SD (Selective Default)	An obligor rated "SD" (Selective Default) has failed to pay one or more of its financial obligations (rated or unrated) when it came due. An "SD" rating is assigned when Standard & Poor's believes that the obligor has selectively defaulted on a specific issue or class of obligations but it will continue to meet its payment obligations on other issues or classes of obligations in a timely manner
Moody's	Ba (high) Caa (low)	Bonds which are rated "Ba" are judged to have speculative elements; their future cannot be considered as well-assured. Often the protection of interest and principal payments may be very moderate, and thereby not well safeguarded during both good and bad times over the future. Uncertainty of position characterizes bonds in this class. Bonds which are rated "Caa" are of poor standing. Such issues may be in default or there may be present elements of danger with respect to principal or interest.
Fitch	DDD RD	Default. Entities rated in this category have defaulted on some or all of their obligations. Entities rated "DDD" have the highest prospect for resumption of performance or continued operation with or without a formal reorganization process. Note that the newly introduced rating of "RD" (Restrictive Default) is described as the classification Fitch will assign to an issuer (including sovereigns) in cases in which the issuer has defaulted on one or more of its financial commitments, although it continues to meet other obligations.

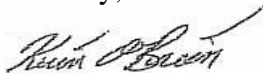
§5.0 China's Fraudulent Sovereign Credit Rating Conceals Defaulted Debt, Injures Defaulted Creditors, and Misstates Actual Risk

As the enclosed materials reveal in detail, the wrongful actions of the credit rating agencies distort the true credit risk endemic to certain rated obligations, including sovereign obligations of the government of China, and thereby pose a hidden danger to U.S. institutions and individual investors (e.g., in the instance of Chinese securities, as noted previously, the Chinese government denied seeking a sovereign credit rating even as it was reportedly pursuing a rating which it subsequently obtained, and which rating concealed, and continues to conceal the existence of the Chinese government's defaulted sovereign debt and its continuing practice of making discriminatory payments to selected creditors, and which artificial rating enabled China to resume international debt financing and establish a sovereign benchmark providing Chinese corporations with the ability to access the international financial markets while the central government continues to evade repayment of its defaulted sovereign debt).

§6.0 Unchecked Power of the NRSROs, Enforcement Failure by the SEC, and Pervasive Credit Contagion Requires Immediate Corrective Action by the Legislative Branch

In addition to domestic concerns, we are credibly informed that significant international concern exists that American regulators are not properly monitoring the disclosure of risk endemic to financial products sold abroad. Financial products continue to be marketed to domestic and international investors which were "not as advertised" (or, in the words of one financial commentator, "The subprime mess is only the latest example of liar's paper pawned off on unsuspecting European banks as triple-A rated 'investment quality' bonds"). Risky investments, masquerading under the guise of quality securities with top ratings, were sold to unsuspecting investors. Continuation of the wrongful practices by the rating agencies, which directly contribute to misstatement of risks and resultant investor losses, is antithetical and inimical to the interests of the public at large. Unified legislation is warranted in order to remedy the continuation of the abusive practices described herein, provide relief to defaulted creditors from the injurious actions of the credit rating agencies, and preserve the integrity and transparency of the international capital markets.

Sincerely,



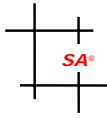
Kevin J. O'Brien, President
KJO: jwc

Hon. Neelie Kroes & Hon. Charlie McCreevy
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cc: Hon. Christopher J. Dodd, Chairman, Senate Committee on Banking
Hon. Richard Shelby, Ranking Member, Senate Committee on Banking
Hon. Roger W. Robinson, Jr., Former Chairman, U.S.-China Commission
Ms. Jonna Z. Bianco, President, American Bondholders Foundation
Mr. John Petty, President, U.S. Foreign Bondholders Protective Council
Consumer Federation of America
International News Media (via newswire release)

An electronic version of this document, including reference materials, is accessible on the world wide web at the following URL:

<http://www.globalsecuritieswatch.org/congress-resource.html>



Issue Brief: NRSROs' Fictitious China Sovereign Credit Ratings

Referencing:

American Bondholders Foundation and the U.S. Foreign Bondholders Protective Council

Defaulted Debt The government of China (PRC) remains in default on the Chinese government's full faith and credit sovereign debt. The debt is the repayment obligation of the PRC (under the successor government doctrine of international law), which refuses to repay American citizens. The refusal to repay the debt is a deliberate action of the PRC government.

PRC Actions The PRC engages in the following actions:

- i) Repudiation of the debt;
- ii) Discriminatory settlement with citizens of Great Britain;
- iii) Maintains a posture of selective default regarding the debt;
- iv) Exclusionary and preferential payments to certain creditors; and
- v) Rejection of the successor government doctrine of international law.

NRSRO Actions The three primary NRSROs, collectively controlling 95% of the industry, publish and distribute false "investment grade" sovereign credit ratings assigned to the government of China, and which are provably false in comparison to the actions of the government of the People's Republic of China. The artificial ratings enable the Chinese government to evade repayment of U.S. bondholders' claims. By assigning artificial ratings to China, the NRSROs violate their own rating methodologies, as shown below:

- i) Intentionally (in the face of constructive notice) violate their published metrics, e.g., evaluation of the debtor's willingness to repay debt (see Exhibit A); and
- ii) Intentionally (in the face of constructive notice) violate their published criteria, e.g., definitions of prevailing ratings vs. truthful rating of "selective default" (see Exhibit B).

Motivation The three primary NRSROs obtain revenue from rating corporations and sovereigns that issue debt. By maintaining an artificial "investment grade" sovereign rating for China, which conceals China's defaulted debt, the rating agencies reduce the costs for Chinese corporations to engage in international financing, thereby setting the stage for windfall ratings profits (see Exhibit C).

Injury The wrongful actions of the NRSROs conceal both the Chinese government's defaulted sovereign debt as well as the actions of the government of the PRC with respect to its treatment of its creditors, and enable the Chinese government to evade repayment of its defaulted sovereign debt.

Public Danger The wrongful actions of the three primary NRSROs, evidenced through the publication of credit ratings which are neither credible nor accurate, represent the application of a reckless standard of care and pose the risk of propagation of yet another credit market contagion.

Information <http://www.globalsecuritieswatch.org/congress-resource.html>

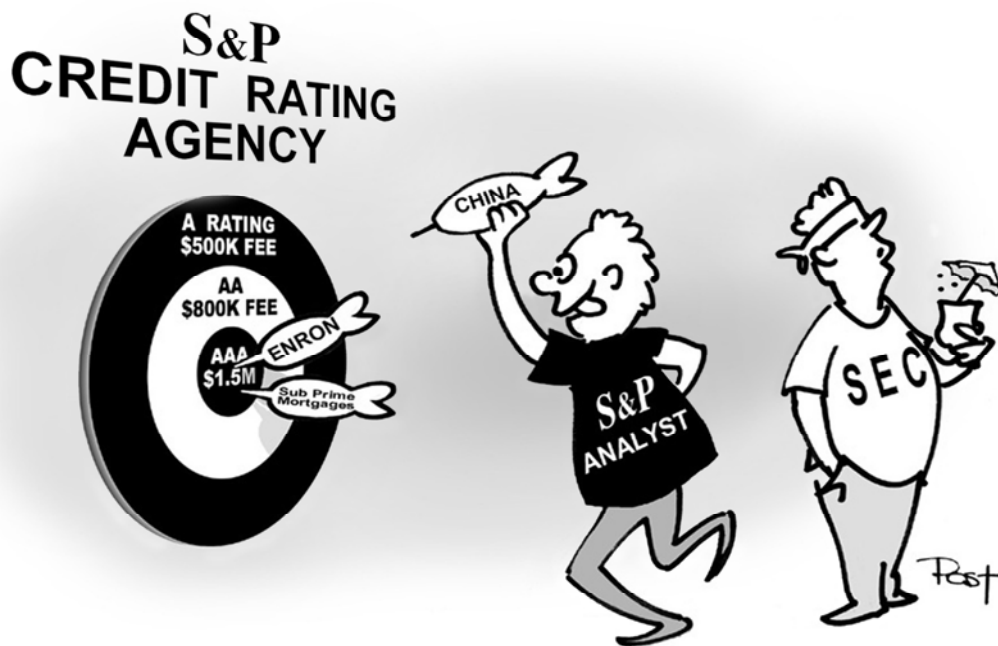
- Exhibit A** **Published Metrics** (e.g., evaluation of a debtor's willingness to pay)
http://www.globalsecuritieswatch.org/S&P_Sovereign_Ratings_Methodology
- Exhibit B** **Published Criteria** (e.g., definitions of credit rating classifications)
http://globalsecuritieswatch.org/Sovereign_Ratings_Definitions_and_Criteria
- Exhibit C** **Moody's Promotion** (soliciting Chinese corporations to issue debt utilizing China's "investment grade" sovereign credit rating)
<http://globalsecuritieswatch.org/Moody's-Promotion.pdf>

September 18, 2007

Top Stories Worldwide

The Great Global Credit Meltdown of 2007 – Brought to You Courtesy of the SEC

How Complacency, Failure to Regulate Credit Rating Firms Led to Subprime Credit Rout - SEC Ignored 2005 Warning / China's Double Standard



Credit rating firms score big profits as SEC looks other way

TUCSON, Ariz., September 18 /PRNewswire/ -- Commentary by Sovereign Advisers -- In the wake of multi-billion dollar losses, shaken investor confidence and increased calls for regulation of global credit markets following the sale of falsely-rated mortgage bonds in the U.S., Europe and Asia, it is noteworthy that this most recent credit implosion could have been avoided, had the SEC acted on a request in 2005 by the Chairman of the Joint Economic Committee of the U.S. Congress for an investigation into the unregulated business practices of the international credit rating agencies (<http://www.globalsecuritieswatch.org/investigation.pdf>). According to a recent article published by the Wall Street Journal, (*Credit and Blame: How Rating Firms' Calls Fueled Subprime Mess*, August 15, 2007), the subprime meltdown appears to have resulted primarily from the sale and subsequent default of "investment-grade" mortgage bonds carrying artificial

triple-A ratings. These bonds were marketed to financial institutions including hedge funds in the United States, Europe and Asia, which were apparently induced into purchasing the bonds on the pretext of artificially high credit ratings assigned by Standard & Poor's, Moody's Investors Service and Fitch Ratings. The ratings assigned to the bonds, which concealed the true credit risk, were intended to make them more appealing (and thus more easily marketed) to institutional and retail investors. Far from representing a deception perpetrated on an unprecedented scale, this latest debacle represents only the most recent instance in a long and unenviable history of questionable practices by the credit rating firms, the true nature of which are only now becoming exposed.

Judging from reports in the media, it appears that not only did the credit raters intentionally hide the true risk of the mortgage bonds they rated in order to make them more marketable to investors around the globe, but this practice is habitually engaged in by these firms in order to boost the fees they charge to companies and governments seeking a rating in order to sell bonds. Such practices routinely leave investors holding the bag after sustaining huge losses from falsely-rated securities, as occurred in the Penn Central bankruptcy (1970), New York City financial crisis (1975), Washington State Public Power default (1983), Orange County debt crisis (1994), Asian financial meltdown (1997), Enron collapse (2001), and Worldcom bankruptcy (2002), to name a few such instances. Following this latest scandal, legislators in the U.S. as well as the European Commission have belatedly cast an unwelcome spotlight upon the business practices of the international credit rating firms with a view toward crafting a much needed regulatory framework with which to finally end such abusive practices.

Enforcement Failure: SEC Rejected 2005 Request by Congress to Investigate Allegations of Fraud by Rating Firms - Policy of "Zero Accountability" Encouraged Market Abuses, Empowered Credit Ratings with Force of Law Free from Regulatory Oversight

Despite the pervasive and influential power wielded by S&P, Moody's and Fitch to shape markets and capital flows (granted by virtue of their exclusive oligopoly franchise which enables the three firms to control 94% of the industry) these firms have historically been able to escape regulation and oversight, including any degree of accountability for their ratings when such ratings are revealed as false, as has frequently proven to be the case, albeit "after the fact". Concerned that the stage was being set for yet another contagion, our firm alerted the SEC Division of Market Regulation in early 2005 to the latent danger of the rating agencies' practices including inflated ratings, and cited the "investment grade" sovereign credit rating assigned to China as an obvious example of a contrived, artificial credit rating designed to open the door to global bond sales by Chinese corporations, thereby creating windfall profits for the rating firms (which receive large fees for rating companies' credit risk) at the expense of defaulted American creditors of the government of China (PRC) whom are owed some \$260 billion by the PRC, and whom found their claims ignored by the Chinese government since it enjoys a pretextual credit rating which conceals its defaulted sovereign debt and so no longer has any incentive to honor repayment (<http://www.globalsecuritieswatch.org/SEC.pdf>).

In a concerted attempt to prevent the creation and spread of another credit contagion, numerous Members of Congress including the then-Chairman of the Joint Economic Committee wrote the SEC requesting an investigation into the matter. Although forewarned of the application of a reckless standard of care, and despite the written request for an investigation into the questionable practices employed by the credit rating agencies by Members of Congress including the JEC Chairman, the warning was soundly ignored by SEC Chairman Christopher Cox in a nod to the Administration's 'Goldman Sachs' China policy (i.e., empowering China and granting special privileges such as exemption from debt repayment at the expense of individual American citizens living on main street while benefiting Wall Street institutions engaged in the highly profitable

sale of Chinese stocks and bonds). As a glaring example of this policy, we observe that Goldman Sachs knew of China's defaulted sovereign debt, the repayment obligation of which is that of the People's Republic of China, yet acted as credit rating adviser to the PRC in 2003 in order to establish an artificially high credit rating which conceals the repayment obligation of the PRC for the defaulted debt in order to help market the PRC's sovereign bonds. Such credit upgrades are frequently timed to bond sales in order to artificially stimulate demand. This practice is revealed by the subtitle of a recent Reuters article, "International ratings agency Moody's Investors Service upgraded its debt ratings on China and Hong Kong in a move that will further tempt investors to snap up China's upcoming \$1 billion bond." (*Moody's upgrades HK and China*, October 16, 2003). As a result of the SEC's inaction, such practices were allowed to continue unabated. In its response to the Committee and instead of launching a probe as requested by Congress, the SEC prepared an internal memorandum, subsequently obtained by our firm, in which the Commission disclaimed any regulatory jurisdiction over the activities of the rating agencies, declined to enforce the federal securities laws prohibiting half-truths and omissions of fact, and demurred to launch an investigation into the artificial "investment grade" credit ratings which conceal true credit risks including, in the instance of China, the Chinese government's practice of discriminatory payments to selected creditors and its policy of selective default whereby it steadfastly refuses to honor any repayment of its defaulted national debt to Americans (<http://www.globalsecuritieswatch.org/memorandum.pdf>). In its response to Congress, the SEC also conveniently ignored the fact that it is responsible for determining which firms qualify as "nationally recognized statistical rating organizations" (i.e., recognized credit rating firms) as well as the fact that the three major international credit rating firms, Standard & Poor's, Moody's Investors Service and Fitch Ratings are each registered with the SEC as Investment Advisers and as such, are prohibited from "engaging in unethical business practices including engaging in any act, practice, or course of business which is fraudulent, deceptive or manipulative." Accordingly, the three primary rating firms are restrained from applying a reckless standard of care in developing their rating classifications. The rating definitions, as published by the credit raters themselves, state that such ratings are an evaluation of the rated entity's willingness and ability to pay financial obligations. As evidenced by the factual record in the instance of China, the prevailing "investment grade" rating classifications assigned to the Chinese government by the three primary credit rating firms do not truthfully reveal the actions of the PRC and thus do not conform to their published definitions, indicative of both foreknowledge of falsity and the application of a reckless standard of care by the rating agencies (<http://www.globalsecuritieswatch.org/definitions.pdf>).

It is also an indictment against the lax enforcement policy adopted by the SEC that the Commission failed to undertake an investigation even though the Advisers Act explicitly requires the SEC to investigate allegations of wrongdoing and to impose penalties upon registrants whose wrongful actions "directly or indirectly result in substantial losses or create a significant risk of substantial losses to other persons." The failure to rein in the rating agencies two years ago thus set the stage for the latest in a long string of credit "events" in which the rating agencies have once again demonstrated how they have utterly failed in their gatekeeper role. The refusal by the SEC to regulate the rating agencies also established a dangerous precedent in light of the extensive incorporation of credit rating classifications into investment policies by both the public and private sectors (e.g., private pension plan administrative standards, municipal retirement systems policies, and federal banking regulations governing permissible activities of insured depository institutions).

**Dangerous Focus on Creating Marketable Products for Investor Consumption –
Example: China’s False Credit Rating Conceals Selective Default, Discriminatory Payments
and Establishes an Artificial Sovereign Benchmark for Sales of Corporate Bonds**

As evidenced by the facts, the root cause of ratings inflation and the recurring cyclical credit contagions is the predilection of the agencies for creating marketable investment products which are highly saleable by the prime brokerage community, targeting institutional and retail investors to the enormous profitable benefit of the rating agencies. Such penchant is evocative of the often articulated industry maxim, “brokers are selling machines when backed by agency ratings.” According to the same Wall Street Journal article previously cited, “Underwriters don’t just assemble a security out of home loans and ship it off to the credit raters to see what grade it gets. Instead, they work with rating companies while designing a mortgage bond or other security, *making sure it gets high-enough ratings to be marketable.*”

Judging from recent events, the three primary credit rating firms continue to actively pursue a policy of rating debt securities in a manner intended to generate ever larger fees from sales of new bonds, including development of customers located in foreign markets. An international sovereign credit rating is absolutely essential for any government seeking to borrow internationally, or more significantly, to establish an international sovereign benchmark against which the country’s corporations may raise capital in the world financial markets in order to compete internationally. The international sovereign credit rating assigned to a specific government acts to set a “sovereign ceiling” which constrains the ratings of the corporate issuers located within that nation. If the ceiling is artificially high, then the creditworthiness of the corporations within that nation enjoy a higher rating and a commensurately lower cost of capital, which translates into a major competitive advantage globally. It also means that more companies will be able to issue bonds, which will need to be rated by the agencies, thereby enabling the credit raters to develop new markets for their services (<http://globalsecuritieswatch.org/Moody's-Promotion.pdf>). The most extreme example of obvious ratings inflation is the instance of China’s contrived “investment grade” ratings assigned by S&P, Moody’s and Fitch, unprecedented for a government in default on its national debt and which conceal the existence of the Chinese government’s defaulted sovereign debt and fail to conform to their published definitions.

Despite their claim that they rate a government’s *willingness* to pay its sovereign obligations, the three primary credit rating firms continue to maintain an artificial “investment grade” credit rating classification for China and have actually upgraded China’s rating six times since disclosure of the Chinese government’s refusal to honor repayment of its defaulted sovereign debt was communicated to each of the primary rating agencies in 2002. The actions of the credit raters may be explained by the apparently irresistible temptation represented by the potential for enormous fees earned from rating the debt of Chinese corporations which are now empowered to issue debt globally due to the creation of an artificial sovereign benchmark rating while the central government enjoys an unimpeded ability to continue its predatory financial markets practices including selective default, evasion of debt repayment, and discriminatory debt payments to preferential creditors. The actions of the central government are the subject of a complaint (<http://www.globalsecuritieswatch.org/disclosure.pdf>) recently filed with the U.S. Securities & Exchange Commission alleging fraud (http://www.globalsecuritieswatch.org/Amended_SEC_Complaint.pdf) in connection with the offer and sale in the U.S. of its sovereign bonds.

Beyond actively assisting a government in default on its national debt in evading repayment, the actions of the rating agencies dangerously understate the true credit risk of both Chinese government bonds and corporate securities, exposing both U.S. and foreign pension funds to hidden risks and greatly increasing the prospect for yet another credit contagion, not to mention

the potential for further dislocation of entire industries. Such an effect would be far less likely to occur if the rating agencies had adhered to their published definitions and assigned the truthful rating classification of “Selective Default” to China, reflecting the existence of the Chinese government’s attempts to evade repayment of its defaulted sovereign debt.

China’s Double Standard: Unique Irony of Financial Losses Incurred by China

When tallying the financial losses incurred by foreign investors as a result of the sale of falsely-rated U.S. mortgage bonds, there is a special irony in the case of China, which recently complained publicly regarding the potential loss of billions of dollars attributable to the central bank’s exposure to such securities which it purchased from U.S. investment banks, yet itself relies on a contrived sovereign credit rating in order to avoid repayment of its defaulted government debt. “This is like the pot calling the kettle black” according to Jonna Bianco, a Tennessee cattle farmer who serves as the president of the ABF, the organization representing U.S. creditors. The ABF is pressing Congress to enact legislation to restrict the sale of new Chinese securities in the U.S. until China fully honors repayment of its defaulted debt. Such legislation is similar to that enacted by the government of Great Britain in order to achieve repayment from the Chinese government in 1987 of British citizens’ claims. “This is the only kind of response that China understands”, said Ms. Bianco. “They don’t adhere to the established international rules followed by other members of the international community. China should be held to the same standard of international conduct as other nations instead of granting unique privileges and exemptions, which only serves to encourage China to write its own rules of international conduct.” According to the U.S. Foreign Bondholders Protective Council, in more than 40 settlements involving defaulted debt of foreign governments, the communist Chinese government represents the only instance of a government refusing to negotiate with American creditors.

Senate Expected to Join with House in Introducing Concurrent Legislation to Increase Transparency and Restore Integrity of U.S. Capital Markets

In acknowledgement of the enforcement failure by the SEC and the abandonment of an appropriate standard of care by the principal credit rating firms, and recognizing that the actions of the credit rating firms, in which the SEC was complicit by evading its regulatory responsibility, have now created the specter of a massive taxpayer-funded government bailout, Members of both Houses of Congress have realized the pressing need for immediate bipartisan action by the legislative branch to remedy the continuation of the abusive practices described herein, provide relief to defaulted creditors from the injurious actions of the credit rating agencies, and restore the transparency and integrity of the U.S. capital markets. Legislation has already been introduced in the United States House of Representatives (<http://www.globalsecuritieswatch.org/h.con.res.160.pdf>), while the Senate is presently drafting concurrent legislation (<http://www.globalsecuritieswatch.org/brief.pdf>) which primarily addresses the issues of inadequate disclosure and misleading credit ratings involving obligations of the government of China, and is expected to specifically address the issue of reclassification of the sovereign credit rating of the People’s Republic of China into the proper classification of selective default (<http://www.globalsecuritieswatch.org/senate.pdf>).

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