Sovereign Advisers®
Specialists in Risk Metrics Analytics
4901 E. Sunrise Drive • Suite 711
Tucson • Arizona • 85718
Tel (USA): 520.327.2482 • Fax: 520.322.9850
Email: sovadvisers@aol.com

Via Facsimile and Priority Mail

June 21, 2005

Mr. David M. Walker, Comptroller General of the United States
Government Accountability Office
Room 7100
441 G Street, N.W.
Washington, D.C. 20548

Re: 1. Request by the United States Congress for Investigation into Complaint Filed with Division of Market Regulation of the U.S. Securities and Exchange Commission.

2. Enforcement of SEC Regulatory Mandate Pertaining to Nationally Recognized Statistical Rating Organizations.

Dear Mr. Walker:

Our firm recently filed a complaint with the Division of Market Regulation of the U.S. Securities and Exchange Commission (the "SEC" or the "Commission").[1] This complaint was the direct result of an investigation we conducted into the credit rating classifications presently assigned to the long-term foreign currency sovereign credit of the People's Republic of China. The investigation was prompted by the existence of defaulted full faith and credit sovereign obligations of the Chinese government, which fact has been and continues to be excluded from consideration by Standard and Poor's, Fitch Ratings and Moody's Investors Service in determining the appropriate sovereign credit rating classifications for the government of China.

The complaint referenced herein was filed with the SEC on March 31, 2005. The complaint requests that the SEC investigate whether the three Nationally Recognized Statistical Rating Organizations ("NRSROs") named in the complaint and referenced herein are in violation of the provisions governing the operation of NRSRO designees by their respective actions (e.g., assignment of deceptive and misleading ratings resulting from the willful omission of material facts). To date, no acknowledgement has been received by our firm from the SEC with respect to this complaint, the allegations of which are described as "very serious" by the Chairman of the Joint Economic Committee of the United States Congress in a letter addressed to the SEC (please refer to copy of enclosed letter).

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[1] See "On Behalf of Defaulted Creditors of the Government of China: **COMPLAINT** Misleading Sovereign Credit Ratings and Inadequate Disclosure Pertaining to the Offer, Sale and Trading of Debt Securities of the People's Republic of China: Deceptive Practices and Violations of International Law." Copy of complaint enclosed with this correspondence. Testimony presented at a hearing conducted by the House International Relations Committee, along with legal memorandums prepared by the law firm of Stites & Harbison PLLC, are accessible on the world wide web at the following URL: *http://www.globalsecuritieswatch.org*

The complaint referenced herein has begun to attract the attention of numerous members of the United States Congress, including the Chairman of the Joint Economic Committee, *supra,* and the Chairman of the House Appropriations Committee, who have publicly called upon the SEC to investigate the substance of the complaint (please refer to copies of additional congressional letters enclosed with this correspondence).[2]

Unfortunately, despite the emerging concern by the Congress over this matter, the SEC appears both to be (1) avoiding confronting the issue and (2) avoiding acting upon the complaint. Apart from the lack of any acknowledgement by the SEC regarding the filing of the complaint, additional concern as to the SEC's handling of the complaint is warranted as a result of certain statements regarding the SEC's position on this matter as published in the June 7, 2005 edition of the *Financial Times* in an article entitled:

"SOVEREIGN CREDIT RATINGS
China's pre-war bond default stirs US anger"

The text of the article includes the following statements:

1. "Although the SEC has yet to issue a formal response to the letters, it is examining whether any Chinese government debt issues are registered with the regulator, which would give it jurisdiction".[3]

2. "People close to the SEC suggested the regulator had not yet reached any conclusions on the matter. However, the SEC is usually reluctant to become involved in the work of credit rating agencies. It does not have a legislative mandate to police the agencies, but does grant them a status, known as "nationally recognised statistical rating organisations", that has entrenched the dominance of the three main agencies: Fitch Ratings, Moody's Investors Service and Standard and Poor's".[4]

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[2] See the comment by the Honorable Jim Saxton, Chairman of the Joint Economic Committee of the United States Congress, "The [rating agencies] should reclassify the sovereign credit ratings of the People's Republic of China [to reflect this]". "SOVEREIGN CREDIT RATINGS China's Pre-War Bond Default Stirs U.S. Anger". Gillian Tett in London, Richard Beales and Andrew Parker in New York, and Andrew Yeh in Beijing. *Financial Times* (June 7, 2005).

[3] See "SOVEREIGN CREDIT RATINGS China's Pre-War Bond Default Stirs U.S. Anger". Gillian Tett in London, Richard Beales and Andrew Parker in New York, and Andrew Yeh in Beijing. *Financial Times* (June 7, 2005). See also "People's Republic Called to Account". Gillian Tett, Richard Beales and Andrew Yeh. *Financial Times* (June 7, 2005). Copy of articles enclosed with this correspondence.

[4] See also in the same article, the revealing statement: "Brian Coulton, senior director at Fitch, said '[These complaints] are not something we take any account of in our rating of the PRC'". Such a statement would

Such statements would appear to indicate that the SEC may be adopting a lax enforcement posture with respect to (1) its responsibility and authority to regulate the NRSROs under the Investment Advisers Act of 1940, *infra*, and (2) its responsibility and authority to mandate adequate disclosure in registration statements and offering documents filed with the SEC (e.g., the supplement to the prospectus filed with the SEC on October 22, 2003 pertaining to the offering by the People's Republic of China of U.S. $1 billion in notes due 2013, which fails to disclose the existence of defaulted full faith and credit sovereign obligations of the Chinese government).[5]

As both yourself and members of the Congress are undoubtedly aware, this is not the first instance of the SEC failing to take action on related issues with the subsequent result of extremely unfortunate (i.e., catastrophic) consequences to the investing public. On January 8, 2003 Mr. B. Riney Green, Esq. of the law firm of Stites & Harbison PLLC notified the SEC Chairman in writing of specific concerns pertaining to (1) misleading Chinese government economic data, (2) political instability of the Chinese government, and (3) risk of debt repudiation by Chinese securities issuers.[6] On January 21, 2003 the SEC Division of Corporation Finance issued a three-sentence acknowledgement of receipt of the correspondence with no further response received to date from the SEC. It is interesting to note that less than twelve months after the date of Mr. Green's letter to the SEC Chairman, China Life Insurance Company engaged in a $3.46 billion initial public offering of shares, including offering to investors within the United States. Just one month after this offering, a class action civil suit was filed on behalf of participating investors seeking to recover damages resulting from an alleged $652 million "massive financial fraud" perpetrated by the company.[7]

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appear to suggest an attitude on the part of at least one rating agency that they do not allow inconvenient facts to interfere with a predisposition to assign a specific rating classification.

[5] See October 22, 2003 supplement to the prospectus dated October 16, 2003 filed with the United States Securities and Exchange Commission pursuant to Rule 424(b)(5). Registration No. 333-108727. The supplement to the prospectus may be accessed on the world wide web at the following URL: *http://www.sec.gov/Archives/edgar/data/909321/000114554903001347/u98681p1e424b5.htm*

[6] See letter addressed to the Honorable Harvey L. Pitt, Chairman and Mr. Alan L. Beller, Director, Corporate Finance Division, Securities and Exchange Commission dated January 8, 2003, wherein Mr. B. Riney Green, Esq. articulated numerous concerns pertaining to inadequate disclosure in registration statements and offering documents utilized in the offer and sale of Chinese corporate and government securities in the United States. Copy of letter enclosed with this correspondence. See also the SEC's response to this letter, dated January 21, 2003. Copy of letter of response enclosed with this correspondence.

[7] See untitled news item published in the *Wall Street Journal* (March 18, 2004). See also "As Investors Rush into China, Cautionary Tales Start to Pile Up". Peter Wonacott. *Wall Street Journal* (May 17, 2004).

From an analysis of the preceding events, and in particular the circumstances which are the subject of this letter, it is obviously and demonstrably not in the public interest for the SEC to maintain a lax enforcement policy and continue to evade its legal authority with respect to enforcing adequate disclosure standards and enforcing regulation of the NRSROs in compliance with existing law. The designation of NRSRO status upon an applicant conveys a high degree of responsibility to the investing public and merits a level of diligence upon which the public-at-large may depend in confidence. The apparently intentional failure to recognize the existence of a series of full faith and credit sovereign obligations remaining in a state of default while the successor government evades payment in violation of international law represents an egregious breach of the public trust and failure of fiduciary duty by Standard and Poor's, Fitch Ratings and Moody's Investors Service. The willful omission of such a material fact also reveals a practice of aiding and abetting the circumvention of an outstanding default by the Chinese government.

Each of the three most prominent NRSROs (Standard and Poor's, Fitch Ratings and Moody's Investors Service) are registered as investment advisers pursuant to the Investment Advisers Act of 1940 (the "Advisers Act").[8] As registered investment advisers, the rating activities and professional conduct of these three NRSROs are subject to SEC review and sanctions.[9] The business activities of the three named NRSROs, *supra,* certainly exert a significant and profound effect on the financial markets through the issuance of their rating opinions.

The language of Rule 102(a)(4)-1 Unethical Business Practices of Investment Advisers states:

> "A person who is an investment adviser or a federal covered adviser is a fiduciary and has a duty to act primarily for the benefit of its clients. The provisions of this subsection apply to federal covered advisers to the extent that the conduct alleged is fraudulent, deceptive, or as otherwise permitted by the National Securities Markets Improvement Act of 1996 (Pub. L. No. 104-290). While the extent and nature of this duty varies according to the nature of the relationship between an investment adviser and its clients and the circumstances of each case, an investment adviser or a federal covered adviser shall not engage in unethical business practices, including the following:
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> ... 20. Engaging in any act, practice, or course of business which is fraudulent, deceptive, or manipulative in contrary to the provisions of section 206 (4) of the Investment Advisers Act of 1940, notwithstanding the fact that such investment adviser is not registered or required to be registered under section 203 of the Investment Advisers Act of 1940".[10]

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[8] Investment Advisers Act of 1940 as amended. August 22, 1940. 54 Stat. 847, 15 U.S. Code §80b-1 - 80b-21, as amended.

[9] See page 34, "Rating Agencies: Is There a Conflict Issue?". Roy C. Smith and Ingo Walter. New York University (February 18, 2001).

[10] Adopted April 27, 1997; amended April 18, 2004.

The language of Section 206 Prohibited Transactions by Investment Advisers states:

> "Section 206. It shall be unlawful for any investment adviser, by use of the mails or any means or instrumentality of interstate commerce, directly or indirectly:
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> (1) To employ any device, scheme, or artifice to defraud any client or prospective client;
> (2) To engage in any transaction, practice, or course of business which operates as a fraud or deceit upon any client or prospective client;
> ... (4) To engage in any act, practice, or course of business which is fraudulent, deceptive, or manipulative. The Commission shall, for the purposes of this paragraph (4) by rules and regulations define, and prescribe means reasonably designed to prevent, such acts, practices, and courses of business as are fraudulent, deceptive, or manipulative".[11]

The language of Section 209 Enforcement of Title states:

> "Section 209. (a) Whenever it shall appear to the Commission, either upon complaint or otherwise, that the provisions of this title or of any rule or regulation prescribed under the authority thereof, have been or are about to be violated by any person, it may in its discretion require, and in any event shall permit, such person to file with it a statement in writing, under oath or otherwise, as to all the facts and circumstances relevant to such violation, and may otherwise investigate all such facts and circumstances.
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> ... (e) (2) (C) (II) Such violation directly or indirectly resulted in substantial losses or created a significant risk of substantial losses to other persons".[12]

The willful exclusion or omission from consideration of the existence of a defaulted series of full faith and credit sovereign obligations and the attendant effect of such defaulted obligations on the "willingness to pay" metric implicit in the presently assigned sovereign credit ratings of the People's Republic of China is also inconsistent with the Commission's proposed definition of the term "NRSRO" as an entity that, *inter alia*, "uses systematic procedures designed to ensure credible and reliable ratings ...". Such willful disregard or exclusion of a material fact in determining a rating classification for an issuer who is in default may also be considered as "reckless" and constitute a breach of fiduciary duty to both clients and the public-at-large. This is particularly the case given consideration of the fact that the three major NRSROs referenced herein were specifically notified in writing of the existence of the defaulted full faith and credit sovereign obligations of the government of China in 2002, and have avoided any inclusion of this fact into their present rating classifications assigned to the government of China.[13]

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[11] Investment Advisers Act of 1940. Section 206.

[12] Investment Advisers Act of 1940. Section 209.

[13] See letter dated November 27, 2002 addressed to Mr. Clifford L. Alexander, Chairman and Mr. John Rutherfund Jr., President and Chief Executive Officer, Moody's Corporation, describing the existence of a

The foregoing provisions of the Advisers Act must be held by the SEC to apply to the firms designated as NRSROs, *supra*, not only because each NRSRO is a registered investment adviser pursuant to the Advisers Act and therefore subject to the regulations prescribed under the Advisers Act, but also in light of the very high degree of reliance by the public-at-large upon their assigned ratings classifications and the resultant extraordinary influence upon capital markets decisions and transactions exercised by these three firms due to their unique NRSRO designation.[14] To exempt the NRSROs from the provisions of the Advisers Act under which they are registered would defeat the purpose of the Advisers Act as a mechanism for protecting the public-at-large, including potentially negative effects resulting as a consequence of actual as well as potential undisclosed conflicts of interest to which the NRSROs are vulnerable.

One of the more pervasive examples of such vulnerability to conflicts of interest in the immediate instance, in which a definite potential exists for a very serious conflict of interest involving the supposedly "objective" assessment of the sovereign credit rating of the People's Republic of China, is the acquisition of significant business opportunity resulting from providing rating services to corporate issuers and government-owned enterprises. Such potential is extremely significant with respect to both the Chinese market and the Asian region.[15]

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defaulted series of full faith and credit sovereign obligations of the Chinese government. Copy of letter enclosed with this correspondence.

[14] See the statement: "As we testified at the hearings held last year by the Commission on issues relating to credit rating agencies, institutional investors are substantial users of information from credit rating agencies and the credit ratings published by rating agencies play a key role in their investment decisions. It is therefore essential that the quality and integrity of these ratings are maintained". Source: Investment Company Institute. Letter addressed to Mr. Jonathan G. Katz, Secretary, Securities and Exchange Commission (July 28, 2003). See also the statement: "It is our view that maintaining the integrity and quality of the credit ratings is essential to investor confidence and to the proper functioning of our capital markets". Source: Investment Company Institute. Statement before the SEC Hearings on Issues Related to Credit Rating Agencies (November 21, 2002).

[15] See the following statement for a recent example of how the prospect of future government and corporate business may influence sovereign ratings: "In early 2000 controversy erupted over the major rating agencies' respective assessment of Mexico's economic prospects. It was alleged that the respective competitive positions of S&P and Moody's in the Mexican ratings business could perhaps explain their very different assessments of the country's debt service prospects. Moody's had put the country's long-term foreign currency debt under review for a possible upgrade from junk to investment grade status, citing Mexico's improving debt service burden and reflecting analysts' perceptions of reduced risk. Standard and Poor's rated Mexico's long-term foreign currency debt as non-investment grade, one notch below Moody's, and indicated that it would not be considering an upgrade until after the Presidential elections in July 2000. Mexican presidential elections have frequently coincided with substantial economic and financial turmoil and policy changes. Moody's announcement was widely praised by the Mexican government and sparked a rally in local bond and equity markets, bolstering Moody's chances of winning mandates for a long queue of government entities and corporates planning to issue bonds in the ensuing months. Moody's denied that

The ability of the NRSROs to realize this potential business opportunity may reasonably be expected to be greatly diminished in the event that the NRSROs were to actually perform an objective evaluation of China's sovereign rating, which would therefore include the "willingness to pay" metric as evidenced by the existence of the defaulted series of full faith and credit sovereign obligations of the Chinese government, which have been neither settled nor discharged, and therefore remain in a state of default.[16] The implied potential for a serious conflict of interest resulting from the prospect of future business remains undisclosed to the public-at-large and represents an egregious risk to investors who rely solely upon the NRSRO ratings classifications when determining the risk of investing in sovereign obligations of the Chinese government and who have no prior knowledge of the existence of a defaulted series of obligations which have been neither settled nor discharged, and which fact is not reflected in the present ratings.[17]

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its aggressive selling effort had anything to do with the unexpected upgrade six months before the Presidential election, citing the primacy of reputation and credibility as the firm's key selling tool (see "Moody's, S&P Are at Odds Over Future of Mexico". Jonathan Friedland and Pamela Druckerman. *Wall Street Journal* (February 7, 2000). Some observers noted that in the presidential elections six years earlier, in 1994, it was S&P that was bullish on the country and Moody's was more cautious, coinciding at that time with a strong marketing effort in the country by S&P." See also the statement: "The rating agencies have not been alone in feeling the pressure of governments in response to their assessments. In February 1999 Goldman Sachs analysts targeted the financial condition of Thailand's largest bank, Bangkok Bank, as a potential threat to the country's financial stability, driving down the price of its shares. The Thai Ministry of Finance immediately chastised Goldman Sachs and implicitly threatened to withdraw government business, which in turn was coupled to the threat of lost private-sector business from companies hesitant to incur the disfavor of the Ministry of Finance." Source: "Rating Agencies: Is There an Agency Issue?". Roy C. Smith and Ingo Walter. New York University (February 18, 2001).

[16] See the statement: "In the same vein, commentators noted that Morgan Stanley had been dismissed in 1997 as financial adviser to Shandong International Power Development in China after publishing a negative research report and that retribution in the case of unfavorable research was hardly unusual in Asia, where links between government, private companies and powerful families are much closer than in some other parts of the world." Source: "Investment Banks Must Soothe Asian Sensibilities". Mark Landler. *New York Times (*March 12, 1999), as cited in: "Rating Agencies: Is There an Agency Issue?". Roy C. Smith and Ingo Walter. New York University (February 18, 2001).

[17] See the statement: "All ratings agencies agree that a debtor is in default when it either misses a payment beyond a grace period or seeks to renegotiate the loan – ***anything, says S&P's Marie Cavanaugh, that is not "timely service of debt according to the terms of issue"*** (emphasis added). Source: "The Ratings Game". Martin Mayer. *The International Economy* (July 1999). Thus, from an examination of the facts in the immediate instance, it would appear that Standard and Poor's is engaged in altering adherence to its own internal procedures on a selective basis in order to accommodate the attainment of a predefined outcome and thereby avoid an inconvenient fact (e.g., the willful omission of the existence of a defaulted series of full faith and credit sovereign obligations of the government of China in its sovereign ratings classification assigned to China). See also the following statements: "NRSROs should be legally accountable for their ratings". Source: Investment Company Institute. Statement before the SEC Hearings on Issues Relating to Credit Rating Agencies (November 21, 2002). "As registered investment advisers,

In addition to obtaining regulatory jurisdiction over the activities of the NRSROs by virtue of the explicit language of the Advisers Act, *supra,* the SEC also obtains jurisdiction over the related issue of inadequate disclosure on the basis of the People's Republic of China having filed a statement as a 424(b)(5) registrant with the Commission pertaining to China's global sovereign bond offering in the month and year of October, 2003 which received an investment grade rating from the three named NRSROs, *supra*, and which filing contains no mention of the existence of defaulted full faith and credit sovereign obligations of the Chinese government[18]

We are concerned that the lack of acknowledgement by the SEC of the complaint referenced herein, in conjunction with the remarks published in the June 7, 2005 *Financial Times* article and the SEC's prior response to the concerns raised in the January 8, 2003 Stites & Harbison letter to the SEC Chairman, may constitute the precursor of an attempt by the SEC to evade jurisdiction or regulatory enforcement action with respect to the willful omission by Standard and Poor's, Fitch Ratings and Moody's Investors Service of a material fact which acts to significantly affect the risk profile of securities of the associated issuer (i.e., the existence of a defaulted series of full faith and credit sovereign obligations of the Chinese Government and the implicit "willingness to pay" metric) and also serves to aid and abet the circumvention of the defaulted obligations by the issuer (i.e., the government of China as well as Chinese corporate issuers subject to the sovereign benchmark).[19]

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the current NRSROs have a legal obligation to avoid conflicts of interest or disclose them fully to subscribers. Reliance by credit rating agencies on issuer fees could lead to a conflict of interest and the potential for rating inflation". Source: "Rating Agencies and the Use of Credit Ratings Under the Federal Securities Laws". U.S. Securities and Exchange Commission (2003). "Given the steps the SEC has taken to improve levels of independence for accounting firms and equity analysts, similar action should be required to restore the credibility of and confidence in the rating system". Source: "Is the SEC Going Soft on Credit Rating Agencies?" Kreag Danvers and B. Anthony Billings. *The CPA Journal* (May, 2004).

[18] See prospectus supplement dated October 22, 2003 filed with the United States Securities and Exchange Commission.

[19] See the statement: "At a hearing today on 'Examining the Role of Credit Rating Agencies in the Capital Markets', AFP President Jim Kaitz called on Congress 'To hold the SEC accountable by demanding immediate action on the issues', including questions about the credibility and reliability of credit ratings and conflicts of interest and abusive practices in the rating process". Source: Testimony before the Senate Committee on Banking, Housing and Urban Affairs. Association for Finance Professionals (February 8, 2005). See also the statement: "These issues are far too important for the SEC to remain silent while the world waits for it to act". Source: Testimony before the Senate Committee on Banking, Housing and Urban Affairs. Association for Finance Professionals (February 8, 2005). See also the statement: "The SEC has failed to exercise any meaningful oversight of the recognized credit rating agencies to ensure that they continue to merit recognition". Source: Testimony before the Senate Committee on Banking, Housing and Urban Affairs. Association for Finance Professionals (February 8, 2005). See also the statement: "If the SEC does not act immediately to aggressively address concerns that have been raised at this hearing, we urge members of this committee to act to restore investor confidence in the credit ratings process". Source:

In light of the circumstances described herein including recognition of the undue influence exerted by NRSROs and the extent of reliance by market participants on the NRSRO rating classifications, including the grave danger posed by any failure to fully investigate the reason for inappropriate and misleading sovereign ratings presently assigned to the Chinese government, we are compelled to bring this matter to your attention in the expectation of further investigation from the office of the GAO.

Sincerely,

/s/ Kevin O'Brien
President

Attachments in Sequence:

1. Copy of complaint filed with the SEC Division of Market Regulation.

2. Copies of letters issued by members of the 109th Congress requesting the SEC to investigate the matter comprising the subject of the complaint.

3. Copy of two recent articles which appeared in the *Financial Times* daily news periodical regarding this matter.

4. Copy of a guest commentary submitted for publication to the *Financial Times* daily news periodical regarding this matter.

5. Copy of letter from Sovereign Advisers addressed to Ms. Jonna Z. Bianco, President of the American Bondholders Foundation.

6. Copy of Letter from Mr. B. Riney Green, Esq., Stites & Harbison PLLC addressed to the Honorable Harvey L. Pitt, Chairman and Mr. Alan L. Beller, Director, Corporate Finance Division, Securities and Exchange Commission.

7. Copy of response from SEC Division of Corporation Finance to letter sent by Mr. B. Riney Green, Esq.

Testimony before the Senate Committee on Banking, Housing and Urban Affairs. Association for Finance Professionals (February 8, 2005).

8. Copy of letter dated November 27, 2002 addressed to Mr. Clifford L. Alexander, Chairman and Mr. John Rutherfund Jr., President and Chief Executive Officer, Moody's Corporation, describing the existence of a defaulted series of full faith and credit sovereign obligations of the Chinese government.[20]

cc: Members of the 109th United States Congress.

Congressional Committee Offices.

United States-China Economic and Security Review Commission.

Congressional Record.

United States Securities and Exchange Commission.

United States Department of Justice.

United States Federal Trade Commission.

Honorable Eliot Spitzer, Attorney General for the State of New York.

Honorable Robert M. Morgenthau, District Attorney for New York County.

Ms. Gillian Tett, Capital Markets Editor, *Financial Times.*

Ms. Jonna Z. Bianco, President, American Bondholders Foundation.

[20] Mr. Clifford Alexander served as a Director of WorldCom Corporation. It is therefore revealing to note the following statement: "Finally, the tone set at the top of the rating organizations alarms many observers. Consider Moody's chairman Clifford Alexander, who was a board member of WorldCom and resigned only one year before the firm became the largest bankruptcy in U.S. history. It is interesting that Alexander believes this relationship did not compromise Moody's ratings of WorldCom's debt instruments, notwithstanding that Moody's did not downgrade WorldCom's debt to subinvestment grade until shortly before its collapse". Source: "Is the SEC Going Soft on Credit Rating Agencies?" Kreag Danvers and B. Anthony Billings. *The CPA Journal* (May 2004). See also the statement: "Credit rating firms are partly blamed in the major corporate failures for their lack of diligence in identifying credit problems. Indeed, Standard and Poor's (S&P) and Moody's did not reduce Enron's credit ratings from investment grade to junk level until four days before Enron's doors shut". Source: "Is the SEC Going Soft on Credit Rating Agencies?" Kreag Danvers and B. Anthony Billings. *The CPA Journal* (May 2004).