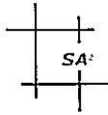

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September 10, 2007

Honorable Christopher J. Dodd, Chairman
U.S. Senate Committee on Banking, Housing, and Urban Affairs
448 Russell Building
Washington, D.C. 20510

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 the Application of a Reckless Standard of Care;
    b) Violations of the Investment Advisers Act; and
    c) Violations of SEC Guidelines.
2. Need for Senate Concurrent Legislation.

Dear Chairman Dodd:

We respectfully write to your attention in regard to a very serious matter directly pertinent to your position as both Committee Chairman of the Senate Banking Committee and as Senior Member of the Senate Committee on Health, Education, Labor and Pensions. 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 (please refer to tab 10 of the companion reference binder).

Continued on Following Page

§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 (please refer to tab 24 of the companion reference binder). 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.

Continued on Following Page

Exhibit 1.0
Recurrent Theme: Credit Raters' Pattern of Deception [1]

Year	Description
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 (please refer to tab 25 of the companion reference binder). In fact, we observe that S&P affirmed China's "investment grade" credit rating

[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). Reprints of each of these articles are included as tab 24 of the companion reference binder.

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the very next day (October 22, 2003) following the Congressional hearing on the ABF, in order to improve the prospects for the sale of China's sovereign bonds and notes registered in the U.S. the same month (October 2003). 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 (please refer to tab 9 of the companion reference binder). 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 U.S. 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

Continued on Following Page

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 (please refer to tab 11 of the companion reference binder). 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 (please refer to tab 22 of the companion reference binder). 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 meet 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 (please refer to tab 9 of the companion reference binder). 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.

Continued on Following Page

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 (please refer to tab 9 of the companion reference binder). 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 (please refer to tab 9 of the companion reference binder).

Continued on Following Page

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 addition of a "2" denotes mid-range ranking within the assigned rating classification.
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.

Continued on Following Page

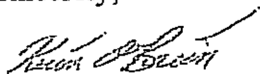
§5.0 China's Fraudulent Sovereign Credit Rating Conceals Defaulted Debt, Injures Defaulted Creditors, and Misstates Actual Risk

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 U.S. public at large. Senate concurrent legislation (please refer to tab 1 of the companion reference binder) 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 U.S. capital markets.

Sincerely,



Kevin J. O'Brien, President
KJO: jwc

Continued on Following Page

Enclosure: Bound reference materials to be transmitted separately.

cc: Hon. Jeff Sessions, U.S. Senator
Hon. Charles Schumer, U.S. Senator
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

Table of Contents

I. Failure by the SEC to acknowledge either the complaint filed September 1, 2006 or the Amendment to the Complaint filed February 15, 2007 describing allegations of disclosure fraud with respect to the U.S. Registration Statement filed by the People's Republic of China in connection with the offering within the United States of sovereign debt obligations of the Communist Chinese government.

In this regard, please see the following Exhibits:

1. Copy of Senate Policy Brief referencing proposed legislation to restore transparency and preserve the integrity of the U.S. capital markets.

2. Copy of the Complaint filed with the SEC Office of the Chief Counsel and the Divisions of Enforcement and Corporation Finance, dated September 1, 2006.

3. Copy of the Amendment to the Complaint filed with the SEC Office of the Chief Counsel and the Divisions of Enforcement and Corporation Finance, dated February 15, 2007.

4. Copy of our letter addressed to Mr. Walter Stachnik, Inspector General, U.S. Securities and Exchange Commission, dated November 13, 2006, referencing and including a copy of our letter addressed to the Honorable Charles Grassley, Chairman, Senate Finance Committee and Mr. David Walker, Comptroller General of the United States, dated October 30, 2006.

Supplemental Exhibits:

5. Copy of letter from the law firm of Stites & Harbison PLLC addressed to the law firm of Sidley Austin Brown & Wood, LLP, dated December 31, 2003.

6. Copy of letter from the law firm of Stites & Harbison PLLC addressed to the Chairman of the SEC, dated January 8, 2003.

7. Copy of letter from SEC Senior Associate Director addressed to the law firm of Stites & Harbison PLLC, dated January 21, 2003.

II. Failure by the SEC to investigate the wrongful practices of the three primary international credit rating agencies in their capacity as Registered Investment Advisers under the Investment Advisers Act, in connection with the development and publication of false, artificial and injurious sovereign credit rating classifications assigned to the Communist Chinese Government.

In this regard, please see the following Exhibits:

8. Copy of the Complaint filed with the SEC Division of Market Regulation, dated March 31, 2005.

9. Additional information regarding the wrongful actions of the three primary international credit rating agencies.

[Continued on Following Page]

10. Copy of letter from the Honorable Jim Saxton, Chairman, Joint Economic Committee of the United States Congress, addressed to the SEC Chairman, dated May 24, 2005 and requesting an investigation into the practices of the international credit rating agencies.

11. Copy of our letter addressed to Mr. David Walker, Comptroller General of the United States, dated June 21, 2005.

12. Copy of letter from SEC Acting Chairman addressed to the Honorable Bob Beauprez, Member of Congress, dated July 29, 2005 and copy of memorandum authored by the Director of the SEC Division of Market Regulation addressed to the SEC Acting Chairman, dated July 29, 2005.

13. Copy of our letter addressed to the Honorable Christopher Cox, SEC Chairman, dated August 4, 2005.

14. Copy of letter from the SEC addressed to Sovereign Advisers, dated August 19, 2005.

15. Copy of our letter addressed to the Honorable Christopher Cox, SEC Chairman, and the Honorable Annette Nazareth, SEC Commissioner, and Mr. Michael Macchiaroli, Associate Director, SEC Division of Market Regulation, dated September 21, 2005.

16. Copy of letter from the SEC Deputy Director addressed to Sovereign Advisers, dated October 11, 2005.

17. Copy of our letter to Mr. Walter Stachnik, Inspector General, SEC, dated October 11, 2005.

18. Copy of our letter addressed to Mr. Walter Stachnik, Inspector General, SEC, dated November 1, 2005.

19. Copy of letter from the SEC Inspector General addressed to Sovereign Advisers, dated October 27, 2005.

Supplemental Exhibits:

20. Summary of Complaint.

21. Copies of articles published by the Financial Times under the heading *Sovereign Credit Ratings*: "China's Pre-War Bond Default Stirs U.S. Anger" (June 7, 2005) and "People's Republic Called to Account" (June 7, 2005).

22. Copy of commentary published by Forbes, entitled "China's Unfair Advantage – How China's Artificial Credit Rating Hurts U.S. Manufacturers" (July 25, 2005).

23. Copy of Washington Times editorial describing the emergence of a new and dangerous dynamic in the Bush Administration's policy regarding the revaluation of the Chinese Yuan, sacrifice of American jobs to China and sale of U.S. assets to Chinese interests financed via China's trade surplus with the United States (June 29, 2007).

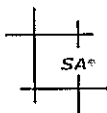
[Continued on Following Page]

24. Washington Post serial investigative report on the business practices of the three primary NRSROs (November 22-24, 2004). Wall Street Journal articles on the credit rating agencies' role in creating the global subprime financial debacle.

25. Schedule of upgrade history of China's sovereign credit rating by the three primary NRSROs.

1

Policy Brief



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July 26, 2007

Electronic version
http://www.globalsecuritieswatch.org/SenatePolicyBrief.pdf

Background Information

Re: Offer and Sale within the United States of Securities of the People's Republic of China

Deceptive Marketing Practices, Misleading and Fraudulent Disclosure, False and Misleading Credit Ratings, Violations of U.S. and International Laws, Selective Enforcement of Federal Agency Regulations, Unlawful Diversion of Monies Due Individual Bondholders, Inducement of the American Investing Public.

Purpose:

1. To protect the American public including U.S. pension funds from the misleading and fraudulent disclosure statements filed by the communist Chinese government (PRC) in connection with the offer and sale within the United States of Chinese securities, which continue to be offered and sold in reliance upon a false and artificial sovereign credit rating which conceals China's defaulted sovereign debt for which the government of the PRC is legally obligated under international law to repay, and refuses to do so;

2. To provide relief to American citizens holding defaulted sovereign debt of the PRC (see for example, the 1960 bond, which remains unpaid and in a state of default) upon which the PRC government continues to evade repayment while engaging in discriminatory and preferential payments to selected creditors; and

3. To establish a policy which will prove effective in encouraging China to restrain and reform its abusive international trade practices and transition into an international, rules-based economy by fostering compliance with established conventions of international trade and commerce.

Example: The U.S. Foreign Bondholders Protective Council, a nonprofit corporation established by the U.S. Department of State, Department of the Treasury, and the Federal Trade Commission to assist U.S. citizens in recovery of defaulted foreign sovereign bonds, reports that in over 40 settlements of defaulted sovereign debt the PRC is the only government which steadfastly refuses to settle its defaulted sovereign debt held by American citizens.

The permissiveness of the Executive branch, made manifest by its failure to enforce the Chinese government's repayment obligation, enables the PRC to escape repayment of its defaulted sovereign debt and further encourages the PRC to write its own rules of international behavior. Such ruinous trade policies toward China have become a matter of interest and concern to a broad segment of the American public, as demonstrated by the national media response to the recent press release announcing the House version of the concurrent resolution.

Research: *http://www.globalsecuritieswatch.org/s&hmemorandums.html*

Public Interest: *http://www.globalsecuritieswatch.org/press_release_06/07/07.pdf*

The Senate legislation will prohibit the issuance within the U.S. financial markets of Chinese securities offered and sold to U.S. investors on the basis of misleading and fraudulent disclosure statements and in reliance upon the false and artificial sovereign credit ratings assigned to the communist Chinese government by the three primary rating agencies, which collectively dominate 95% of the industry, and which ratings contravene both the successor government doctrine of settled international law confirming continuity of obligations as well as the agencies' own published definitions, and which false and artificial ratings also act to conceal the actions of the government of the PRC, including the actions of repudiation; selective default; rejection of the successor government doctrine of international law; discriminatory settlement with Great Britain; and discriminatory and preferential payments to selected creditors.

I. <u>Fraudulent Disclosure in U.S. Registration Statement Involving Chinese Government Securities Offered and Sold in the United States.</u>

SEC Rule 10b-5 and Section 10(b) of the Exchange Act impose an affirmative obligation upon issuers not to speak in half-truths or to make incomplete statements in accordance with SEC Schedule B, governing the disclosure requirements for sovereign issuers. The following half-truths and incomplete statements appear in the 2003 U.S. registration statement filed with the SEC by the PRC in connection with the sale of its sovereign bonds:

- Intentional omission of any mention of the existence, and refusal to honor repayment as required under international law, of the defaulted sovereign debt of the Chinese government.

Example: *"The central government has always paid when due the full amount of principal of, any interest and premium on, and any amortization or sinking fund requirements of, external and internal indebtedness incurred by it since the PRC was founded in 1949."* [Page 69 of the Prospectus]

The above statement is both misleading and constitutes a half-truth. Under the successor government doctrine of settled international law, the central government assumed the repayment obligation for the Chinese government's sovereign debt issued by the internationally-recognized predecessor government of China, including the obligation for repayment of the 1960 bond (issued prior to 1949) upon its assumption of power in 1949. The communist Chinese government refuses to honor repayment of any of this debt held by Americans. It is also revealing to note the complete omission from the Supplement to the Prospectus of any reference to the televised public hearing conducted by the Committee on International Relations of the U.S. House of Representatives in October of 2003 concerning China's defaulted sovereign debt, which occurred prior to the date of the Supplement to the Prospectus.

Research: *http://www.globalsecuritieswatch.org/Letter_from_Stites_&_Harbison_to_Sidley_Austin_Brown_&_Wood*
http://www.globalsecuritieswatch.org/Sovereign_Disclosure_Obligation.pdf
http://www.foreignaffairs.house.gov/archives/108/90360.pdf

- Intentional falsehood regarding the "equal ranking" of China's sovereign debt obligations.

Example: *"The notes will rank equally ... with all other general and (subject to the provisions in the notes providing for the securing of such obligations in the event certain other obligations of China are secured) unsecured obligations of China for money borrowed ... . China will pledge its full faith and credit ... for the due and timely performance of all obligations of China ..."* [Page S-7 of the Supplement to the Prospectus]

The above statement is disingenuous in the extreme. The notes do not "rank equally" with other general obligations of the PRC and the associated repayment as well as the interest payments are preferential and discriminatory in nature and exclude any repayment by the PRC of the defaulted sovereign obligations held by Americans (e.g., the Chinese government's 1960 bond which remains unpaid and in a state of default).

Research: *http://www.globalsecuritieswatch.org/Amended_SEC_Complaint.pdf*

- No mention of the PRC government's actions of repudiation of the debt, selective default, rejection of the successor government doctrine of international law, discriminatory settlement with Great Britain, and discriminatory and preferential payments to selected creditors. These omissions and half-truths, appearing in a U.S. Registration Statement, upon which no action has been taken to amend in the face of constructive notice, rise to the level of fraud and are expressly prohibited under federal law. They act to misstate the actual risk of investment in Chinese securities and further act to induce prospective investors into such high-risk securities leading to extremely adverse consequences.

Example: China Life Investor Fraud: *http://www.globalsecuritieswatch.org/Spitzer.pdf* [see footnote #42 (page 22)]
China Aviation Oil Investor Fraud: *http://www.energyrisk.com/public/showPage.html?page=200016*
http://www.deloitte.com/dtt/article/0,1002,cid%253D113280,00.html

Research: *http://www.globalsecuritieswatch.org/Letter_from_Stites_&_Harbison_to_SEC*

II. The Primary NRSROs Continue to Publish and Distribute a False and Artificial International Sovereign Credit Rating for China

The three primary international credit rating agencies (Standard & Poor's Corporation, Moody's Investors Service and Fitch Ratings) are designated "nationally recognized statistical rating organizations (NRSROs) by the SEC. These three rating agencies operate independent from any regulatory oversight or supervision, and routinely engage in business practices which have been heavily criticized for serious conflicts of interest which create the incentive for assigning inflated and artificial ratings, and which frequently result in major credit implosions and financial market debacles (see for example, the instances of Enron, WorldCom, the 1997 Asian crisis, the U.S. sub-prime mortgage market, etc.). In 2005, the then-chairman of the Joint Economic Committee of the U.S. Congress expressed serious concern regarding the actions of the rating agencies with respect to China in a letter to the SEC chairman. Despite the validity of the Committee's concerns, the SEC declined to investigate the matter.

Research: *http://www.globalsecuritieswatch.org/Wrongful_Actions_of_the_International_Credit_Ratings_Agencies*
[See Exhibit 4 (page 8) entitled, "Washington Post Special Feature"]

http://www.globalsecuritieswatch.org/chairman_saxton_demand_for_investigation.pdf

http://www.globalsecuritieswatch.org/GAO_LETTER.pdf

http://www.globalsecuritieswatch.org/SEC_Memorandum_Disclaiming%20Regulatory%20Jurisdiction

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 its 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. In the instance of China, the three primary rating agencies have intentionally and wrongfully assigned false and artificial sovereign credit ratings to the communist Chinese government which conceal the existence of the Chinese government's defaulted sovereign debt and which do not conform to the published definitions, and have knowingly done so in order to maximize the profits of the rating agencies.

Example: The Chinese government's 1960 bond which remains unpaid and in a state of default. The bond certificates explicitly state that the obligations are intended to be binding upon the government of China and any successor government.

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 a nation 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 unable to issue international sovereign bonds until it repays its defaulted sovereign debt.

Research: *http://globalsecuritieswatch.org/Sovereign_Ratings_Definitions_and_Criteria*

http://www.globalsecuritieswatch.org/SEC

http://www.globalsecuritieswatch.org/Summary_of_Complaint

http://www.globalsecuritieswatch.org/Letter_from_Sovereign_Advisors_to_SEC_Chairman_and_Associate_Director

The international sovereign credit ratings assigned to the communist Chinese government by the three primary NRSROs explicitly contravene the successor government doctrine of settled international law affirming the continuity of obligations issued by an internationally-recognized predecessor government (see e.g., *the Restatement (Third) of the Foreign Relations Law of the United States,* Section 712(2) and Creditors Claims in International Law, The International Lawyer, Vol. 34, page 235, Spring, 2000).

Example: Standard & Poor's published methodology asserts that "Standard & Poor's sovereign credit ratings are an assessment of each government's ability **and willingness** to service its debt in full and on time (*emphasis added*)." All three primary rating agencies assert that a debtor government is in default whenever it misses a payment or seeks to renegotiate a loan – "Anything", according to S&P's Marie Cavanaugh, "that is not timely service of debt according to the terms of issue." In the interest of maximizing their profits, the three primary agencies continue to grant China a special exemption from their published standards.

Research: *http://www.globalsecuritieswatch.org/S&P_Sovereign_Ratings_Methodology*

In addition to concealing the default of the Chinese government's sovereign debt, which remains in default, the current ratings maintained by the three primary NRSROs act to conceal the PRC government's actions of repudiation of the debt; selective default; rejection of successor government doctrine of international law; discriminatory settlement with Great Britain; and discriminatory and preferential payments to selected creditors, all of which are the actions of the post-1949 communist Chinese government and all of which continue in effect today with the cooperation of, and to the immense financial and profitable benefit of, the three primary NRSROs. Although each of the three primary NRSROs are registered as Investment Advisers under the Advisers Act, the SEC refuses to enforce any of the pertinent regulations concerning the wrongful actions of the agencies.

Research: *http://www.globalsecuritieswatch.org/Letter_from_Sovereign_Advisors_to_SEC_Chairman_and_Associate_Director*
http://www.globalsecuritieswatch.org/GAO_LETTER.pdf
http://www.globalsecuritieswatch.org/Letter_from_Sovereign_Advisors_to_SEC_Inspector_General

Expert Observation: Indiana University's Dr. Scott Kennedy, who specializes in China's political economy: "If you have any credibility, you would probably be rating everything junk in China." [*Wall Street Journal*, January 5, 2004]

The duopoly franchise enjoyed by the primary rating agencies, conveyed upon them by virtue of the exclusivity of their "NRSRO" designation, imbues their ratings with the force of law, resulting in pervasive prudential and regulatory codification and further insulates the agencies from accountability for wrongful and injurious actions arising from self-serving profit motivations.

Research: *http://www.globalsecuritieswatch.org/Forbes_Article.re.China's_Artificial_Sovereign_Credit_Rating*

Since the communist Chinese sovereign benchmark can be shown to be artificial, then by extension, the rating of all Chinese corporate issuers is phony as well. Furthermore, since corporations cannot generally penetrate the sovereign ceiling, creation of a false and artificial benchmark opens the door to global issuance by Chinese corporations, resulting in the dislocation of entire industries. Such an effect would not have occurred to the effect which is manifest at present if the rating agencies had followed their published methodologies 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.

Conclusion:

The facts reveal that after an absence of nearly fifty years from the international financial markets, the communist Chinese government decided to re-engage in international debt financing and to establish a sovereign benchmark in order to pave the way for issuance in the global markets by Chinese corporations. In order to do so, China bought and paid for an international sovereign credit rating which it denied seeking, and which concealed and continues to conceal the fact that the Chinese government is in default on its sovereign debt and that it continues to make discriminatory payments to preferential creditors.

Research: *http://www.globalsecuritieswatch.org/China_Denies_Seeking_Sovereign_Credit_Rating*

Preserving the integrity of U.S. financial markets and respect for the rule of law must rank superior to the profits to be made by underwriting the securities of the totalitarian communist Chinese regime in the U.S. The permissiveness of the Executive branch empowers China to write its own rules of international conduct. The Congress now has the opportunity to put a halt to the wrongful practices of the PRC and protect the investing public from the harmful effects which will most certainly occur owing to the continued offer and sale of PRC securities premised upon tactics comprising inducement and fraud.

EXHIBIT

Published Definitions
International Sovereign Credit Rating Classifications [1]

Exhibit 1
Prevailing Artificial Sovereign Credit Rating Classifications
Long-Term Foreign Currency Debt of the Chinese Government [2]

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 addition of a "2" denotes mid-range ranking within the assigned rating classification.[3]
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 with the published definitions maintained by the same agencies as illustrated in Exhibit 2, 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).

Exhibit 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 [4]

Agency	Rating	Definition
Standard & Poor's	SD (Selective Default) [5]	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.[6]
Moody's	Ba (high range) Caa (low range)	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.[7]
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.

As illustrated in Exhibit 2, the Communist Chinese government continues to engage in a pattern of discriminatory, exclusionary and preferential practices while refusing repayment of its sovereign obligations for which it is legally responsible as the successor government of all China, and which actions are concealed by the assignment, publication and distribution of false international sovereign credit rating classifications by the three primary rating agencies, the published definitions of which do not conform to the fact pattern comprising the immediate instance.[8] It is the ability of the Communist Chinese government to engage in international debt financing in reliance upon its prevailing rating classifications, and so establish and maintain a sovereign benchmark for the benefit of Chinese corporate issuers, which constitutes the proximate mechanism by which the Chinese government is able to escape its repayment obligation to defaulted creditors. It thus becomes evident that the practices engaged in by the primary international credit rating agencies evidence selective adherence to their respective published definitions, methodologies and criteria in order to attain a predefined result and so avoid an inconvenient truth, to the calculated effect of maximizing their profits.[9]

Endnotes:

[1] The definition for each specific rating classification was obtained as published by the respective credit rating agencies on the respective agency's website, accessed via the following URLs:
Standard and Poor's: *http://www2.standardandpoors.com*
Moody's Investors Service: *http://www.moodys.com*
Fitch Ratings: *http://www.fitchratings.com*

[2] Prevailing long-term foreign currency sovereign credit rating classifications assigned to the Chinese government as of August 1, 2006 by the three largest nationally recognized statistical rating organizations.

[3] When applied to debt issued by a sovereign issuer, this rating classification denotes an investment grade debt rating for an issuer which has no full faith and credit sovereign obligations remaining in default.

[4] According to the United States Foreign Bondholders Protective Council, established by the U.S. Department of State, Department of the Treasury, and the Federal Trade Commission for the purpose of assisting U.S. citizens in recovery of repayment of defaulted obligations of foreign governments, the Communist Chinese government represents the only instance, in over 40 successful settlements of defaulted sovereign debt, of a government refusing to negotiate the settlement of its defaulted sovereign debt.

[5] Recent instances in which Standard and Poor's has assigned an "SD" rating classification to the long-term foreign currency debt of a sovereign issuer include Russia in 1998 (which defaulted on its domestic obligations while continuing to service its eurobonds); Argentina, following its sovereign debt default in December 2001 and subsequent restructuring, including an exchange offer to existing bondholders; and the Dominican Republic in 2005 (which became delinquent on payments owed to commercial bank creditors while continuing to service its bonded debt). The "SD" rating remained in full force and effect until all outstanding defaulted obligations were resolved.

[6] A prime example of "Selective Default" is the series of full faith and credit sovereign obligations issued as the "Chinese Government Five Per Cent Reorganization Gold Loan", scheduled to mature in 1960 and which debt remains in default as an external payment obligation of the successor government of China (i.e., the Communist Chinese government, which was established on October 1, 1949). The Communist Chinese government replaced the Republic of China in the United Nations as the recognized government of China on November 23, 1971 and was subsequently recognized as the government of all China.

[7] This rating classification is appropriate with respect to acknowledging the judicial risk inherent to investment in such obligations arising from the discriminatory, preferential and exclusionary treatment of selected general obligation creditors.

[8] See in particular the Communist Chinese government's unwillingness to respect repayment of the defaulted full faith and credit sovereign obligations held by United States citizens, for which the government of China is liable under the successor government convention of settled international law and which convention was invoked by the 1983 *Aide Memoire* in which the Communist Chinese government explicitly attempted to repudiate its obligation to repay the debt. We further note the determination by the United States Foreign Claims Settlement Commission in *Carl Marks & Co.* wherein the Commission found that the unpaid debt represents a general obligation of the government of China. By their published definitions, the prevailing sovereign credit rating classifications assigned to the Communist Chinese government exclude and thereby conceal the fact of selective default, as shown in Exhibit 1 and Exhibit 2.

[9] In this regard, we note the following statement, *"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). See also the statement, *"Reliance by credit rating agencies on issuer fees could lead to a conflict of interest and the potential for rating inflation."* United States Securities and Exchange Commission, Rating Agencies and the Use of Credit Ratings Under the Federal Securities Laws (2003). See also the statement, *"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?"* Danvers, Kreag and Billings, B. Anthony, The CPA Journal (May 2004). We observe that the Chinese government's defaulted sovereign debt, existing unpaid and in a state of default, has come to rest principally in the hands of individual investors as opposed to institutions, and that the agencies and the advisers to the Communist Chinese government therefore anticipated a very minimal risk of objection via a unified voice as respects the assignment of a long-term foreign currency sovereign credit rating to the Chinese Government which has the action of concealing the existence of the Chinese Government's defaulted sovereign debt. When Standard & Poor's first assigned the rating in 1992, it did not reflect the existence of the Chinese Government's defaulted sovereign debt and established a new, and artificial, foundation upon which the Chinese Government could resume international financing without repaying its defaulted sovereign debt, and also constitute the basis upon which to inflate the rating over the future term.

Press Release

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Congress Acts to Halt the Selling-Out of America

In Bid to End Ruinous Trade Policy with China, House and Senate Introduce Concurrent Resolutions to Deny China Access to U.S. Financial Markets

Commentary by Sovereign Advisers

(TUCSON, AZ – June 6, 2007) In the face of the People's Republic of China's continuing manipulation of its currency and other intentional and flagrant violations of international law, both Houses of the United States Congress recently introduced concurrent resolutions (**H.Con.Res.160**) stripping the People's Republic of China of access to U.S. capital markets. In a strongly bipartisan measure, Congress has squarely taken aim at reforming the abusive trade practices employed by the communist Chinese government to reap the economic benefit of access to U.S. markets at the expense of America's middle class, which continues to suffer the loss of an estimated 2,250 jobs each day to China.

The concurrent resolutions are expected to reform the disastrous trade policies which have only served to enable a few select Wall Street institutions and individuals to reap millions of dollars in revenue (see Goldman Sachs' recent $16 billion bonus pool) from assisting China in recycling its surplus trade dollars earned from its $300 billion (2007 estimate) trade imbalance with the U.S. into its military build-up and the purchase of U.S. assets (see, for example, the recent purchase by the Chinese government of a 10% interest in the U.S. buyout fund Blackstone), all at the expense of America's middle class.

The action by the Congress will also afford protection to U.S. workers from **ill-considered investments** in Chinese securities offerings by U.S. public pension funds in light of the recent statements by the World Bank that these offerings act only to create "insider wealth" (see "World Bank Claims 'Billions' Lost on China IPOs", *Financial News*, May 31, 2007). The communist Chinese government has a long history of **predatory** financial markets practices including making discriminatory debt payments to preferential creditors, which are the subject of a **complaint** recently filed with the U.S. Securities & Exchange Commission alleging **fraud** in connection with the offer and sale in the U.S. of its sovereign bonds.

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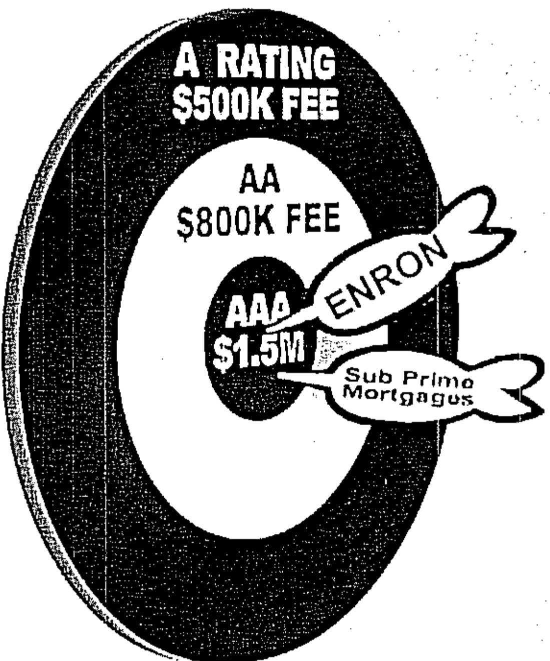
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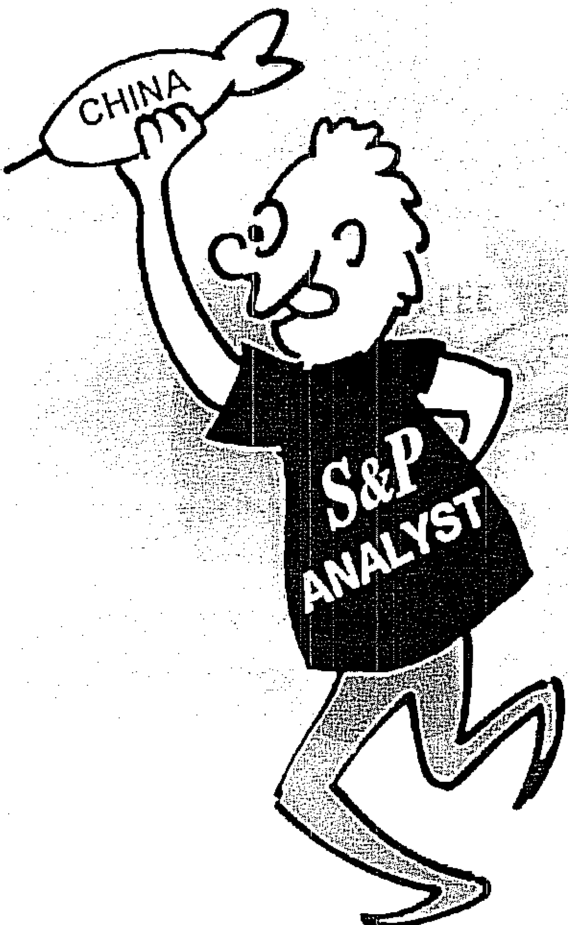
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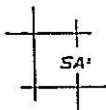

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September 1, 2006

Mr. Brian G. Cartwright, General Counsel
Office of the General Counsel

Ms. Linda Thomsen, Director
Division of Enforcement

Mr. John W. White, Director
Division of Corporation Finance

United States Securities and Exchange Commission
100 F Street, N.E.
Washington, D.C. 20549

Re: Recent actions evidencing failure to comply with disclosure obligations of registered sovereign issuers under the federal securities laws of the United States in respect to the offer, sale and trading of sovereign debt securities of the People's Republic of China: violations of Rule 10b-5 and Section 10(b) of the Exchange Act.

Dear Mr. Cartwright, Ms. Thomson and Mr. White:

We respectfully write to your attention concerning the matter of the defaulted sovereign debt of the Government of China as this matter pertains to the disclosure requirements affecting recent, as well as future, offers, sales and trading of debt securities of the Government of China and its state-owned enterprises within the United States.[1]

In the United States, the disclosure obligations for registered sovereign issuances are governed by the Securities and Exchange Commission's Schedule B, which affirmatively requires only minimal disclosure including pricing, payments schedule, and volume. However, an affirmative obligation by registered sovereign issuers to speak with respect to additional disclosure does exist in that statements made in connection with an offering of securities, although literally true, may not be misleading through their incompleteness as specified by Rule 10b-5 and Section 10(b) of

[1] Please refer to the complaint dated March 31, 2005 filed with the SEC Division of Market Regulation describing the wrongful actions of the underwriters of recent offerings of debt securities of the Government of China and the credit rating agencies in the matter of selectively ignoring the full faith and credit sovereign debt of the Government of China presently existing unpaid and in a state of default: (http://www.globalsecuritieswatch.org/SEC.pdf). The complaint was subsequently the subject of a comprehensive internal review by the SEC at the request of numerous members of the United States Congress: (http://www.globalsecuritieswatch.org/congress.html). See also the letter dated May 24, 2005 addressed to the SEC Chairman by the Honorable Jim Saxton, Chairman of the Joint Economic Committee: (http://www.globalsecuritieswatch.org/chairman_saxton_demand_for_investigation.pdf). We are informed that the facts and circumstances described in the complaint were influential in the recent passage of legislation (HR 2990) reforming federal regulatory oversight of the credit rating agencies.

the Exchange Act.[2] Under Rule10b-5 and Section 10(b) of the Exchange Act, a duty is imposed upon an issuer to refrain from disclosing materially incomplete statements (i.e., the prohibition against "half-truths").

Accordingly, a source of a sovereign's obligation to disclose additional risks in the offering documents arises from additional disclosure which the sovereign volunteers. In the event that a registered sovereign issuer may elect to provide additional disclosure beyond the requirements imposed by SEC Schedule B, such statements must constitute full and complete disclosure and not be misleading through their incompleteness. Under Rule 10b-5, statements that are literally true can create liability if they create a materially misleading interpretation because they omit some key fact (or, in other words, are "half-truths"). The duty not to make "half-truths" under Rule 10b-5 applies to both registered and non-registered sovereign bond issuances.

We refer now to the inadequate disclosure contained in the prospectus dated October 16, 2003 and in the prospectus supplement dated October 22, 2003 pertaining to the registered offering, sale and issuance of sovereign obligations of the People's Republic of China, and offer several obvious examples of disclosure obligations required by Rule 10b-5 and Section 10(b) of the Exchange Act which are omitted from mention in the above offering document.[3]

Examples of failures to fully disclose key facts, constituting violations of Rule 10b-5 and Section 10(b) of the Exchange Act:

1. Voluntary Disclosure: **Debt Record** *(page 69 of the prospectus)* –

> "The central government has always paid when due the full amount of principal of, any interest and premium on, and any amortization or sinking fund requirements of, external and internal indebtedness incurred by it since the PRC was founded in 1949."

Omission: This statement is misleading to offerees and prospective purchasers. Both the prospectus and the prospectus supplement intentionally omit any mention of the existence of pre-1949 defaulted full faith and credit sovereign obligations of the Government of China, which under accepted conventions of international law, the payment obligation for such indebtedness was incurred by the central government of China in 1949 and on which that government has since settled with British bondholders while continuing to evade the claims of American bondholders.

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[2] The lack of meaningful affirmative disclosure obligations in the Schedule B context, elevates the importance of the obligation not to speak in "half-truths". See James D. Cox, *Rethinking U.S. Securities Laws in the Shadow of International Competition*, L. & Contemp. Problems, Autumn 1992, at 177, 192-193 (cited at 13, *An Empirical Study of Securities Disclosure Practices,* authored by Mitu Gulati and Stephen Choi, Duke Law School Working Paper, 2006).

[3] Registration no. 333-108727. (ISIN US712219AJ30 / CUSIP 712219AJ3). See prospectus dated October 16, 2003 and the prospectus supplement dated October 22, 2003: (http://www.sec.gov/Archives/edgar/data/909321/000114554903001347/u98681p1e424b5.htm).

As we have previously described, neither the prospectus nor the prospectus supplement contain any mention whatsoever regarding the existence of defaulted full faith and credit sovereign debt of the Government of China which remains unpaid in a state of default, and for which the People's Republic of China is liable for repayment under settled international law as the internationally-recognized successor government of China, and which government continues to engage in actions evidencing both selective default and discriminatory settlement under settled international law.[4] Such actions act to create the risk of seizure of proceeds of any securities offering by the Government of China or any of its state owned enterprises and also act to expose purchasers of sovereign obligations issued by the People's Republic of China to the risk of injunctions preventing discriminatory payments to such purchasers.

2. Voluntary Disclosure: **External Debt** *(page 67 of the prospectus)* – Note: this section contains extensive narrative and numerous schedules referencing the outstanding obligations and external debt of the Government of China. No mention is made regarding the existence of defaulted sovereign debt of the Government of China. An excerpt of this section appears below:

"Loans are the primary source of external debt. Non-trade loans accounted for approximately 84.4% of the total external debt outstanding at December 31, 2002. Commercial loans (i.e., loans obtained from any source on commercial terms), official primary government loans (i.e., loans obtained on favorable terms from foreign governments and international financial organizations including the World Bank and Asian Development Bank) and other types of debt financing accounted for approximately 53.5%, 30.9% and 15.6%, respectively, of total external debt in the form of loans at December 31, 2002. The central government's current policy is to continue to

---

[4] The U.S. registration statement including the prospectus and prospectus supplement pertaining to the 2003 sovereign bond offering and sale by the People's Republic of China was prepared by the U.S. law firm of Sidley Austin Brown & Wood LLP. We note that this is the same law firm that, through its predecessor firm of Brown & Wood LLP, admitted to orchestrating an artifice which was then operated as a knowingly fraudulent tax shelter scheme and which defrauded the U.S. Treasury out of an estimated $2.5 billion in tax revenues, and which firm then agreed to make a $40 million payment to settle a civil class action lawsuit for tax shelter fraud in connection with the very recent KPMG case. This settlement is in addition to separate actions brought by the U.S. Department of Justice and the Internal Revenue Service in the largest criminal tax case ever. Sidley Austin was also the subject of a special inquiry conducted by the Senate Permanent Subcommittee on Investigations. Apparently, this law firm not only engineered the fraudulent tax shelter scheme, but also issued a knowingly fraudulent tax opinion to support the massive multi-billion dollar scheme. We note that Sidley Austin also concealed the fact of a public hearing entitled, "U.S.-China Ties: Reassessing the Economic Relationship" conducted by the House Committee on International Relations, which invited and did include testimony pertaining to the existence of defaulted sovereign debt of the Government of China, and which occurred prior to the date of the 2003 prospectus supplement. We further note the fact that Sidley Austin concealed the existence of a House Concurrent Resolution ("H.Con.Res.60") in the United States Congress which specifically referenced the existence of the defaulted sovereign debt of the Government of China. We also note that subsequent to the receipt of constructive notice provided by the letter prepared by the law firm of Stites & Harbison dated December 31, 2003, that Sidley Austin failed to take any action to amend the 2003 U.S. registration statement and prospectus. Such failure evidences the application of a reckless standard of care.

seek loans from foreign governments and international financial institutions to finance infrastructure projects in China. At the end of 2002, the total outstanding external debt was US$168.5 billion."

"The Ministry of Finance, on behalf of the central government, has raised funds in the international capital markets through various debt securities and bond issues since 1993. The Ministry of Finance's principal objective is to set up benchmarks for other Chinese borrowers. Several state-owned financial institutions and enterprises have also issued debt securities in the international capital markets with the approval of the State Council."

"Unless the central government expressly provides otherwise, the central government does not guarantee or provide any direct or indirect credit support to any entity in China. However, debtors that have their external debt registered with the State Administration of Foreign Exchange have the right to buy foreign currencies as permitted by the central government at the China Foreign Exchange Trading System rate in order to service the interest and principal payments on their registered external debt."

Omission: The language of this section intentionally conceals the existence of a significant liability of the People's Republic of China under the successor government doctrine of settled international law espousing continuity of obligations. The failure to disclose the existence of the defaulted sovereign debt of the Government of China and the existence of a defaulted class of creditors also exposes purchasers of the offered obligations to the risk of judicial and other actions brought by the class of defaulted creditors, the existence of which remains undisclosed, and whose actions to recover payment on the defaulted obligations would reasonably be considered to be adverse to the interests of purchasers of newly-offered obligations. The concealment of the defaulted sovereign debt of the Government of China also acts to intentionally deceive prospective purchasers as to the actual risk of non-repayment inherent to the actions of the Government of China towards its defaulted creditors and the refusal to honor repayment of its outstanding defaulted sovereign debt.

3. Voluntary Disclosure: Recent Developments *(page S-6 of prospectus supplement)* –

"The credit ratings accorded to China's debt securities by the rating agencies are not recommendations to purchase, hold or sell the notes to the extent such ratings do not comment as to market price or suitability for you. Any rating may not remain in effect for any given period of time or may be revised or withdrawn entirely by a rating agency in the future if in its judgment circumstances so warrant, and if any such rating is so revised or withdrawn, we are under no obligation to update this prospectus supplement. On October 15, 2003, Moody's Investors Service, Inc. upgraded China's sovereign rating from A3 to A2 for long-term foreign-currency denominated debt. The rating outlook is stable. On October 22, 2003, Standard & Poor's Ratings Group affirmed its BBB senior unsecured foreign currency credit rating for China. The outlook is positive. On October 13, 2003, Fitch IBCA, Inc. affirmed the long-term foreign currency rating of China at A-. The rating outlook is positive. This rating applies to all of China's senior unsecured long-term sovereign debt issues."

Omission: Any mention of the specific risks to purchasers arising as a result of the suspension of the sovereign credit rating of the Government of China owing to a credible and reasonably foreseeable threat of litigation seeking recovery of payment on the defaulted sovereign debt of the Government of China. Although the language of this section of the prospectus supplement does acknowledge the generic possibility of the withdrawal of the sovereign credit rating of the Government of China, the language fails to disclose the existence of known facts evidencing the falsity of the prevailing sovereign credit rating classifications assigned to the Government of China by Standard and Poor's Ratings Service, Moody's Investors Service, and Fitch Ratings and the attendant prospect for litigation in this regard.[5] The generic risk disclosure language offered in this section fails to fully disclose the existence of the actual and known specific risks attributable to the failure to disclose the existence of the defaulted sovereign debt of the Government of China, and which risks would reasonably be expected and foreseeable to cause the occurrence of suspension of the sovereign ratings assigned to the Government of China (i.e., the risk that suspension may occur as a result of an action brought in the future against the credit rating agencies by defaulted creditors of the Government of China). Such actions brought by defaulted creditors would reasonably be expected to include recovery of damages sustained as a consequence of a tort injury (e.g., the "taking" of the defaulted creditors' ability to enforce the debt contract occurring as a direct consequence of the intentional assignment of a knowingly fraudulent credit rating classification to the Government of China).

4. Voluntary Disclosure: **General Information** *(page S-11 of the prospectus supplement)* –

> "China is neither involved in any litigation, arbitration or administrative proceedings which are material in the context of the issue of the notes nor aware of any such litigation, arbitration or administrative proceedings, whether pending or threatened."
>
> "Except as disclosed in this prospectus supplement and the accompanying prospectus, there has been no significant change in the condition (financial, political, economic or otherwise) or the affairs of China which is material in the context of the issue of the notes since December 31, 2002."

Omission: At the time of the dates appearing on the prospectus and the prospectus supplement, there existed a reasonably anticipated prospect for litigation in the form of a judicial action for recovery of repayment of the defaulted sovereign debt of the Government of China, including imposition of injunctions and restraining orders acting to adversely affect the flow of payments to selected classes of creditors, halt trading in affected securities, and the possible seizure of offering proceeds or interest payments by defaulted creditors.

[5] The three Nationally Recognized Statistical Rating Organizations named above command a dominant position of the rating business, comprising a 94% market share.

The American Bondholders Foundation, comprising a large group of affiliated U.S. persons holding defaulted sovereign debt of the Government of China, was organized in early 2001 to consolidate the claims of defaulted creditors of the Government of China and was actively engaged along with other parties in both the United States as well as outside the United States, in efforts, including possible judicial action(s), to recover repayment of the defaulted full faith and credit sovereign debt of the Government of China prior to, at the time of, and subsequent to the dates of the prospectus and prospectus supplement, and remains actively engaged in such recovery efforts at present. Such efforts, which were widely publicized at the time and so should have been known to the parties responsible for preparing the prospectus and the prospectus supplement, would have been reasonably anticipated as of the dates of the prospectus and the prospectus supplement to produce judicial and other action(s) affecting various creditors of the Government of China, including purchasers of the 2003 sovereign bond offering.[6]

The language of this section completely fails to disclose not only the risks to purchasers of litigation in connection with recovery of the defaulted sovereign debt of the Government of China, but also fails to disclose the engagement of the United States Congress on behalf of the interests of the defaulted class of U.S. creditors of the Government of China, and the reasonably foreseeable and highly potential prospect of political and legislative action(s) by the United States Congress to enforce fair trade and commerce practices and which may adversely affect both the liquidity and the market price of sovereign bonds issued by the Government of China on which that government selectively honors payment while refusing to honor payment to its defaulted creditors in violation of both settled international law and the established *pari passu* legal doctrine prohibiting discriminatory payments among creditors.[7] We have previously noted that public testimony was provided at a public hearing prior to the date of the prospectus supplement before the House International Relations Committee on October 21, 2003 describing the very pertinent issue of the unpaid full faith and credit sovereign debt of the Government of China existing in a state of default, as the Government of China continues

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[6] See news article entitled, *U.S. Holders of Pre-1949 China Bonds Sue Rating Agencies.* EuroWeek (July 21, 2006). See also, the letter prepared by Sovereign Advisers addressed to the McGraw-Hill Companies dated May 18, 2006, providing constructive notice of the taking of defaulted creditors' ability to enforce collection of the defaulted sovereign debt of the Government of China as a result of the intentional application of a reckless standard of care in developing the previous as well as the prevailing sovereign credit rating classifications assigned to the long-term foreign currency debt of the Government of China and which wrongful practices enabled the Government of China to resume international financing while avoiding repayment of the Government of China's defaulted sovereign debt. Identical versions of this letter were also delivered to Moody's Investors Service and Fitch Ratings, providing each firm with constructive notice.

[7] See information describing the effect on holders of sovereign debt as a result of the Belgian Court's decision in *Elliott Associates*, as well as letters from members of the United States Congress endorsing regulatory enforcement relating to matters pertinent to full disclosure and recovery of repayment of the defaulted full faith and credit sovereign debt of the Government of China:
(http://www.globalsecuritieswatch.org).

to evade repayment to defaulted creditors through actions evidencing a pattern of selective default and discriminatory settlement.[8]

In particular regard to litigation disclosure, please note the existence of at least one civil lawsuit against the Government of China which is presently pending in the U.S. District Court for the Southern District of New York comprising a judicial action for recovery of repayment on the defaulted sovereign debt of the Government of China.[9] The occurrence of this action was reasonably foreseeable in October 2003, and the attendant risks to investors in newly-offered debt securities of the Government of China were not disclosed to the investing public which relied on the 2003 prospectus and prospectus supplement, many of whom may have been induced to purchase the offered securities owing to concealment of both the existence of the full faith and credit sovereign debt of the Government of China which remains unpaid in a state of default, as well as the attendant risks posed by this fact, including recent actions evidencing both selective default and discriminatory settlement by the Government of China.[10]

Please be advised that regardless of the ultimate disposition of the specific instance referenced in this section (i.e., Marvin L. Morris vs. People's Republic of China), we expect additional parallel and derivative actions to subsequently occur as a result of this action. The continuing evasion by the Government of China as respects repayment of its defaulted sovereign debt necessitates the aggressive prosecution of judicial actions for recovery. We anticipate the filing of additional civil suits by various parties seeking recovery of the defaulted sovereign debt of the Government of China in both U.S. courts and in various foreign jurisdictions as well. We also anticipate the imminent filing of numerous petitions requesting the grant of injunctions and restraining orders both in the United States and abroad pursuant to a concerted recovery action to collect repayment of this debt.

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[8] See transcript of testimony provided at the public hearing conducted by the House Committee on International Relations on October 21, 2003 entitled, "U.S.-China Ties: Reassessing the Economic Relationship": (http://wwwc.house.gov/International_Relations/108/bian2021.htm). This publicly televised testimony was presented to members of the House Committee on International Relations prior to the date of the prospectus supplement (October 22, 2003), yet the circumstances described in the Congressional testimony were intentionally and wrongfully omitted from disclosure in both the prospectus and the prospectus supplement. Both the prospectus and the prospectus supplement noticeably fail to disclose any reference to, or mention of, the letter sent by the law firm of Stites & Harbison PLLC to the Ministry of Finance of the People's Republic of China demanding payment of the claims of defaulted U.S. creditors of the Government of China (copy enclosed).

[9] See Marvin L. Morris, Jr. vs. People's Republic of China (05 CIV 4470) presently pending in the U.S. District Court for the Southern District of New York:
(http://www.globalsecuritieswatch.org/civil_complaint.pdf).

[10] The Government of China continues to ignore the claims of U.S. bondholders who are victims of both selective default and discriminatory settlement by the Government of China (see the 1987 treaty with Great Britain which settled the claims of British bondholders), which continues to attempt to evade repayment in flagrant violation of accepted conventions of international trade and commerce including rejection of the successor government doctrine of settled international law.

Accordingly, the grant of such injunctions and restraining orders may reasonably be expected to include any of the following on either a pre-judgment or post-judgment basis:

1. Injunction(s) enjoining and prohibiting the offer or sale of securities of the Government of China or any of its state-owned enterprises;
2. Injunction(s) enjoining and prohibiting the transmittal of any proceeds derived from any securities offering by the Government of China or any of its state-owned enterprises;[11]
3. Injunction(s) enjoining and prohibiting the Government of China from making discriminatory payments to other creditors in circumvention of payments to defaulted creditors;[12]
4. Injunction(s) enjoining and suspending publication of the sovereign credit rating assigned to the Government of China;[13]
5. Injunction(s) enjoining and suspending trading activities involving any securities of the Government of China or any of its state-owned enterprises; and
6. Enforcement of judgments attaching commercial assets of the Government of China, including the seizure of proceeds from the offer and sale of securities.

The potential for such actions poses material risks to investors holding outstanding obligations of the Government of China which that government selectively honors and on which the Government of China continues to make discriminatory payments, as well as to investors in future debt securities issued by the Government of China.

In light of the voluntary disclosures contained in the 2003 prospectus and the prospectus supplement, the intentional omissions of the "full and complete story" (including material facts and attendant risk factors) constitute violations of Rule 10b-5 and Section 10(b) of the Exchange Act.

In the absence of proactive regulatory enforcement mandating full and complete disclosure as required by Rule 10b-5 and Section 10(b) of the Exchange Act, we are concerned that investors who have purchased previous debt securities issued by the Government of China, as well as investors solicited for future offerings of debt securities issued by the Government of China or its state-owned enterprises, may in light of the inadequate disclosure offered in connection with such offerings and sale, constitute induced purchasers whom have not been fully apprised of the attendant risks associated with any investment in such securities. We are therefore confident that the Commission will act promptly to ensure full compliance with the disclosure obligation imposed by the federal securities laws, and specifically Rule 10b-5 and Section 10(b) of the Exchange Act, in connection with future registered offerings in the United States by the Government of China and its state-owned enterprises.

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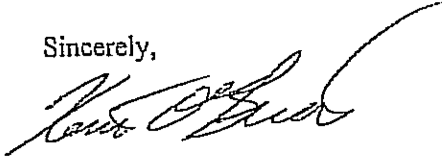
[11] An example would be a grant of injunction either preventing any public offering(s) of securities of a bank owned by the Government of China or preventing the inter-jurisdictional transfer of any proceeds of such securities offering(s) to the Government of China or any of its state-owned enterprises.

[12] See Elliott Associates, L.P., General Docket no. 2000/QR/92 (Court of Appeals of Brussels, 8th Chamber, Sept. 26, 2000). The Court granted Elliott's *ex parte* petition for a restraining order against Euroclear.

[13] Please refer to copy of letter dated May 18, 2006 addressed to Mr. Harold McGraw III, Chairman of the McGraw-Hill Companies (copy enclosed).

Sincerely,



Kevin O'Brien
President

KO:jwc

Enclosures:

1. Copy of letter prepared by the law firm of Stites & Harbison PLLC addressed to the Ministry of Finance of the People's Republic of China dated February 5, 2002, evidencing a demand for payment of the defaulted full faith and credit sovereign debt of the Government of China held by United States bondholders.

2. Copy of letter prepared by the law firm of Stites & Harbison PLLC addressed to the United States Securities and Exchange Commission dated January 8, 2003, providing notice to the primary regulatory agency of the United States Government responsible for enforcement of the federal securities laws regarding inadequacy of disclosure referencing undisclosed risk factors pertinent to compliance with the disclosure obligation of Chinese Government issuers engaging in U.S.-registered securities offerings.

3. Copy of letter prepared by the law firm of Stites & Harbison PLLC addressed to the law firm of Sidley Austin Brown & Wood LLP dated December 31, 2003, providing constructive notice of the existence of full faith and credit sovereign debt of the Government of China which presently remains unpaid in a state of default, and including a schedule referencing such debt, prepared by the Foreign Bondholders Protective Council.

4. Copy of letter prepared by Sovereign Advisers addressed to the McGraw-Hill Companies dated May 18, 2006, providing constructive notice of the taking of defaulted creditors' ability to enforce collection of the defaulted sovereign debt of the Government of China as a result of the intentional application of a reckless standard of care in developing the previous as well as the prevailing sovereign credit rating classifications assigned to the long-term foreign currency debt of the Government of China and which wrongful practices enabled the Government of China to resume international financing while avoiding repayment of the Government of China's defaulted sovereign debt. Identical versions of this letter were also delivered to Moody's Investors Service and Fitch Ratings, providing each firm with constructive notice.

cc: Members of the 109th United States Congress

Honorable F. James Sensenbrenner, Jr., Chair
U.S. House of Representatives Committee on the Judiciary

Honorable Sue Kelly, Chair
U.S. House of Representatives Subcommittee on Oversight and Investigations

Honorable Norm Coleman, Chair
Senate Permanent Subcommittee on Investigations

Honorable Michael J. Garcia
United States Attorney for the Southern District of New York

Honorable Eliot Spitzer
Attorney General for the State of New York

Honorable Robert M. Morgenthau
New York County District Attorney for the District of Manhattan

Mr. Russ Iuculano, Executive Director
North American Securities Administrators Association

Mr. Thurbert E. Baker, President
National Association of Attorneys General

Mr. Eddy Wymeersch, Chairman
Committee of European Securities Regulators

[57 Foreign Securities Commissions]

Mr. Ronald Scott Moss, Esq.
Moss & Associates, P.C.

Mr. John Petty, President
Foreign Bondholders Protective Council

Ms. Jonna Bianco, President
American Bondholders Foundation

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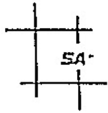

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February 15, 2007

Mr. Brian G. Cartwright, General Counsel
Office of the General Counsel

Ms. Linda Thomsen, Director
Division of Enforcement

Mr. John W. White, Director
Division of Corporation Finance

United States Securities and Exchange Commission
100 F Street, N.E.
Washington, D.C. 20549

Re: AMENDMENT STATING ALLEGATION OF FRAUD

For incorporation into the following document dated September 1, 2006 and filed with the SEC Divisions of Enforcement and Corporation Finance and the Office of the General Counsel:

COMPLAINT

Recent actions evidencing failure to comply with disclosure obligations of registered sovereign issuers under the federal securities laws of the United States in respect to the offer, sale and trading of sovereign debt securities of the People's Republic of China: violations of Rule 10b-5 and Section 10(b) of the Exchange Act.

Dear Mr. Cartwright, Ms. Thomson and Mr. White:

We respectfully write to your attention in reference to the Complaint dated September 1, 2006 (the "Complaint", a copy of which is enclosed with this correspondence) as filed with the Divisions of Enforcement and Corporation Finance and the Office of the General Counsel, to incorporate the additional specification of fraud as described below and as appears in "Exhibit A" attached hereto, as pertains to the failure to disclose the existence of the defaulted sovereign debt of the government of China in matters involving the registration of recent as well as future offers and sales of debt securities of the Government of China and its state-owned enterprises within the United States.[1] We reiterate each and every specification stated in the Complaint describing the omission of certain facts and the intentional concealment (as evidenced by the failure to amend certain statements in the face of constructive notice) of material information comprising violations of Rule 10b-5 and Section 10(b) of the Exchange Act as regards the debt record of the Chinese government, and now pray leave of the Commission to amend said Complaint to include the additional specifications and allegations as described herein.

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[1] Please note that the Complaint may be accessed and viewed on the world wide web at the following URL: *http://www.globalsecuritieswatch.org/Sovereign_Disclosure_Obligation.pdf*

Action of the Specifications Articulated in the Complaint:

The action of the specifications articulated in the Complaint presently on file with the Commission operates to the effect of enabling the government of China to continue to escape the repayment obligation for its defaulted sovereign debt and to thereby perpetrate a deception upon the investing public through omissions of fact (in the form of "half-truths") and the intentional concealment of material facts, and which thereby further operates to misstate the actual risks endemic to investment in debt obligations of the government of the People's Republic of China.

Amendment to the Complaint Stating Allegation of Fraud:

The subject of this Amendment to the Complaint pertains to certain representations contained in the U.S. Registration Statement, including the Prospectus dated October 16, 2003 and the Supplement to the Prospectus dated October 22, 2003 as filed with the United States Securities and Exchange Commission pertaining to the registration, offering and sale of U.S. $1 billion of 4.75% notes due 2013 issued by the People's Republic of China[2], and specifically to the following language which appears on page S-7 of the Supplement to the Prospectus describing the ranking of the obligations publicly registered, offered and sold within the United States in 2003 and which obligations remain outstanding as of the date of this letter:

> "Ranking — **The notes will rank equally** with each other and **with all other general and (subject to the provisions in the notes providing for the securing of such obligations in the event certain other obligations of China are secured) unsecured obligations of China for money borrowed** and guarantees given by China in respect of money borrowed by others. **China will pledge its full faith and credit** for the due and punctual payment of the notes and **for the due and timely performance of all obligations of China** with respect to the notes." *(Emphasis added).*

The above language, excerpted from the Supplement to the Prospectus, purposefully conceals the existence of the defaulted full faith and credit sovereign debt of the government of China (the "Defaulted Debt"), and in particular, the Chinese Government Five Per Cent Reorganisation Gold Loan which was scheduled to mature in 1960 and which remains outstanding, unpaid and in a state of default as a general obligation of the government of China.[3]

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[2] Registration Number 333-108727. The Common Code for this offering of notes is 017941941, the ISIN is US712219AJ30 and the CUSIP is 712219AJ3. The Prospectus and the Supplement to the Prospectus may be accessed and viewed on the world wide web at the following URL:
http://www.sec.gov/Archives/edgar/data/909321/000114554903001347/u98681p1e424b5.htm

[3] See attached schedule of China's defaulted sovereign debt, prepared by the United States Foreign Bondholders Protective Council. The U.S. Foreign Bondholders Protective Council was established by the United States Department of State, Department of the Treasury, and the Federal Trade Commission for the purpose of assisting U.S. citizens in recovery of repayment of defaulted obligations issued by foreign governments. According to the president of the Foreign Bondholders Protective Council, China represents

Actions of the Government of China:

A comparison of the factual record with the description of China's actions as stated in the U.S. Registration Statement and the Prospectus reveals numerous departures from the truth. The language claiming equal ranking and punctual payment by China of its sovereign obligations conceals the existence of the Defaulted Debt and further conceals the wrongful actions of the government of the People's Republic of China with respect to its treatment of the general obligation creditors of the Chinese government holding the Defaulted Debt as summarized below:

Post-1949 Actions of the Government of the People's Republic of China	Date
1. The attempt to repudiate the Defaulted Debt[4]	1983
2. The practice of selective default[5]	Continues in effect at present
3. The practice of engaging in discriminatory payments to a selected group of general obligation creditors, e.g., purchasers of its recently issued notes, while excluding payment to another group of general obligation creditors, e.g., the holders of the Defaulted Debt[6]	Continues in effect at present
4. Rejection of the successor government doctrine of settled international law[7]	Continues in effect at present
5. Discriminatory settlement of the Defaulted Debt with a selected group of creditors (i.e., citizens of Great Britain) while refusing to honor repayment to other members of the same class of creditors[8]	1987

the sole instance, in over 40 settlements of defaulted sovereign debt, in which the debtor government refuses to negotiate the settlement of its defaulted debt. As a result of the continuation of China's wrongful actions and the wrongful actions of other parties actively engaged in the operation of a profitable scheme to assist China in escaping its repayment obligation to defaulted creditors, various court actions are either presently pending or are in the development phase. See, for example, the article describing a second complaint recently filed in United States District Court for the Southern District of New York: "Bondholders Say China Owes $2.3 Billion", *Bank & Lender Liability Litigation Reporter*, Vol. 12, Issue16 (Dec. 14, 2006). Thomson West Publishing Company. The article may be accessed and viewed on the world wide web at the following URL:
http://www.globalsecuritieswatch.org/Bondholders_Say_China_Owes__2.3_Billion.doc

[4] See *Aide Memoire* issued by the Ministry of Foreign Affairs of the People's Republic of China dated February 2, 1983. That the government of the People's Republic of China understood its obligation for repayment of the Defaulted Debt is implicit to the decree of repudiation. There would have been no occasion for repudiation were there no obligation.

[5] Ibid.

[6] Ibid. Specifically, interest payments made to purchasers of the Chinese government's recently issued general obligation notes, while excluding proportional payments to pre-existing general obligation creditors of the Chinese government. This practice is being addressed in pending court actions in order to restrain and enjoin non-proportional payments to selected creditors.

[7] Ibid.

The International Claims Settlement Act Excludes Settlement by the U.S. Foreign Claims Settlement Commission of Claims Relating to the Government of China's Defaulted Sovereign Debt:

The claims of United States citizens involving the defaulted sovereign debt of the government of China have not been settled as of the date of this letter.[9] Certain instances involving such claims have been brought before the United States Foreign Claims Settlement Commission (the "Commission").[10] The Commission subsequently determined that any claim for repayment of the Defaulted Debt evidenced by the bonds was not within the purview of Title V of the International Claims Settlement Act of 1949, as amended, and was therefore outside the authority of the FCSC.[11] Claims pertaining to the Defaulted Debt have been consistently referred by the United States Department of State to the United States Foreign Bondholders Protective Council.[12] As

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[8] See the 1987 treaty between the governments of China and Great Britain which settled the claims of British citizens holding the Defaulted Debt.

[9] See materials cited in supra note 3 (schedule of the Chinese government's defaulted sovereign debt, prepared by the United States Foreign Bondholders Protective Council).

[10] See, e.g., *In the Matter of the Claim of Carl Marks & Co. Inc.* (Claim No. CN-0420; Decision No. CN-472, entered as a Proposed Decision on June 17, 1970 and reaffirmed as the Final Decision of the Commission on March 11, 1971); *In the Matter of the Claim of Catharine E. Olive* (Claim No. CN-2-012; Decision No. CN-2-058, entered as a Proposed Decision on October 17, 1979 and reaffirmed as the Final Decision of the Commission on Nov. 21, 1979); and *In the Matter of the Claim of Welthy Kiang Chen* (Claim No. CN-2-015; Decision No. CN-2-066, entered as a Proposed Decision on October 17, 1979 and reaffirmed as the Final Decision of the Commission on April 1, 1981).

[11] See the Final Decision of the Commission in *Carl Marks & Co., Inc.*, Foreign Claims Settlement Commission, Claim No. CN-0420; Decision No. CN-472, March 11, 1971 (supra note 10). See in particular, the statement articulated by the Commission in its decision: "... a claim based upon such bonds does not come within the purview of Title V of the International Claims Settlement Act of 1949, as amended." The Foreign Claims Settlement Commission is an independent quasi-judicial federal agency organized administratively as a separate agency within the United States Department of Justice. The Commission's primary mission is to determine the validity and monetary value of claims of United States nationals for loss of property or for personal injury in foreign countries, as authorized by Congress, upon referral by the Secretary of State, or following government-to-government claims settlement agreements. The Commission was vested with the authority for adjudicating claims against the Chinese Communist regime arising since 1949. The Foreign Claims Settlement Commission does not have, nor has it ever had, the authority to settle any claims against the government of China arising prior to 1949, including any claims related to the Defaulted Debt, which entered into default in 1939. See also, the letter dated December 11, 1979 prepared by the U.S. Department of State and addressed to the Chairman of the U. S. House of Representatives Subcommittee on Trade of the Committee on Ways and Means, acknowledging that the defaulted Chinese bonds owned by American citizens were outside the scope of the 1979 U.S. - China Agreement between the governments of the United States and China, and referring United States claimants to the U.S. Foreign Bondholders Protective Council.

[12] See letter prepared by the Foreign Bondholders Protective Council dated July 11, 1979 and addressed to His Excellency Chai-Zemin, Ambassador of the People's Republic of China. See also, the letter prepared by the United States Department of State dated August 13, 2002 and addressed to Mr. Marvin L. Morris, Jr.

noted previously, the U.S. Foreign Bondholders Protective Council has reported that in over forty successful attempts to settle the defaulted foreign debt of foreign states, the government of China represents the only instance of a government refusing to negotiate the settlement of its defaulted sovereign debt. As a result, the Defaulted Debt remains an outstanding general obligation of the government of China existing unpaid and in a state of default.

<u>Summary and Conclusion of Allegation Asserting Specification of Fraud</u>:

Under established international law, a nation's international obligations remain unchanged after a mere change of government, even if such a change is a radical one, such as from a dictatorship to a democracy.[13] The Defaulted Debt therefore remains an unpaid, defaulted general obligation of the government of China.

China recognized its liability for the repayment of its defaulted sovereign debt owed to British citizens in 1987, yet continues to attempt to escape its repayment obligation on this same debt held by citizens of the United States through the making of discriminatory payments to selected creditors holding China's general obligation debt, while excluding other creditors from proportional payments.[14] The notes registered in the United States and offered and sold to investors in 2003 pursuant to the registration statement do not rank equally with all other general obligations of China, and the government of the People's Republic of China does not honor the "due and timely performance of all obligations of China."

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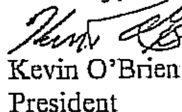
[13] See Pieter H. F. Bekker, *The Legal Status of Foreign Economic Interests in Occupied Iraq*, American Society of International Law (July 2003). International decisions have recognized that it does not matter that the former Government represented a dictatorship. See, e.g., Tinoco Case (Gr. Br. V. Costa Rica), *U.N. Reports of International Arbitral Awards*, Vol. I, 369, 375 (1923), reprinted in 18 AJIL 147 (1924). The decision held that the new Government of Costa Rica was bound by concessions and bank notes given by Tinoco, the former dictator of Costa Rica, to British companies, and dismissed as irrelevant that Tinoco's regime was unconstitutional under Costa Rican law and had not been recognized by several states. The United Nations Security Council has never declared null and void the contracts of a former Government of a U.N. member state and its authority to do so would be questionable. Article 46 of the Hague Regulations makes clear that "private property", which can be said to include proprietary rights granted in a state contract, "must be respected". See also, Paragraph 17 of the United Nations Security Council Resolution 687 (1991), whereby the Council decided that Iraqi statements repudiating its foreign debt were null and void. See also, United Nations General Assembly Resolution V (Dec. 2, 1950) acknowledging the status of contractual rights as property ("No one shall be deprived of property, including contractual rights, without due process of law and without payment of just and effective compensation"). See also, *Restatement (Third) of the Foreign Relations Law of the United States* (1986), Section 712(2). See also, *Creditors' Claims in International Law*, 34 Int'l Law. 235 (2000). See also, the court's reasoning in *Pravin Banker Associates v. Banco Popular Del Peru*, 1997 WL 134390 (2nd Cir NY) wherein the court noted that the United States steadfastly maintains the policy of ensuring the enforceability of valid debts under principles of contract law. The Second Circuit affirmed the District Court's ruling that Pravin's claims should be recognized.

[14] Prior to the 1987 treaty with Great Britain, China was barred from the issuance of any debt on the London market because of its refusal to honor the debts incurred by the pre-1949 government.

The making of a false statement or claim, which in the face of constructive notice[15] becomes a knowingly false statement or claim, and the subsequent failure to take any action to amend such false statement or claim, and which false statement or claim has the action of misleading the investing public through concealment of the truth, constitutes a falsehood which rises to the level of fraud.[16]

In the absence of proactive regulatory enforcement mandating full and complete disclosure as required by Rule 10b-5 and Section 10(b) of the Exchange Act, we are concerned that investors who have purchased previous debt securities issued by the government of China, as well as investors solicited for future offerings of debt securities issued by the government of China or its state-owned enterprises, may in light of the inadequate disclosure offered in connection with such offerings and sale, constitute induced purchasers whom have not been fully apprised of the attendant risks associated with any investment in such securities. We are therefore confident that the Commission will act promptly to ensure full compliance with the disclosure obligation imposed by the federal securities laws, and specifically Rule 10b-5 and Section 10(b) of the Exchange Act, in connection with future registered offerings in the United States by the government of China and its state-owned enterprises.

Sincerely,



Kevin O'Brien
President

KO:jwc

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[15] The existence of the Defaulted Debt of the Chinese government was explicitly disclosed in a letter prepared by the law firm of Stites & Harbison PLLC dated December 31, 2003 and delivered to the law firm of Sidley Austin Brown & Wood LLP. No action has been taken by Sidley Austin as of the date of this writing to amend the U.S. Registration Statement describing the notes offered and sold by the People's Republic of China.

[16] See definition of "fraud", *n. 1. A knowing misrepresentation of the truth or concealment of a material fact to induce another to act to his or her detriment. 2. A misrepresentation made recklessly without belief in its truth to induce another person to act. 3. A tort arising from a knowing misrepresentation, concealment of a material fact, or reckless misrepresentation made to induce another to act to his or her detriment.* See in particular, "fraud in the inducement", *fraud occurring when a misrepresentation leads another to enter into a transaction with a false impression of the risks, duties, or obligations involved; an intentional misrepresentation of a material risk or duty reasonably relied on, thereby injuring the other party without vitiating the contract itself, esp. about a fact relating to value.* See also, "mail fraud", *an act of fraud using the U.S. Postal Service, as in making false representations through the mail to obtain an economic advantage. 18 USCA §§ 1341-1347.* See also, "wire fraud", *an act of fraud using electronic communications, as by making false representations on the telephone to obtain money. The Federal Wire Fraud Act provides that any artifice to defraud by means of wire or other electronic communications (such as radio or television) in foreign or interstate commerce is a crime. 18 USCA § 1343.* Source: Black's Law Dictionary (Eighth Edition). Bryan A. Garner, Editor in Chief. West Publishing Company (2004). ISBN 0-314-15199-0.

Enclosures:

1. Reproduction (titled as "Exhibit A") of page S-7 of the Supplement dated October 22, 2003, to the Prospectus dated October 16, 2003, falsely describing the debt obligations of the People's Republic of China being registered thereunder and publicly offered and sold in the United States as ranked equally with all other general and unsecured obligations of China and the timely performance of payment of all obligations of China.

2. Copy of Complaint dated September 1, 2006 filed with the Divisions of Enforcement and Corporation Finance and the Office of the General Counsel of the United States Securities and Exchange Commission.

3. Schedule of the defaulted sovereign debt of the Chinese government prepared by the United States Foreign Bondholders Protective Council.

4. Copy of letter dated July 11, 1979 authored by Mr. John Petty, President of the United States Foreign Bondholders Protective Council, addressed to His Excellency Chai-Zemin, Ambassador of the People's Republic of China regarding the matter of the claims of United States citizens involving the defaulted full faith and credit sovereign debt of the Chinese government.

cc: Members of the 110th United States Congress

Honorable Max Baucus, Chairman
United States Senate Committee on Finance

Honorable Christopher Dodd, Chairman
United States Senate Committee on Banking, Housing, and Urban Affairs

Honorable Patrick Leahy, Chairman
United States Senate Committee on the Judiciary

Honorable Carl Levin, Chairman
United States Senate Permanent Subcommittee on Investigations

Honorable Jack Reed, Chairman,
United States Senate Subcommittee on Securities, Insurance, and Investment

Honorable Tim Johnson, Chairman
United States Senate Subcommittee on Financial Institutions

Honorable Craig Thomas, Chairman
United States Senate Subcommittee on International Trade

Honorable Evan Bayh, Chairman
United States Senate Subcommittee on Security and International Trade and Finance

Honorable Herb Kohl, Chairman
United States Senate Subcommittee on Antitrust, Competition Policy and Consumer Rights

Honorable Charles Schumer, Chairman
Joint Economic Committee

Honorable Henry Waxman, Chairman
U.S. House of Representatives Committee on Oversight and Government Reform

Honorable Barney Frank, Chairman
U.S. House of Representatives Committee on Financial Services

Honorable John Conyers, Jr., Chairman
U.S. House of Representatives Committee on the Judiciary

Honorable Paul Kanjorski, Chairman
U.S. House of Representatives Subcommittee on Capital Markets, Insurance, and Government-Sponsored Enterprises

Honorable Melvin Watt, Chairman
U.S. House of Representatives Subcommittee on Oversight and Investigations

Honorable Luis Gutierrez, Chairman
U.S. House of Representatives Subcommittee on Domestic and International Monetary Policy, Trade, and Technology

Honorable Linda Sanchez, Chairwoman
U.S. House of Representatives Subcommittee on Commercial and Administrative Law

Mr. David M. Walker, Comptroller General of the United States
United States Government Accountability Office

Honorable Michael J. Garcia
United States Attorney for the Southern District of New York

Honorable Andrew M. Cuomo
Attorney General for the State of New York

Honorable Robert M. Morgenthau
New York County District Attorney for the District of Manhattan

Mr. Joseph Borg, President
North American Securities Administrators Association

Mr. Russ Iuculano, Executive Director
North American Securities Administrators Association

Mr. Thurbert E. Baker, President
National Association of Attorneys General

Mr. Eddy Wymeersch, Chairman
Committee of European Securities Regulators

[57 Foreign Securities Commissions]

Mr. Ronald Scott Moss, Esq.
Moss & Associates, P.C.

Mr. John Petty, President
Foreign Bondholders Protective Council

Ms. Jonna Bianco, President
American Bondholders Foundation

EXHIBIT A

Offering Summary

This offering summary highlights information contained elsewhere in this prospectus supplement and the accompanying prospectus. It is not complete and does not contain all the information that you should consider before investing in the notes. You should read this entire prospectus supplement and the accompanying prospectus carefully.

Issuer	The People's Republic of China.
Notes offered	US$1,000,000,000 aggregate principal amount of 4.75% notes due 2013.
Issue date	October 29, 2003.
Maturity date	October 29, 2013.
Issue price	99.426% of the principal amount of the notes plus accrued interest, if any.
Interest rate	4.75% per year.
Interest payment dates	April 29 and October 29 of each year, beginning on April 29, 2004.
Ranking	The notes will rank equally with each other and with all other general and (subject to the provisions in the notes providing for the securing of such obligations in the event certain other obligations of China are secured) unsecured obligations of China for money borrowed and guarantees given by China in respect of money borrowed by others. China will pledge its full faith and credit for the due and punctual payment of the notes and for the due and timely performance of all obligations of China with respect to the notes.
Listings	China has applied for listing of and permission to deal in the notes on the Luxembourg Stock Exchange and The Stock Exchange of Hong Kong Limited.
Form	The notes will be issued in the form of global securities registered in the name of Cede & Co., nominee of The Depository Trust Company, or DTC.
Clearance and settlement	Beneficial interests in the notes will be shown on, and transfer of such beneficial interests will be effected only through, records maintained by DTC and its participants, unless certain contingencies occur, in which case the notes will be issued in definitive form. You may elect to hold interests in the notes through DTC, Euroclear Bank S.A./N.V., or Euroclear, or Clearstream Banking, *société anonyme*, or Clearstream, if you are a participant in these clearing and settlement systems.
Payment of principal and interest	Principal and interest on the notes will be payable in U.S. dollars. As long as the notes are in the form of a book-entry security, payments of principal and interest will be made through the facilities of DTC.
Common Code, ISIN and CUSIP	The Common Code is 017941941, the ISIN is US712219AJ30 and the CUSIP is 712219AJ3.

Founded 1933

Telephone
(212) 586-6720

FOREIGN BONDHOLDERS PROTECTIVE COUNCIL, Inc.
1775 Broadway, New York, N. Y. 10019

July 11, 1979

His Excellency Chai-Zemin
Ambassador of the People's Republic
of China
2300 Connecticut Avenue
Washington, D.C.

Dear Mr. Ambassador:

You will recall my visit with you on Friday, April 13. At the time, the Senate Foreign Relations Committee delegation, under the chairmanship of Senator Church, was leaving for Beijing and I was to depart the following day to meet them. During my visit with you I was speaking in my capacity as President of the Foreign Bondholders Protective Council and not in my corporate responsibility.

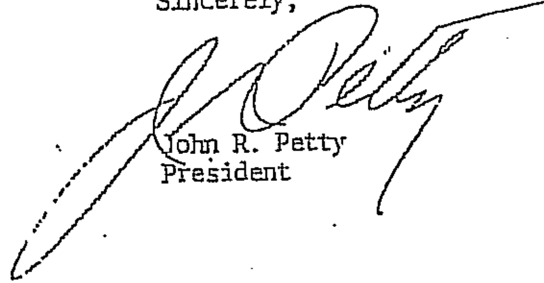
The background to my visit was set during the course of the various senior visits by U.S. Government officials which a few years ago commenced our normalization of relations. In those visits and most recently, the Chairman of the U.S. delegation visiting Beijing in February, cited the issue of defaulted bonds and identified the Foreign Bondholders Protective Council, Inc. as the body with which the matter should be resolved.

During our discussion, I mentioned that the claims arising from the defaulted government bonds were specifically excluded from the Claim Settlement. In particular, the Council understands that the claims of holders of the publicly issued defaulted obligations of the Government of China with which the counsel is concerned and which are described in the attached aide memoire are not claims settled pursuant to Article I(a) of the Agreement because all such obligations were in default prior to October 1, 1949 and the subsequent failure on the part of the People's Republic of China to reaffirm such obligations does not constitute any "nationalization, expropriation, intervention and other taking of, or special measures directed against, property of nationals of the USA on or after October 1, 1949..." within the meaning of Article I(a).

At our April meeting I believe you indicated your Embassy would be taking this matter up with the U.S. Treasury and that this course of action was preferable to my pursuit of the matter in Beijing the following week. I am nowwriting to advance our discussions of this subject.

The aide memoire attached provides information additional to that which we discussed in April. Toward the end of this month I would like to call your office for another meeting on this subject.

Sincerely,



John R. Petty
President

JRP:cm
Attachment

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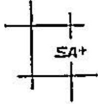

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Website: http://www.sov-advisers.com

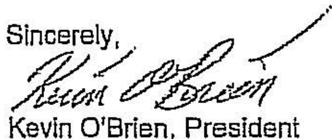
Fax

To:	**Mr. Walter Stachnik, Inspector General** **United States Securities and Exchange Commission**
cc:	1. House Committee on Appropriations 2. House Committee on the Judiciary 3. House Subcommittee on Oversight and Investigations 4. Senate Permanent Subcommittee on Investigations 5. Consumer Federation of America 6. Transactional Records Access Clearinghouse
From:	Kevin O'Brien, President Sovereign Advisers
Re:	Evidence of Lax Enforcement Policy Adopted by SEC
Date:	November 13, 2006
No. Pages:	12

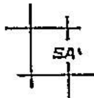
Message:

Please see the following letter addressed jointly to the Honorable Charles Grassley, Chairman of the Senate Committee on Finance, and Mr. David Walker, Comptroller General of the United States, Government Accountability Office. The letter references the Complaint dated September 01, 2006 filed with the U.S. Securities and Exchange Commission, pertaining to inadequate disclosure by Chinese Government issuers of securities within the United States. To date, there has been no response forthcoming from the SEC as regards the matter described in the Complaint. We are concerned that this incident may be symptomatic of a larger enforcement failure, evidencing a lax enforcement policy on the part of the SEC Division of Enforcement. It is reassuring to learn that an investigation has been initiated by the GAO into the lax enforcement practices undertaken by the SEC Division of Enforcement. We remain hopeful that this investigation will stimulate action on the matter comprising the subject of the Complaint, a copy of which follows. Thank you for allowing us to present the foregoing information to your attention.

Sincerely,



Kevin O'Brien, President



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Tel (USA): 520.327.2482 • Fax: 520.322.9850
Email: info@sov-advisers.com
Website: http://www.sov-advisers.com

Via Facsimile and U.S. Mail

October 30, 2006

Honorable Charles Grassley, Chairman
United States Senate Committee on Finance
219 Dirksen Senate Office Building
Washington, D.C. 20510

and

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

Re: SEC Enforcement Posture Regarding Violations of U.S. Federal Securities Laws.

Dear Chairman Grassley and Mr. Walker,

We respectfully write to your attention in reference to the matter described in our Complaint dated September 1, 2006 (copy enclosed) filed with the U.S. Securities and Exchange Commission, and to which we have received no response to date.[1] We believe that the matter comprising the subject of the Complaint is extremely serious, and we are concerned whether the Commission's failure to acknowledge, and act upon, the Complaint evidences an enforcement failure and may be symptomatic of a larger problem relating to a lax enforcement posture adopted by the Commission in recent years.

Sincerely,

Kevin O'Brien
President

KO:jwo

Enclosure

cc: Ms. Linda C. Thomsen, Director of the Division of Enforcement
United States Securities and Exchange Commission

Members of the 109th United States Congress

U.S. and international news media (via newswire release)

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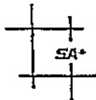
[1] The Complaint may be viewed on the world wide web at the following URL: *http://www.globalsecuritieswatch.org/Sovereign_Disclosure_Obligation.pdf*



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September 1, 2006

Mr. Brian G. Cartwright, General Counsel
Office of the General Counsel

Ms. Linda Thomsen, Director
Division of Enforcement

Mr. John W. White, Director
Division of Corporation Finance

United States Securities and Exchange Commission
100 F Street, N.E.
Washington, D.C. 20549

Re: Recent actions evidencing failure to comply with disclosure obligations of registered sovereign issuers under the federal securities laws of the United States in respect to the offer, sale and trading of sovereign debt securities of the People's Republic of China: violations of Rule 10b-5 and Section 10(b) of the Exchange Act.

Dear Mr. Cartwright, Ms. Thomson and Mr. White:

We respectfully write to your attention concerning the matter of the defaulted sovereign debt of the Government of China as this matter pertains to the disclosure requirements affecting recent, as well as future, offers, sales and trading of debt securities of the Government of China and its state-owned enterprises within the United States.[1]

In the United States, the disclosure obligations for registered sovereign issuances are governed by the Securities and Exchange Commission's Schedule B, which affirmatively requires only minimal disclosure including pricing, payments schedule, and volume. However, an affirmative obligation by registered sovereign issuers to speak with respect to additional disclosure <u>does exist</u> in that statements made in connection with an offering of securities, although literally true, may not be misleading through their incompleteness as specified by Rule 10b-5 and Section 10(b) of

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[1] Please refer to the complaint dated March 31, 2005 filed with the SEC Division of Market Regulation describing the wrongful actions of the underwriters of recent offerings of debt securities of the Government of China and the credit rating agencies in the matter of selectively ignoring the full faith and credit sovereign debt of the Government of China presently existing unpaid and in a state of default: (http://www.globalsecuritieswatch.org/SEC.pdf). The complaint was subsequently the subject of a comprehensive internal review by the SEC at the request of numerous members of the United States Congress: (http://www.globalsecuritieswatch.org/congress.html). See also the letter dated May 24, 2005 addressed to the SEC Chairman by the Honorable Jim Saxton, Chairman of the Joint Economic Committee: (http://www.globalsecuritieswatch.org/chairman_saxton_demand_for_investigation.pdf). We are informed that the facts and circumstances described in the complaint were influential in the recent passage of legislation (HR 2990) reforming federal regulatory oversight of the credit rating agencies.

the Exchange Act.[2] Under Rule10b-5 and Section 10(b) of the Exchange Act, a duty is imposed upon an issuer to refrain from disclosing materially incomplete statements (i.e., the prohibition against "half-truths").

Accordingly, a source of a sovereign's obligation to disclose additional risks in the offering documents arises from additional disclosure which the sovereign volunteers. In the event that a registered sovereign issuer may elect to provide additional disclosure beyond the requirements imposed by SEC Schedule B, such statements must constitute full and complete disclosure and not be misleading through their incompleteness. Under Rule 10b-5, statements that are literally true can create liability if they create a materially misleading interpretation because they omit some key fact (or, in other words, are "half-truths"). The duty not to make "half-truths" under Rule 10b-5 applies to both registered and non-registered sovereign bond issuances.

We refer now to the inadequate disclosure contained in the prospectus dated October 16, 2003 and in the prospectus supplement dated October 22, 2003 pertaining to the registered offering, sale and issuance of sovereign obligations of the People's Republic of China, and offer several obvious examples of disclosure obligations required by Rule 10b-5 and Section 10(b) of the Exchange Act which are omitted from mention in the above offering document.[3]

Examples of failures to fully disclose key facts, constituting violations of <u>Rule 10b-5</u> and <u>Section 10(b) of the Exchange Act</u>:

1. <u>Voluntary Disclosure</u>: Debt Record *(page 69 of the prospectus)* –

> "The central government has always paid when due the full amount of principal of, any interest and premium on, and any amortization or sinking fund requirements of, external and internal indebtedness incurred by it since the PRC was founded in 1949."

<u>Omission</u>: This statement is misleading to offerees and prospective purchasers. Both the prospectus and the prospectus supplement intentionally omit any mention of the existence of pre-1949 defaulted full faith and credit sovereign obligations of the Government of China, which under accepted conventions of international law, <u>the payment obligation for such indebtedness was incurred by the central government of China in 1949</u> and on which that government has since settled with British bondholders while continuing to evade the claims of American bondholders.

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[2] The lack of meaningful affirmative disclosure obligations in the Schedule B context, elevates the importance of the obligation not to speak in "half-truths". See James D. Cox, *Rethinking U.S. Securities Laws in the Shadow of International Competition*, L. & Contemp. Problems, Autumn 1992, at 177, 192-193 (cited at 13, *An Empirical Study of Securities Disclosure Practices*, authored by Mitu Gulati and Stephen Choi, Duke Law School Working Paper, 2006).

[3] Registration no. 333-108727. (ISIN US712219AJ30 / CUSIP 712219AJ3). See prospectus dated October 16, 2003 and the prospectus supplement dated October 22, 2003: (http://www.sec.gov/Archives/edgar/data/909321/000114554903001347/u98681p1e424b5.htm).

As we have previously described, neither the prospectus nor the prospectus supplement contain any mention whatsoever regarding the existence of defaulted full faith and credit sovereign debt of the Government of China which remains unpaid in a state of default, and for which the People's Republic of China is liable for repayment under settled international law as the internationally-recognized successor government of China, and which government continues to engage in actions evidencing both selective default and discriminatory settlement under settled international law.[4] Such actions act to create the risk of seizure of proceeds of any securities offering by the Government of China or any of its state owned enterprises and also act to expose purchasers of sovereign obligations issued by the People's Republic of China to the risk of injunctions preventing discriminatory payments to such purchasers.

2. Voluntary Disclosure: **External Debt** *(page 67 of the prospectus)* – Note: this section contains extensive narrative and numerous schedules referencing the outstanding obligations and external debt of the Government of China. No mention is made regarding the existence of defaulted sovereign debt of the Government of China. An excerpt of this section appears below:

"Loans are the primary source of external debt. Non-trade loans accounted for approximately 84.4% of the total external debt outstanding at December 31, 2002. Commercial loans (i.e., loans obtained from any source on commercial terms), official primary government loans (i.e., loans obtained on favorable terms from foreign governments and international financial organizations including the World Bank and Asian Development Bank) and other types of debt financing accounted for approximately 53.5%, 30.9% and 15.6%, respectively, of total external debt in the form of loans at December 31, 2002. The central government's current policy is to continue to

[4] The U.S. registration statement including the prospectus and prospectus supplement pertaining to the 2003 sovereign bond offering and sale by the People's Republic of China was prepared by the U.S. law firm of Sidley Austin Brown & Wood LLP. We note that this is the same law firm that, through its predecessor firm of Brown & Wood LLP, admitted to orchestrating an artifice which was then operated as a knowingly fraudulent tax shelter scheme and which defrauded the U.S. Treasury out of an estimated $2.5 billion in tax revenues, and which firm then agreed to make a $40 million payment to settle a civil class action lawsuit for tax shelter fraud in connection with the very recent KPMG case. This settlement is in addition to separate actions brought by the U.S. Department of Justice and the Internal Revenue Service in the largest criminal tax case ever. Sidley Austin was also the subject of a special inquiry conducted by the Senate Permanent Subcommittee on Investigations. Apparently, this law firm not only engineered the fraudulent tax shelter scheme, but also issued a knowingly fraudulent tax opinion to support the massive multi-billion dollar scheme. We note that Sidley Austin also concealed the fact of a public hearing entitled, "U.S.-China Ties: Reassessing the Economic Relationship" conducted by the House Committee on International Relations, which invited and did include testimony pertaining to the existence of defaulted sovereign debt of the Government of China, and which occurred prior to the date of the 2003 prospectus supplement. We further note the fact that Sidley Austin concealed the existence of a House Concurrent Resolution ("H.Con.Res.60") in the United States Congress which specifically referenced the existence of the defaulted sovereign debt of the Government of China. We also note that subsequent to the receipt of constructive notice provided by the letter prepared by the law firm of Stites & Harbison dated December 31, 2003, that Sidley Austin failed to take any action to amend the 2003 U.S. registration statement and prospectus. Such failure evidences the application of a reckless standard of care.

seek loans from foreign governments and international financial institutions to finance infrastructure projects in China. At the end of 2002, the total outstanding external debt was US$168.5 billion."

"The Ministry of Finance, on behalf of the central government, has raised funds in the international capital markets through various debt securities and bond issues since 1993. The Ministry of Finance's principal objective is to set up benchmarks for other Chinese borrowers. Several state-owned financial institutions and enterprises have also issued debt securities in the international capital markets with the approval of the State Council."

"Unless the central government expressly provides otherwise, the central government does not guarantee or provide any direct or indirect credit support to any entity in China. However, debtors that have their external debt registered with the State Administration of Foreign Exchange have the right to buy foreign currencies as permitted by the central government at the China Foreign Exchange Trading System rate in order to service the interest and principal payments on their registered external debt."

Omission: The language of this section intentionally conceals the existence of a significant liability of the People's Republic of China under the successor government doctrine of settled international law espousing continuity of obligations. The failure to disclose the existence of the defaulted sovereign debt of the Government of China and the existence of a defaulted class of creditors also exposes purchasers of the offered obligations to the risk of judicial and other actions brought by the class of defaulted creditors, the existence of which remains undisclosed, and whose actions to recover payment on the defaulted obligations would reasonably be considered to be adverse to the interests of purchasers of newly-offered obligations. The concealment of the defaulted sovereign debt of the Government of China also acts to intentionally deceive prospective purchasers as to the actual risk of non-repayment inherent to the actions of the Government of China towards its defaulted creditors and the refusal to honor repayment of its outstanding defaulted sovereign debt.

3. Voluntary Disclosure: **Recent Developments** *(page S-6 of prospectus supplement)* –

"The credit ratings accorded to China's debt securities by the rating agencies are not recommendations to purchase, hold or sell the notes to the extent such ratings do not comment as to market price or suitability for you. Any rating may not remain in effect for any given period of time or may be revised or withdrawn entirely by a rating agency in the future if in its judgment circumstances so warrant, and if any such rating is so revised or withdrawn, we are under no obligation to update this prospectus supplement. On October 15, 2003, Moody's Investors Service, Inc. upgraded China's sovereign rating from A3 to A2 for long-term foreign-currency denominated debt. The rating outlook is stable. On October 22, 2003, Standard & Poor's Ratings Group affirmed its BBB senior unsecured foreign currency credit rating for China. The outlook is positive. On October 13, 2003, Fitch IBCA, Inc. affirmed the long-term foreign currency rating of China at A-. The rating outlook is positive. This rating applies to all of China's senior unsecured long-term sovereign debt issues."

Omission: Any mention of the specific risks to purchasers arising as a result of the suspension of the sovereign credit rating of the Government of China owing to a credible and reasonably foreseeable threat of litigation seeking recovery of payment on the defaulted sovereign debt of the Government of China. Although the language of this section of the prospectus supplement does acknowledge the generic possibility of the withdrawal of the sovereign credit rating of the Government of China, the language fails to disclose the existence of known facts evidencing the falsity of the prevailing sovereign credit rating classifications assigned to the Government of China by Standard and Poor's Ratings Service, Moody's Investors Service, and Fitch Ratings and the attendant prospect for litigation in this regard.[5] The generic risk disclosure language offered in this section fails to fully disclose the existence of the actual and known specific risks attributable to the failure to disclose the existence of the defaulted sovereign debt of the Government of China, and which risks would reasonably be expected and foreseeable to cause the occurrence of suspension of the sovereign ratings assigned to the Government of China (i.e., the risk that suspension may occur as a result of an action brought in the future against the credit rating agencies by defaulted creditors of the Government of China). Such actions brought by defaulted creditors would reasonably be expected to include recovery of damages sustained as a consequence of a tort injury (e.g., the "taking" of the defaulted creditors' ability to enforce the debt contract occurring as a direct consequence of the intentional assignment of a knowingly fraudulent credit rating classification to the Government of China).

4. Voluntary Disclosure: General Information *(page S-11 of the prospectus supplement)* –

"China is neither involved in any litigation, arbitration or administrative proceedings which are material in the context of the issue of the notes nor aware of any such litigation, arbitration or administrative proceedings, whether pending or threatened."

"Except as disclosed in this prospectus supplement and the accompanying prospectus, there has been no significant change in the condition (financial, political, economic or otherwise) or the affairs of China which is material in the context of the issue of the notes since December 31, 2002."

Omission: At the time of the dates appearing on the prospectus and the prospectus supplement, there existed a reasonably anticipated prospect for litigation in the form of a judicial action for recovery of repayment of the defaulted sovereign debt of the Government of China, including imposition of injunctions and restraining orders acting to adversely affect the flow of payments to selected classes of creditors, halt trading in affected securities, and the possible seizure of offering proceeds or interest payments by defaulted creditors.

[5] The three Nationally Recognized Statistical Rating Organizations named above command a dominant position of the rating business, comprising a 94% market share.

The American Bondholders Foundation, comprising a large group of affiliated U.S. persons holding defaulted sovereign debt of the Government of China, was organized in early 2001 to consolidate the claims of defaulted creditors of the Government of China and was actively engaged along with other parties in both the United States as well as outside the United States, in efforts, including possible judicial action(s), to recover repayment of the defaulted full faith and credit sovereign debt of the Government of China prior to, at the time of, and subsequent to the dates of the prospectus and prospectus supplement, and remains actively engaged in such recovery efforts at present. Such efforts, which were widely publicized at the time and so should have been known to the parties responsible for preparing the prospectus and the prospectus supplement, would have been reasonably anticipated as of the dates of the prospectus and the prospectus supplement to produce judicial and other action(s) affecting various creditors of the Government of China, including purchasers of the 2003 sovereign bond offering.[6]

The language of this section completely fails to disclose not only the risks to purchasers of litigation in connection with recovery of the defaulted sovereign debt of the Government of China, but also fails to disclose the engagement of the United States Congress on behalf of the interests of the defaulted class of U.S. creditors of the Government of China, and the reasonably foreseeable and highly potential prospect of political and legislative action(s) by the United States Congress to enforce fair trade and commerce practices and which may adversely affect both the liquidity and the market price of sovereign bonds issued by the Government of China on which that government selectively honors payment while refusing to honor payment to its defaulted creditors in violation of both settled international law and the established *pari passu* legal doctrine prohibiting discriminatory payments among creditors.[7] We have previously noted that public testimony was provided at a public hearing prior to the date of the prospectus supplement before the House International Relations Committee on October 21, 2003 describing the very pertinent issue of the unpaid full faith and credit sovereign debt of the Government of China existing in a state of default, as the Government of China continues

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[6] See news article entitled, *U.S. Holders of Pre-1949 China Bonds Sue Rating Agencies.* EuroWeek (July 21, 2006). See also, the letter prepared by Sovereign Advisers addressed to the McGraw-Hill Companies dated May 18, 2006, providing constructive notice of the taking of defaulted creditors' ability to enforce collection of the defaulted sovereign debt of the Government of China as a result of the intentional application of a reckless standard of care in developing the previous as well as the prevailing sovereign credit rating classifications assigned to the long-term foreign currency debt of the Government of China and which wrongful practices enabled the Government of China to resume international financing while avoiding repayment of the Government of China's defaulted sovereign debt. Identical versions of this letter were also delivered to Moody's Investors Service and Fitch Ratings, providing each firm with constructive notice.

[7] See information describing the effect on holders of sovereign debt as a result of the Belgian Court's decision in *Elliott Associates*, as well as letters from members of the United States Congress endorsing regulatory enforcement relating to matters pertinent to full disclosure and recovery of repayment of the defaulted full faith and credit sovereign debt of the Government of China: (http://www.globalsecuritieswatch.org).

to evade repayment to defaulted creditors through actions evidencing a pattern of selective default and discriminatory settlement.[8]

In particular regard to litigation disclosure, please note the existence of at least one civil lawsuit against the Government of China which is presently pending in the U.S. District Court for the Southern District of New York comprising a judicial action for recovery of repayment on the defaulted sovereign debt of the Government of China.[9] The occurrence of this action was reasonably foreseeable in October 2003, and the attendant risks to investors in newly-offered debt securities of the Government of China were not disclosed to the investing public which relied on the 2003 prospectus and prospectus supplement, many of whom may have been induced to purchase the offered securities owing to concealment of both the existence of the full faith and credit sovereign debt of the Government of China which remains unpaid in a state of default, as well as the attendant risks posed by this fact, including recent actions evidencing both selective default and discriminatory settlement by the Government of China.[10]

Please be advised that regardless of the ultimate disposition of the specific instance referenced in this section (i.e., Marvin L. Morris vs. People's Republic of China), we expect additional parallel and derivative actions to subsequently occur as a result of this action. The continuing evasion by the Government of China as respects repayment of its defaulted sovereign debt necessitates the aggressive prosecution of judicial actions for recovery. We anticipate the filing of additional civil suits by various parties seeking recovery of the defaulted sovereign debt of the Government of China in both U.S. courts and in various foreign jurisdictions as well. We also anticipate the imminent filing of numerous petitions for injunctions and restraining orders both in the United States and abroad pursuant to a concerted recovery action to collect repayment of this debt.

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[8] See transcript of testimony provided at the public hearing conducted by the House Committee on International Relations on October 21, 2003 entitled, "U.S.-China Ties: Reassessing the Economic Relationship": (http://wwwc.house.gov/International_Relations/108/bian2021.htm). This publicly televised testimony was presented to members of the House Committee on International Relations prior to the date of the prospectus supplement (October 22, 2003), yet the circumstances described in the Congressional testimony were intentionally and wrongfully omitted from disclosure in both the prospectus and the prospectus supplement. Both the prospectus and the prospectus supplement noticeably fail to disclose any reference to, or mention of, the letter sent by the law firm of Stites & Harbison PLLC to the Ministry of Finance of the People's Republic of China demanding payment of the claims of defaulted U.S. creditors of the Government of China (copy enclosed).

[9] See Marvin L. Morris, Jr. vs. People's Republic of China (05 CIV 4470) presently pending in the U.S. District Court for the Southern District of New York
(http://www.globalsecuritieswatch.org/civil_complaint.pdf).

[10] The Government of China continues to ignore the claims of U.S. bondholders who are victims of both selective default and discriminatory settlement by the Government of China (see the 1987 treaty with Great Britain which settled the claims of British bondholders), which continues to attempt to evade repayment in flagrant violation of accepted conventions of international trade and commerce including rejection of the successor government doctrine of settled international law.

Accordingly, the grant of such injunctions and restraining orders may reasonably be expected to include any of the following on either a pre-judgment or post-judgment basis:

1. Injunction(s) enjoining and prohibiting the offer or sale of securities of the Government of China or any of its state-owned enterprises;
2. Injunction(s) enjoining and prohibiting the transmittal of any proceeds derived from any securities offering by the Government of China or any of its state-owned enterprises;[11]
3. Injunction(s) enjoining and prohibiting the Government of China from making discriminatory payments to other creditors in circumvention of payments to defaulted creditors;[12]
4. Injunction(s) enjoining and suspending publication of the sovereign credit rating assigned to the Government of China;[13]
5. Injunction(s) enjoining and suspending trading activities involving any securities of the Government of China or any of its state-owned enterprises; and
6. Enforcement of judgments attaching commercial assets of the Government of China, including the seizure of proceeds from the offer and sale of securities.

The potential for such actions poses material risks to investors holding outstanding obligations of the Government of China which that government selectively honors and on which the Government of China continues to make discriminatory payments, as well as to investors in future debt securities issued by the Government of China.

In light of the voluntary disclosures contained in the 2003 prospectus and the prospectus supplement, the intentional omissions of the "full and complete story" (including material facts and attendant risk factors) constitute violations of Rule 10b-5 and Section 10(b) of the Exchange Act.

In the absence of proactive regulatory enforcement mandating full and complete disclosure as required by Rule 10b-5 and Section 10(b) of the Exchange Act, we are concerned that investors who have purchased previous debt securities issued by the Government of China, as well as investors solicited for future offerings of debt securities issued by the Government of China or its state-owned enterprises, may in light of the inadequate disclosure offered in connection with such offerings and sale, constitute induced purchasers whom have not been fully apprised of the attendant risks associated with any investment in such securities. We are therefore confident that the Commission will act promptly to ensure full compliance with the disclosure obligation imposed by the federal securities laws, and specifically Rule 10b-5 and Section 10(b) of the Exchange Act, in connection with future registered offerings in the United States by the Government of China and its state-owned enterprises.

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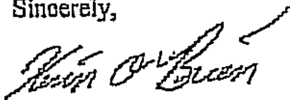
[11] An example would be a grant of injunction either preventing any public offering(s) of securities of a bank owned by the Government of China or preventing the inter-jurisdictional transfer of any proceeds of such securities offering(s) to the Government of China or any of its state-owned enterprises.

[12] See Elliott Associates, L.P., General Docket no. 2000/QR/92 (Court of Appeals of Brussels, 8th Chamber, Sept. 26, 2000). The Court granted Elliott's *ex parte* petition for a restraining order against Euroclear.

[13] Please refer to copy of letter dated May 18, 2006 addressed to Mr. Harold McGraw III, Chairman of the McGraw-Hill Companies (copy enclosed).

Sincerely,



Kevin O'Brien
President

KO:jwc

Enclosures:

1. Copy of letter prepared by the law firm of Stites & Harbison PLLC addressed to the Ministry of Finance of the People's Republic of China dated February 5, 2002, evidencing a demand for payment of the defaulted full faith and credit sovereign debt of the Government of China held by United States bondholders.

2. Copy of letter prepared by the law firm of Stites & Harbison PLLC addressed to the United States Securities and Exchange Commission dated January 8, 2003, providing notice to the primary regulatory agency of the United States Government responsible for enforcement of the federal securities laws regarding inadequacy of disclosure referencing undisclosed risk factors pertinent to compliance with the disclosure obligation of Chinese Government issuers engaging in U.S.-registered securities offerings.

3. Copy of letter prepared by the law firm of Stites & Harbison PLLC addressed to the law firm of Sidley Austin Brown & Wood LLP dated December 31, 2003, providing constructive notice of the existence of full faith and credit sovereign debt of the Government of China which presently remains unpaid in a state of default, and including a schedule referencing such debt, prepared by the Foreign Bondholders Protective Council.

4. Copy of letter prepared by Sovereign Advisers addressed to the McGraw-Hill Companies dated May 18, 2006, providing constructive notice of the taking of defaulted creditors' ability to enforce collection of the defaulted sovereign debt of the Government of China as a result of the intentional application of a reckless standard of care in developing the previous as well as the prevailing sovereign credit rating classifications assigned to the long-term foreign currency debt of the Government of China and which wrongful practices enabled the Government of China to resume international financing while avoiding repayment of the Government of China's defaulted sovereign debt. Identical versions of this letter were also delivered to Moody's Investors Service and Fitch Ratings, providing each firm with constructive notice.

cc: Members of the 109th United States Congress

Honorable F. James Sensenbrenner, Jr., Chair
U.S. House of Representatives Committee on the Judiciary

Honorable Sue Kelly, Chair
U.S. House of Representatives Subcommittee on Oversight and Investigations

Honorable Norm Coleman, Chair
Senate Permanent Subcommittee on Investigations

Honorable Michael J. Garcia
United States Attorney for the Southern District of New York

Honorable Eliot Spitzer
Attorney General for the State of New York

Honorable Robert M. Morgenthau
New York County District Attorney for the District of Manhattan

Mr. Russ Iuculano, Executive Director
North American Securities Administrators Association

Mr. Thurbert E. Baker, President
National Association of Attorneys General

Mr. Eddy Wymeersch, Chairman
Committee of European Securities Regulators

[57 Foreign Securities Commissions]

Mr. Ronald Scott Moss, Esq.
Moss & Associates, P.C.

Mr. John Petty, President
Foreign Bondholders Protective Council

Ms. Jonna Bianco, President
American Bondholders Foundation

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December 31, 2003

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VIA E-MAIL AND FEDERAL EXPRESS

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RE: Defaulted Sovereign Debt of China

Dear Mr. Li and Mr. Ding:

We represent the more than 250 American holders of defaulted full faith and credit sovereign debt of the nation of China who have organized under the auspices of the American Bondholders Foundation, LLC. Because you are the counsel to the People's Republic of China listed on China's registration statement filed October 15, 2003 with the United States Securities and Exchange Commission related to the offering of $4,500,000,000 principal amount of debt securities of China, it seems appropriate that we direct our clients' claims to you for proper resolution by your client, the Government of China. We have previously submitted proper demands for payment on behalf of our defaulted Chinese Government bond clients to the People's Republic of China—both to the Chinese Embassy in Washington and to the Office of the Ministry of Finance in Beijing. To date, China apparently refuses to acknowledge its legal obligations under international law and established commercial law principles to honor Chinese sovereign debt issued prior to 1949.

When the United States and the People's Republic of China established diplomatic relations in 1979, the valid claims of Americans owning defaulted pre-1949 Chinese government bonds were left unresolved. Attempts by the American based Foreign Bondholders Protective Council to settle the matter through communications with the Chinese Ambassador to the United States were unsuccessful.[1] I enclose a copy of defaulted unpaid Chinese Government bonds cataloged by the Foreign Bondholders Protective Council.

China continues, inexplicably, to discriminate against American holders of its full faith and credit pre-1949 debts even though China paid comparable claims of British holders of similar pre-1949 Chinese sovereign debt securities pursuant to a June 1987 agreement with Great Britain[2].

[1] See, for example, the letter by the President of the Foreign Bondholders Protective Council dated July 11, 1979 to the Chinese Ambassador to the United States.
[2] _New York Times_ June 8, 1987

Contrary to the position submitted by China in an *Aide Memoire* to a representative of the United States Department of State in 1983 purporting to repudiate the obligation of China for its pre-1949 sovereign debt[3], there is no basis in international law to support the position of the Chinese government[4]. Our clients are the holders of full faith and credit bonds issued by the internationally recognized government of the nation of China between 1912 and 1949. In fact, that government (Republic of China) continued to be recognized by the United Nations until 1970 and by the United States until 1979.

The weakness of China's position asserted in 1983 that a successor government may lawfully and unilaterally repudiate the sovereign debts of an internationally recognized predecessor government is evident by the Chinese Government's own position today with respect to sovereign Iraqi debts owed to China. The Chinese government has proclaimed that the successor government in Iraq remains responsible for the payment of the sovereign debts issued by the internationally recognized predecessor government of that nation (even one as barbaric as the Saddam Hussein regime of 1979-2003)[5]. And even if the so-called "odious debt" doctrine had validity, its applicability would be highly limited and would not apply to sovereign debts issued by a government as widely recognized internationally as was the Republic of China between 1912 – 1949.

In addition to the precedent created by the 1987 settlement between China and Great Britain, it is noteworthy that the current post Soviet successor government of Russia in the late 1990's accepted its legal liability for pre-1917 Czarist era sovereign Russian debt held by French bondholders by payment to French bondholders of approximately $400,000,000.[6]

Our clients are bewildered by the omission in the October 15, 2003 Registration Statement/Prospectus of China of information regarding the fifty years of default by China of its debt securities. In the section captioned "Debt Record" there is no reference to China's repudiation and non-payment of pre 1949 full faith and credit Chinese debt securities and how such repudiation departs from the norms of international and commercial law. Nor is there any inclusion of the judicial battle that China waged in the United States courts in the mid 1980's against American

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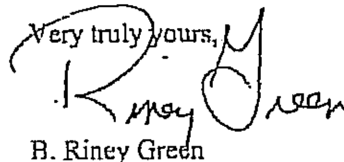
[3] February 2, 1983 Aide Memoire of the Ministry of Foreign Affairs of the People's Republic of China.
[4] See, for example, *The Restatement (Third) of the Foreign Relations Law of the United States*, Section 712(2) and Creditors Claims in International Law, The International Lawyer, Vol. 34, page 235, Spring, 2000).
[5] See news reports related to the visit earlier this week to President Hu Jintao and Premier Wen Jiabao by special United States envoy James A. Baker III seeking the consent of the Chinese Government to some reduction in the Iraqi sovereign debt payments to China.
[6] Associated Press article, October 30, 2000.

holders of defaulted pre-1949 Chinese government bonds[7] and how American bondholders have been discriminated against in comparison to their British counterparts. Is a future post-Communist Party-controlled China reserving the right to repudiate post 1949 Chinese government debt securities?

Please contact me promptly so that arrangements can be made for a full and fair settlement of the proper claims of hundreds of American owners of defaulted full faith and credit sovereign debt of China. Thank you.

Very truly yours,



B. Riney Green

BRG:rhc

cc: Ministry of Finance, People's Republic of China
American Bondholders Foundation
Foreign Bondholders Protective Council
Chief Counsel, Securities and Exchange Commission

10327N:010369:563642:1-NASHVILLE

[7] The Jackson v. People's Republic of China case, United States District Court for the Northern District of Alabama.

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January 8, 2003

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Hon. Harvey L. Pitt
Chairman
Securities & Exchange Commission
450 Fifth Street, NW
Washington, DC 20549

Alan L. Beller, Esq.
Director, Corporate Finance Division
and Senior Counselor to the Commission
Securities & Exchange Commission
450 Fifth Street N.W.
Washington, DC 20549

Re: Inadequate Disclosure of Risks to American Investors of Unreliable Chinese Government Economic Data, of Predicted Political Instability in China, and of Prior Chinese Government Debt Repudiation

Gentlemen:

On behalf of our client the American Bondholders Foundation[1], we request that the Securities and Exchange Commission carefully examine whether foreign issuers based in China are adequately disclosing investment risks to current and prospective American owners of Chinese corporate or government stocks and bonds.

In particular, we request that the Commission evaluate whether Chinese corporate issuers who are presently, or who will become, subject to the Commission's disclosure requirements under the 1933 Act or the 1934 Exchange Act, especially those issuers with a controlling or large bloc of equity securities owned directly or indirectly by the Chinese Government (the People's Republic of China – PRC), are properly disclosing the known risks posed by (1) the credible allegations that official Chinese Government economic statistics are unreliable and misleading; (2) the adverse consequences of increasing and predicted political instability of the Chinese government; and (3) the official Chinese Government position of the repudiation of Chinese sovereign debts issued by established predecessor Chinese governments.

[1] The American Bondholders Foundation is an organization of U.S. individual owners of Chinese Government full faith and credit bonds issued prior to 1949 that seek to require China to honor its sovereign and contractual obligations to bondholders. Although China in 1987 made payments to British holders of pre- 1949 Chinese government bonds to settle the claims of British bondholders, China has failed to refused to make any payments to American bondholders of similar Chinese government bonds.

We believe that current and future American investors need the protection which the Commission can provide by ensuring that all Chinese corporate and government issuers make full and fair disclosure to the investing American public of the unique risks associated with investing in stocks or bonds of Chinese companies or of the Chinese government.

1. **Misleading Chinese Government Economic Data.**

In its recent (October 31, 2002) quarterly filing with the Commission on Form 6-K, the China Petroleum & Chemical Corporation (called Sinopec) (NYSE/symbol:SPN) stated:

> "In the first three quarters of 2002, the PRC economy continued to maintain rapid growth, with a GDP growth rate of 7.9%. Benefiting from the above, there was a stable growth in the domestic demand for refined oil and petrochemical products...." (emphasis added).
>
> "The Company believes that in the fourth quarter of 2002 .... China's economy will maintain a steady and healthy growth, which will create more demand for petrochemical products in China and a positive market environment for the business of the Company." (emphasis added).

Sinopec is basing its projections of future profitability and stockholder value on the reliability of the Chinese government's rosy economic data. According to a December 16, 2002 report included in the New Republic magazine, the official Chinese government claims of 7%- 10% annual growth during each of the last 20 years "do not add up".[2] The article further reports that the actual growth rate during the 1998-2001 period was closer to 4% and that "China has been plagued by deflation, rising unemployment and declining energy use."[3] The article goes on to state that China's national economic statistics are subject to "political meddling" and "corruption"[4], that more than two-thirds of the biggest Chinese companies "falsify their accounting"[5], that China's "economy is becoming less efficient and competitive, that the country is "without a decent legal system", and that its banking system could be insolvent by 2008. The author concludes that "Ultimately, China's economic façade probably will crack. And, when it does, the consequences may be disastrous." [6]

The Commission has correctly focused attention during the last year on the accuracy, completeness and transparency of American companies' financial statements and their

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[2] "Asia Minor, Is China's Economic Boom a Myth", by Joshua Kurlantzick, The New Republic, December 16,2002, page 20.
[3] Id.
[4] Id., pages 20 and 24
[5] Id., page 24.
[6] Id., page 25.

management's analysis. We believe the same level of scrutiny should be applied to those Chinese based companies whose shares are listed on U.S. exchanges or that otherwise desire to access the American capital markets. Otherwise, American investors risk significant losses as a result of their investment in Chinese companies based on their misplaced reliance on information which, if recently published reports are accurate, is materially misleading.

We urge the Commission to confer with U.S. intelligence and Treasury officials in order to access the resources available to make an independent analysis of the statements on the performance and stability of China's economy contained in filings made with the Commission and relied upon by the American investing public.

According to the July 2002 report of the U.S. – China Security Review Commission (established and appointed by the U.S. Congress), "Chinese firms raising capital or otherwise trading their securities in the U.S. markets have predominately been major [majority] state-owned enterprises, some of which have ties to China's military, defense industry, or intelligence services." As a result, since the Chinese PRC government directly or indirectly controls a majority of the ownership of most of the Chinese companies which are listed on U.S. exchanges and are subject to the periodic filing of reports with the Commission, it is doubtful that most such Chinese companies have the independence needed to vigorously challenge the accuracy of the Chinese government's official economic data.

The U.S. – China Security Review Commission recommended in July 2002 that the Securities and Exchange Commission more carefully scrutinize the disclosure in the United States of certain foreign issuers, including certain Chinese corporate issuers, to minimize concerns about U.S. national security risks posed by the activities of certain foreign companies"[7]. Similarly, the SEC should carefully scrutinize the accuracy of statements and implied optimistic forecasts contained in SEC filings of Chinese issuers whenever such statements and forecasts are based on the questionable economic data of the Chinese government.

2. Political Instability of Chinese Government.

Experts and political analysts are expressing increasing doubt about the ability of the present Communist Party controlled Chinese government to either reform or survive. This looming political crisis poses real financial risks to Americans investing in Chinese based companies and in debt securities of the Chinese government. The Chinese Government (through sovereign bond offerings) and Chinese state-owned and other enterprises have raised significant funds in overseas capital

[7] Chapter 6 of the July 2002 Report to Congress of the U.S. –China Review Commission – The National Security Implications of the Economic Relationship Between the United States and China – "China's Presence in U.S. Capital Markets"

markets in recent years, including the U.S. capital markets.[8] Accordingly, the American Bondholders Foundation urges the Securities and Exchange Commission to (1) carefully review each registration statement and periodic report filed by a Chinese government or corporate issuer and (2) require the conspicuous inclusion of adequate disclosure that will alert the investing American public to the material risks posed by this incipient instability and volatility.

In a recent edition of Foreign Affairs one prominent analyst of Chinese political affairs noted the increasing dysfunction of the Chinese government and the associated threat to economic and political stability.

> China's governance deficits are likely to continue to grow and threaten the sustainability of its economic development. The slow-brewing crisis of governance may not cause an imminent collapse of the regime, but the accumulation of severe strains on the political system will eventually weigh down China's economic modernization as poor governance makes trade and investment more costly and more risky. The current economic dynamism may soon fade as long-term stagnation sets in.
>
> Such a prospect raises questions about some prevailing assumptions about China. ...[t]he international business community, in its enthusiasm for the Chinese market, has greatly discounted the risks embedded in the country's political system. Few appear to have seriously considered whether their basic premises about China's rise could be wrong. These assumptions should be revisited through a more realistic assessment of whether China, without restructuring its political system, can ever gain the institutional competence required to generate power and prosperity on a sustainable basis. As Beijing changes its leadership, the world needs to reexamine its long-cherished views about China, for they may be rooted in little more than wishful thinking"[9]

The American Bondholders Foundation respectfully requests the Commission to ensure full and fair disclosure by Chinese corporate and government issuers of the financial risks posed by governmental and political instability within China this so that American investors may make fully informed decisions whether to purchase the equity or debt securities of such issuers. Because many of the Chinese corporate issuers subject to the Commission's jurisdiction are majority owned, directly or indirectly, by the very Chinese government whose stability is at risk, a conflict of

[8] Id. The U.S. – China Review Commission estimated that Chinese entities have raised more than $40 billion in international equity markets since 1992, including $14 billion in U.S. markets since 1998. An additional $20 billion in U.S dollar denominated bonds have been sold by Chinese issuers in international offerings since 1992.

[9] "China's Governance Crisis", September/October 2002 Foreign Affairs, Minxin Pei

interest may inhibit management of the corporate issuers from making full disclosure of the potential adverse consequences in the absence of a specific Commission mandate. Accordingly, a specific disclosure mandate by the Commission is warranted in order to ensure protection of American investors. Such mandated disclosure would be similar to other recent Commission initiatives to ensure that issuers provide timely and adequate information about the potentially adverse consequences associated with such risks as environmental liabilities, derivatives and currency fluctuations, and inadequate internal accounting controls.

3. Risk of Debt Repudiation.

The Commission should adopt a policy that requires all registration statements (and subsequent annual reports) filed with the Commission for debt securities issued by a Chinese issuer, including sovereign debt of the Chinese PRC government, to contain a clear statement that the PRC Government of China has repudiated the sovereign debt obligations of predecessor Chinese governments. Prospective American investors are entitled to be fully informed of the official Chinese government position that the current Chinese government is not bound by the sovereign full faith and credit debt obligations incurred by the established and internationally recognized government of China during the pre World War II period.[10] Such disclosure will alert American investors to the possibility that a future Chinese government might be tempted to seek to invoke the precedent of its PRC predecessor by renouncing any obligation to honor Chinese government bonds issued in the 1990's or the first years of the 2000 decade.

The position of the current PRC government of China disclaiming the obligations of an established and widely recognized predecessor government of the same nation is inconsistent with the norms of international law. (See *the Restatement (Third) of the Foreign Relations Law of the United States*, Section 712(2) and Creditors Claims in International Law, The International Lawyer, Vol. 34, page 235, Spring, 2000)[11] In fact, in 1987 China entered into a treaty with Great Britain that recognized the obligation of the current PRC Chinese government for bonds issued prior to the

[10] February 2, 1983 Aide Memoire of the Ministry of Foreign Affairs of the People's Republic of China, included as pages 81-82 of the American Society of International Law, International Legal Materials, 22I.L.M. 75 (1983) wherein the PRC declared "The Chinese Government recognizes no external debts incurred by the defunct Chinese governments and has no obligation to repay them. ...It is a long-established principle of international law that odious debts are not to be succeeded to."

[11] The widely reported assurances of the United States and the international community that financial obligations incurred by the current (Saddam Hussein era) Iraqi government to Russia and to France will be honored by any new Iraqi government following a change of regime is indicative of the prevailing applicability of this principle of international law. As recently as the late 1990's post Soviet era Russia acknowledged its liability to French bondholders for pre-1917 Czarist era Russian sovereign debt.

1949 change of governments.[12] This treaty provided compensation to British holders of Chinese Government bonds issued prior to 1949.[13] American investors are entitled to full disclosure of the repudiations made by the current PRC Chinese government of the sovereign debts of predecessor Chinese governments. Such information is critical to enable prospective American purchasers of Chinese government debt securities to assess the likelihood that a successor Chinese government which might emerge from a political transition to a non-Communist Party dominated state will abide by accepted international law norms and honor debt securities issued by the current PRC government of China. Clearly, as the possibility of political volatility in China becomes increasingly noted by credible analysts,[14] the repudiation by the present Chinese government of a predecessor Chinese government's sovereign debt is a highly material fact that a prudent investor would want to know.

In summary, the American Bondholders Foundation urges the Commission to adopt policies and procedures to ensure the full disclosure to the Commission and the investing American public of the unique and material risks outlined in this letter of investing in Chinese corporate and governmental securities.

Very truly yours,

B. Riney Green

cc: Hon. Paul Atkins
Commissioner

Hon. Roel Campos
Commissioner

Hon. Cynthia A. Glassman
Commissioner

[12] According to the New York Times of June 8, 1987, Britain reached a settlement with the Chinese Government. "China was previously barred from issuing bonds on the London market because of its refusal to honor debts incurred by governments before the 1949 Communist Revolution." The settlement did not provide full value to the British bondholders, but it does provide official evidence of the Chinese government's willingness, however reluctantly, to recognize its obligation to honor bonds like those held by American bondholders.

[13] Unfortunately, only British citizens and British companies, and no American bondholders or other non-British nationals, were eligible to submit claims. See Part IV of the Foreign Compensation (People's' Republic of China) Order 1987 of Her Majesty's Government.

[14] See Parts 1 and 2 of this Letter.

Hon. Harvey Goldschmid
Commissioner

Giovanni P. Prezioso, General Counsel

Foreign Bondholders Protective Council

American Bondholders Foundation

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UNITED STATES
SECURITIES AND EXCHANGE COMMISSION
WASHINGTON, D.C. 20549

DIVISION OF
CORPORATION FINANCE

January 21, 2003

B. Riney Green, Esq.
Stites & Harbison PLLC
SunTrust Center Suite 1800
424 Church Street
Nashville, TN 37219-2376

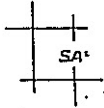
Dear Mr. Green:

Thank you for your January 8th letter to Chairman Pitt and Alan Beller written on behalf of the American Bondholders Foundation. In your letter, you suggest that we consider certain factors relating to the adequacy of disclosure provided in filings with the Securities & Exchange Commission by Chinese governmental issuers and companies based in China. We will consider the information you provided as we seek to ensure that companies and other issuers whose securities are registered with the SEC fulfill their responsibility to provide investors with full and fair information that is material to an investment decision.

Sincerely,

Shelley A. Parratt
Senior Associate Director

8



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Via Certified Mail, Electronic Mail and Facsimile

March 31, 2005

Mr. Michael Macchiaroli, Associate Director
Division of Market Regulation
U.S. Securities and Exchange Commission
450 Fifth Street, N.W.
Washington, D.C. 20549

Re: 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.

Dear Mr. Macchiaroli:

The following matter is pertinent to the supervisory and regulatory mandate of the Division of Market Regulation with respect to the operation of the nation's securities markets generally, and specifically the diligent enforcement of regulations governing the operation of the Nationally Recognized Statistical Rating Orgnizations ("NRSROs"). Accordingly, on behalf of defaulted creditors of the Government of China including the United States bondholders organized as the American Bondholders Foundation, we present the following concerns and Complaint to your attention.[1]

[1] As referenced herein, the term "ABF affiliated bondholders" shall be interpreted to refer to U.S. citizens affiliated with the American Bondholders Foundation, who are holders of full faith and credit sovereign obligations of the Chinese Government on which that government has defaulted and continues to evade payment. As referenced herein, the term "other defaulted creditors" shall be interpreted to refer generally to all defaulted creditors holding full faith and credit sovereign obligations of the Chinese Government, regardless of domicile, who continue to suffer discriminatory treatment regarding settlement of claims. As used herein, the term "other defaulted creditors" shall specifically exclude reference to citizens of Great Britain who participated in the 1987 settlement accord between Britain and the Government of China, and shall also specifically exclude reference to citizens of France, who are presently engaged in negotiations with the Government of China regarding settlement of defaulted obligations held by French citizens.

SECTION 1

American Bondholders Foundation and Claims of American Citizens Holding Defaulted Full Faith and Credit Sovereign Bonds of the Government of China.

§1.01 Defaulted Chinese Government Bonds

The American Bondholders Foundation (the "ABF") is the incorporated national organization representing the consolidated claims of thousands of United States bondholders who are holders of full faith and credit sovereign bonds issued by the Government of China and on which that government has defaulted and continues to evade payment to both American citizens and non-U.S. bondholders.[2] The most prevalent among the defaulted series of bonds which are the subject of the ABF collection action is the Chinese Government Five Per Cent Reorganization Gold Loan. This series of bonds was issued by the Government of China as a full faith and credit obligation of the Chinese Government and was sold to investors in the United States and Europe by a global syndicate of international banks. The bonds were scheduled to mature in 1960. The language of the bond certificates, as well as the language of the Loan Agreement authorizing the bond issue, mandated that the obligations were to be considered as binding upon the Government of China and its successors.[3] The obligations which are the subject of the ABF collection action have been valued by a recognized specialist in international bond valuation in accordance with the provisions of the debt covenants as specified in the Loan Agreement. All such bonds which have been tendered for collection are presently held in trust by the ABF.[4]

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[2] The ABF is a U.S. corporation duly incorporated under the laws of the state of Delaware. The ABF and its members have retained the law firm of Stites & Harbison to act as counsel in the matter of collecting on the defaulted Chinese government debt. On June 13, 2001, at the direction of the White House Counsel, the United States Department of State and the Securities and Exchange Commission, the ABF contacted the Foreign Bondholders Protective Council (the "FBPC") to initiate collection proceedings on these defaulted obligations. The FBPC was created by Presidential Executive Order to assist U.S. citizens in collecting on defaulted debts of foreign issuers and has successfully completed collection of 47 previous defaulted bond settlements. The ABF has been featured extensively by the international print and broadcast media, including the British Broadcast Corporation, Financial Times, Wall Street Journal, Associated Press, Bloomberg Financial News, USA Today, Congressional Quarterly, Voice of America, Business Week and Barron's Financial News. The ABF has also hosted a congressional forum with the participation of the National Congress of American Indians. Federally-recognized American Indian tribes constitute eligible recipients of the charitable and humanitarian programs to be funded from the 30% contribution of debt collection proceeds. The charitable and humanitarian programs will be administered under the auspices of the affiliated ABF foundation.

[3] Under established conventions of international law, a successor government is responsible for payment of the sovereign obligations of a predecessor government. In fact, the language which appears on the bond certificates which are the subject of the ABF collection action explicitly states: "These obligations are intended to be binding upon the Government of China and any Successor Government".

[4] Note that the bonds held by ABF affiliated bondholders are exclusive of similar bonds acquired by the United States Government Office of Foreign Asset Management through the Trading with the Enemy Act and presently held by the "public-at-large".

§1.02 1987 Discriminatory Settlement

Although repeated demands by individual bondholders to China for payment of these obligations have been ignored for years by the Chinese Government, the People's Republic of China has previously settled payment with the citizens of Great Britain on their holdings of defaulted bonds from this series in 1987.[5]

§1.03 Statement of Intent to Resume Payments and Continued Evasion of Payments

Subsequent to defaulting on the external bonded debt represented by this series of bonds, the Government of China pledged its intention to resume service on the debt when economic conditions permitted, although the People's Republic of China has not made any payments to date on the bonds to the ABF affiliated bondholders or to other defaulted creditors.[6] The continued evasion of payment by the Chinese Government on this series of defaulted bonds represents a discriminatory attempt to evade payment of full faith and credit sovereign debt by a government which possesses the financial ability to honor its nation's valid and binding obligations.[7]

§1.04 Recent Settlement Precedents

In addition to general principles of international law, there exist several recent precedents that are applicable to the situation described herein:

- 1986

  The Government of the Soviet Union settled the claims of British citizens who were holders of defaulted pre-1917 Russian government bonds.

- 1987

  The Government of the People's Republic of China settled the claims of British citizens who were holders of an identical series of defaulted Chinese government obligations as the ABF affiliated bondholders.

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[5] The People's Republic of China negotiated a settlement accord with British bondholders in June of 1987.
[6] See letter dated December 11, 1979 from Mr. J. Brian Attwood, Assistant Secretary for Congressional Relations, U.S. Department of State, addressed to the Honorable Charles A. Vanik, Chairman of the Subcommittee on Trade, Committee of Ways and Means, U.S. House of Representatives.
[7] A complete set of Memorandums addressed to the United States Congress have been prepared by the law firm of Stites & Harbison PLLC which present a comprehensive analysis and discussion, including relevant authorities, of the liability of the Government of the People's Republic of China for payment of the bonds held in trust by the ABF affiliated bondholders. This set of Memorandums may be viewed at the following URL: *http://www.globalsecuritieswatch.org/s&hmemorandums.html*
According to the Global Association of Risk Professionals, the People's Republic of China presently has in excess of $610 billion in foreign exchange reserves, representing an increase of over $200 billion during the past twelve months. "China Vows Better Forex Management". *RiskAlert*. February 22, 2005.

- 1996

  The Government of Russia settled the claims of French citizens who were holders of defaulted pre-1917 Russian government bonds.

- 2004

  Recently, the People's Republic of China has notified the Government of France that it intends to settle the claims of French citizens who are holders of an identical series of defaulted Chinese government obligations as the ABF affiliated bondholders.

§1.05 Selective Default and Discriminatory Settlement Practices

Despite the obligation of the People's Republic of China to honor the claims of the ABF affiliated bondholders and other defaulted creditors under international law, the Chinese Government continues to blatantly disregard these claims and continues its discriminatory treatment of United States citizens and other defaulted creditors in an attempt to evade payment. As a direct result, the ABF affiliated bondholders as well as other defaulted creditors are victims of both **selective default** and **discriminatory settlement** (i.e., selective repudiation of this specific series of obligations by the People's Republic of China and the exclusionary settlement with British citizens in 1987).[8] Accordingly, in addition to other venues, the ABF is pursuing the resolution of affiliated bondholders' claims through the United States Congress. Members of the 107th United States Congress, including the House Majority Leader and the Chairman of the House Financial Services Committee, signed a letter to President George W. Bush expressing the support of the Congress for the Government of China to settle the claims of the ABF affiliated bondholders. Subsequently, the 108th Congress held a televised hearing in the U.S. House of Representatives on this matter.[9]

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[8] See Aide Memoire issued by the Chinese Ministry of Foreign Affairs, included as pages 81-82 of the American Society of International Law, International Legal Materials, 221.L.M75 (1983), wherein the People's Republic of China declared "The Chinese Government recognizes no external debts incurred by the defunct Chinese Governments and has no obligation to repay them ...". For the matter of discrimination against the claims of United States citizens and non-U.S. bondholders, excluding citizens of Great Britain, refer to the provisions of the 1987 treaty between China and Great Britain which provides for settlement and payment of bondholder claims of British nationals and which does not provide for any payment on the claims of American or non-U.S. bondholders.

[9] It has long been the policy of the United States Department of State that intervention by the United States Government in bondholder disputes is appropriate in situations involving either debt repudiation or discrimination. See policy letter addressed to the Honorable Charles A. Vanik, Chairman, Subcommittee on Trade Committee on Ways and Means, United States House of Representatives, authored by J. Brian Atwood, Assistant Secretary of State for Congressional Relations (December 11, 1979), stating that examples in which intervention by the United States Government is appropriate in resolving the bondholder claims of U.S. citizens includes the following: (1) situations in which the obligations are repudiated; and (2) situations in which American nationals are discriminated against. On October 21, 2003, Ms. Jonna Z. Bianco, President of the American Bondholders Foundation presented testimony in the United States Congress on this issue during the televised public hearing conducted by the International Relations Committee of the U.S. House of Representatives. Other witnesses presented additional testimony at this hearing regarding the U.S.–China economic relationship, specifically addressing the loss of approximately

§1.06 Deceptive Practices and Misleading Investor Information: New Sovereign Bond Issues

Having provided some background on this important issue, please allow us to now direct your attention to certain recent events related to the situation described above, which we believe merits further investigation. On behalf of the American Bondholders Foundation and other defaulted creditors of the Government of China, the specific complaints described below are hereby presented to your attention. The ABF affiliated bondholders and other defaulted creditors continue to suffer economic harm as a result of the actions of the Government of the People's Republic of China acting in concert with the major credit rating agencies and the complicity of various underwriters including Morgan Stanley, J.P. Morgan, Goldman Sachs, Citigroup and others which are actively assisting the People's Republic of China in the issuance of new debt securities in the global capital markets. Such actions, evidencing a blatant disregard for accepted conventions of international law, established international credit rating protocols and appropriate disclosure standards as described in the following sections, represent a grave threat to the integrity of the international capital markets.

SECTION 2

The Government of China Continues to Evade Settlement of Bondholders' Claims and Continues to Sell Sovereign Bonds in the International Capital Markets in Reliance on Deceptive Practices Including Misleading Credit Ratings and Concealment of an Outstanding Series of Full Faith and Credit Sovereign Bonds Remaining in Default.

§2.01 Recent Issuance of New Sovereign Bonds

Despite ignoring the claims of the existing bondholders in violation of international law, The Government of the People's Republic of China continues to access the international capital markets through the periodic issuance of global sovereign bond issues. During the most recent bond sales in 2003 and again in 2004, the Government of the People's Republic of China sold in excess of $3 billion in global sovereign bonds to investors in the United States, Europe and Asia.

§2.02 Global Sale of New Sovereign Bonds in the U.S., Europe and Asia

The 2003 Chinese Government global sovereign bond offering was registered in the United States, Luxembourg and Hong Kong, and was sold throughout Europe, the United States and Asia.[10] The 2004 Chinese Government global sovereign bond offering was registered in Luxembourg and Hong Kong, and was sold throughout Europe and Asia.[11]

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three million manufacturing jobs from the U.S. to China since mid-2000. Witnesses presenting testimony included representatives of the National Association of Manufacturers and the AFL-CIO. A transcript of the testimony presented at the hearing conducted by the House International Relations Committee on October 21, 2003 may be viewed at either of the following Congressional web-links:
http://wwwc.house.gov/International_Relations/108/bian2021.htm
http://www.nist.gov/hearings/2003/uschina.html

[10] According to the prospectus supplement dated October 16, 2003 filed with the United States Securities and Exchange Commission, the lead underwriters participating in the offer and sale of People's Republic of

§2.03 Comparative Summary of Chinese Government Sovereign Bond Issues

Exhibit 2.01 provides a comparative summary of recent Chinese Government sovereign bond sales in the international capital markets.

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China sovereign bond offering (common code 017941941; ISIN US712219AJ30; CUSIP 712219AJ3) include the following firms: Goldman Sachs (Asia) LLC, J.P. Morgan Securities, Inc., Merrill Lynch, Pierce, Fenner & Smith Incorporated, Banc One Capital Markets, Inc., Citigroup Global Markets, Inc., Credit Suisse First Boston LLC, Daiwa Securities SMBC Europe Limited, The Hong Kong and Shanghai Banking Corporation Limited, ICEA Securities Limited, Lehman Brothers International (Europe), Morgan Stanley & Co. International Limited, and Nomura International plc. The notes were registered and listed for trading with the Luxembourg and Hong Kong Exchanges.

[11] Public notice published in the *Wall Street Journal*. October 22, 2004. The lead underwriters include the following firms: Goldman Sachs Group Inc., J.P. Morgan Chase & Co., Merrill Lynch & Co., Morgan Stanley, BNP Paribas SA, Deutsche Bank AG, and UBS AG.

Exhibit 2.01

People's Republic of China
Global Sovereign Bond Issuance Summary

YEAR OF ISSUANCE	DENOMINATION / AMOUNT	REGISTRATION / EXCHANGE LISTING	LEAD UNDERWRITERS
Pre-1986	Various series of Chinese Government global sovereign bonds enter into default including the Chinese Government Five Per Cent Reorganization Gold Loan issued for £25 million sterling The Government of the People's Republic of China ignores international bondholders' claims and leaves bonds in default including the Chinese Government Five Per Cent Reorganization Gold Loan series due to mature in 1960 The Government of the People's Republic of China enters into an exclusionary settlement with citizens of Great Britain in 1987 of the defaulted Chinese Government Five Per Cent Reorganization Gold Loan and continues to discriminate against bondholders in other countries After selectively defaulting on its outstanding global sovereign bonds the Government of China re-accesses the international capital markets and commences issuing new series of global sovereign bonds	Great Britain France Germany Japan Russia	The following firms acted as the lead underwriters of the Chinese Government Five Per Cent Reorganization Gold Loan: Banque de L'Indo-Chine; Deutsch-Asiatische Bank (Deutsche Bank); Hong Kong & Shanghai Banking Corporation (HSBC); Russo-Asiatic Bank; Yokohama Specie Bank Limited
1986 – 2002[12]	$8.5 Billion[13] (Low Estimate) / $13 Billion[14] (High Estimate)	(N/A)	(N/A)
2003[15]	Tranches: $1 Billion (Due 2013) €400 Million (Due 2008)	United States (Registration No. 333-108727) Luxembourg Hong Kong	Goldman Sachs (Asia); J.P. Morgan Securities; Merrill Lynch; Banc One Capital Markets; Citigroup Global Markets; Credit Suisse First Boston; Daiwa Securities SMBC Europe; Hong Kong and Shanghai Banking Corporation; ICEA Securities; Lehman Brothers International (Europe); Morgan Stanley & Co. International; Nomura International
2004[16]	Tranches: $500 Million (Due 2009) €1 Billion (Due 2014)	Luxembourg Hong Kong	Goldman Sachs Group; J.P. Morgan Chase & Co.; Merrill Lynch; Morgan Stanley; BNP Paribas; Deutsche Bank; UBS

[12] Reliable data for the indicated period unavailable. Estimates of the amount of long-term foreign currency sovereign bonds issued by the Government of the People's Republic of China for the period 1986 – 2002 vary depending upon source. According to a report published by the William J. Casey Institute Center for Security Policy, the People's Republic of China had issued sovereign bonds in the amount of $4.2 billion which were outstanding in the United States as of mid-2001. *Watch this Space: Beijing Says it Won't Bring Sovereign Bond to U.S. Capital Markets – But For How Long?* Publication no. 01-C31. William J. Casey Institute Center for Security Policy. May 21, 2001.

[13] Source: U.S.-China Economic and Security Review Commission Report to the United States Congress (2002). All amounts which are stated in dollar figures represent United States dollars.

[14] Source: *Foreign Participation in Local-Currency Bond Markets*. John D. Burger and Francis E. Warnock. International Finance Discussion Paper No. 794. Board of Governors of the Federal Reserve System. February 2004.

[15] Source: Prospectus supplement dated October 16, 2003 filed with the United States Securities and Exchange Commission.

[16] Source: Notice of bond offering appearing in the *Wall Street Journal*. October 18, 2004.

SECTION 3

Inappropriate and Misleading Sovereign Credit Rating of the Long-Term Foreign Currency Debt of the Government of the People's Republic of China.

§3.01 Improper and Misleading Credit Rating Classifications Assigned to the Government of China

The three major nationally-recognized statistical rating organizations ("NRSROs"), commonly referred to as credit rating agencies (i.e., Moody's Investors Service, Standard and Poor's Rating Group and Fitch Ratings) continue their deceptive practice of selectively disregarding pertinent facts associated with the situation described herein, particularly the "*willingness to pay*" metric, which represents a significant and continuing component of embedded risk implicit to general obligations of the Chinese Government.[17]

§3.02 Current Credit Ratings Ignore Repudiation of Sovereign Debt and Selective Default

According to representatives of the U.S. Department of State, the People's Republic of China explicitly repudiated all bond claims originating prior to its 1949 assumption of the Government of China.[18] Since the assumption and payment of any valid outstanding obligations of a pre-existing government by a recognized successor government is a basic tenant of international law, the refusal of the People's Republic of China to abide by this established convention violates accepted principles of international trade and commerce and demonstrates its unwillingness to comply with commonly accepted standards of conduct.[19] The People's Republic of China explicitly acknowledged its responsibility for payment of pre-1949 Chinese sovereign bonds pursuant to the 1987 accord which settled the claims of British citizens, thereby establishing a precedent for collection by other bondholders. Despite the 1987 accord with British bondholders, the People's Republic of China continues to attempt to evade payment to the ABF affiliated bondholders and other defaulted creditors holding the identical series of full faith and credit sovereign bonds.[20] Such an attitude, manifested as a form of institutionalized behavior, is inconsistent with increased recognition of the quality of the Chinese Government's international obligations.

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[17] Nationally Recognized Statistical Rating Organizations ("NRSROs"). The three organizations historically comprising this classification of credit rating service providers are Moody's Investors Service, Standard and Poor's Rating Group and Fitch Ratings. Dominion Bond Rating Service was recognized in 2003 as a fourth NRSRO. A.M. Best was recently recognized as the fifth NRSRO.

[18] Aide Memoire issued by the Chinese Ministry of Foreign Affairs, included as pages 81-82 of the American Society of International Law, International Legal Materials, 221.L.M75 (1983), wherein the People's Republic of China declared "The Chinese Government recognizes no external debts incurred by the defunct Chinese Governments and has no obligation to repay them ...".

[19] See *Restatement (Third) of the Foreign Relations Law of the United States*, Section 712(2) and "Creditors Claims in International Law", *The International Lawyer*, Volume 34, page 235, Spring 2000. See also, for example, the recent United Nations Security Council resolution on weapons inspections in Iraq which stipulates that a subsequent government in Iraq following a regime change will remain liable for predecessor national debt obligations.

[20] The 1987 agreement with Great Britain did not provide any settlement for non-British citizens.

§3.03 Credit Rating Agencies Continue to Discriminate Against Defaulted Creditors

In preparation for the October 2003 global sovereign bond sale, the major credit rating agencies conducted a review of the long-term foreign currency sovereign debt rating of the People's Republic of China. Prior to such review, the omission of significant and material aspects from the prevailing rating assessments of the Chinese Government, including the situation described above, was explicitly brought to the attention of the chief executive officers of Moody's Investors Service, Standard and Poor's Rating Group and Fitch Ratings in a letter dated November 27, 2002 authored by Ms. Jonna Z. Bianco, President of the American Bondholders Foundation.[21] To date, no acknowledgement or response to this letter has been received from any of the three major credit rating agencies.

§3.04 Credit Rating Agencies Act to Facilitate Chinese Government's Global Bond Sale

On October 13, 2003 Fitch Ratings affirmed its investment grade assessment and assigned a "positive" outlook. On October 15, 2003 Moody's Investors Service announced that it was upgrading the long-term foreign currency sovereign credit rating of the Chinese Government from the previous A3 rating to a newly-assigned rating of A2. Incredibly, on October 22, 2003, the very day after the United States Congress House of Representatives International Relations Committee conducted a televised public hearing on the ABF issue, Standard and Poor's Corporation actually affirmed its investment grade assessment of the long-term foreign currency sovereign credit rating of the Chinese Government and assigned a "positive" outlook. Coincidentally, each of these development occurred during October, 2003, the same month that the Government of the People's Republic of China filed a prospectus with the SEC for the offer and sale of $1 billion in government notes.

§3.05 Summary of Ratings Action Preceding Chinese Government's 2003 Global Sovereign Bond Sale

The following is a summary of actions taken by the major credit rating agencies during the month of October, 2003:

- October 13, 2003

  Fitch Ratings affirmed the long-term foreign currency rating of China at A-. The rating outlook is positive. This rating applies to all of China's senior unsecured long-term sovereign debt issues.

- October 15, 2003

  Moody's Investors Service, Inc. upgraded China's sovereign rating from A3 to A2 for long-term foreign-currency denominated debt. The rating outlook is stable.

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[21] The full faith and credit sovereign obligations of the Chinese Government referenced herein exist in a state of "discriminatory repudiation" due to the 1987 settlement with British bondholders which excluded non-British bondholders, and the pending settlement-in-progress with respect to French bondholders which is also expected to exclude U.S. bondholders, among others.

- October 22, 2003

  Standard & Poor's Ratings Group affirmed its BBB senior unsecured foreign currency credit rating for China. The outlook is positive.[22]

§3.06 Current Credit Ratings Ignore Defaulted Series of Full Faith and Credit Sovereign Obligations

The intentional and willful omission of the existence of a significant dollar value of defaulted obligations of the Chinese Government in the prevailing debt rating assessments of the People's Republic of China constitutes a blatant rejection of the generally accepted international standard that the degree of rigor exercised in assessing the adequacy of issuer disclosures should be strengthened rather than relaxed. Such egregious and spurious conduct is outrageous, particularly in light of the fact that the circumstances described herein were previously brought to the explicit attention of the three major credit rating agencies by the ABF. In light of the persistent evasion by the Chinese Government with respect to payment of its defaulted sovereign obligations and the potential financial impact arising from the emergence of a significant liability, the present credit rating classifications assigned to the Chinese Government are inappropriate and misleading.

§3.07 Current Credit Ratings Selectively Ignore Pertinent Risk Metrics

As revealed below, not only do the current rating classifications assigned to the long-term foreign currency debt of the People's Republic of China by the three major credit rating agencies ignore the existence of a defaulted series of full faith and credit sovereign obligations of the Chinese Government remaining in default, the current rating classifications also do not reflect an accurate assessment of the following material risk metrics:

Judicial risk (i.e., pari passu risk of interest attachment / coupon seizure by defaulted creditors);

Legislative risk (i.e., risk of U.S. and foreign jurisdiction capital markets or trade sanctions);

Liquidity risk (i.e., risk of U.S. regulatory agency sanctions imposed on dealers and ban on quotation pursuant to the Johnson Debt Default Act);

Repayment risk accruing from the "willingness to pay" metric (i.e., evasion of payment on outstanding full faith and credit sovereign obligations in violation of international law and reassessment of the PRC's willingness to honor outstanding obligations in the event of future adverse economic conditions); and

International setoff risk (i.e., vulnerability to international setoff, adversely affecting the PRC's balance of payments position and impairing the PRC's ability to maintain its current level of external debt).[23]

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[22] Source: People's Republic of China offering prospectus for the offer and sale of sovereign obligations of the Government of China filed with the U.S. Securities and Exchange Commission. October 16, 2003.

[23] The Global Association of Risk Professionals recently reported on the downgrade of the long-term credit of the People's Republic of China by our firm to sub-investment grade status. The justification for the downgrade of the PRC's credit rating is predicated upon the continuing evasion of payment on a series of defaulted full faith and credit sovereign bonds of the Chinese Government (e.g., the Chinese Government

§3.08 Comparative Summary of Chinese Government Sovereign Debt Rating Classifications

Exhibit 3.01 presents a comparative analysis of the appropriate and inappropriate rating classifications for the long-term foreign currency debt of the People's Republic of China.[24]

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Five Per Cent Reorganization Gold Loan). Discriminatory settlements of the defaulted sovereign series increases the risk of interest payments seizure by defaulted creditors. The article may be viewed online at the following URL: *http://www.garp.com/risknews/newsfeed.asp?Category=10&MyFile=2004-09-21-9418.html*

[24] The definition for each specific rating classification was obtained from the respective credit rating agency website, utilizing the following URLs: Standard and Poor's: *http://www2.standardandpoors.com* Moody's Investors Service: *http://www.moodys.com* Fitch Ratings: *http://www.fitchratings.com*
The Japan credit rating agency Rating and Investment Information, Inc. ("R&I") currently assigns an inappropriate "A" sovereign rating classification to the long-term foreign currency debt of the People's Republic of China. The appropriate R&I rating classification for the long-term foreign currency debt of the People's Republic of China should be "CCC", indicating the existence of defaulted debt.

Exhibit 3.01

People's Republic of China
Long-Term Foreign Currency Sovereign Debt Rating

CREDIT RATING AGENCY	INAPPROPRIATE CREDIT RATING	DEFINITION
Standard & Poor's	BBB+	An obligor rated "BBB" has adequate capacity to meet its financial commitments. However, adverse economic conditions or changing circumstances are more likely to lead to a weakened capacity of the obligor to meet its financial commitments. The addition of a "+" symbol denotes the relative standing within the assigned rating classification.[25]
Moody's	A2	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 addition of a "2" denotes mid-range ranking within the assigned rating classification.
Fitch Ratings	A-	High credit quality. "A" ratings denote a low expectation of credit risk. The capacity for timely 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.
CREDIT RATING AGENCY	**APPROPRIATE CREDIT RATING**	**DEFINITION**
Standard & Poor's	SD (Selective Default)[26]	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.[27]
Moody's	Ba (high range) Caa (low range)	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.[28]
Fitch Ratings	DDD RD (Proposed)	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. Proposed new rating classification: a newly introduced rating of "RD" (Restrictive Default) is proposed for assignment 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.

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[25] When applied to debt issued by a sovereign issuer, this rating classification denotes an investment grade debt rating for an issuer which has no full faith and credit sovereign obligations remaining in default.

[26] Recent instances in which Standard and Poor's has assigned an "SD" rating classification to the long-term foreign currency debt of a sovereign issuer include Russia in 1998 (which defaulted on its domestic obligations while continuing to service its eurobonds); Argentina, following its sovereign debt default in December 2001 and subsequent restructuring, including an exchange offer to existing bondholders; and the Dominican Republic in 2005 (which became delinquent on payments owed to commercial bank creditors while continuing to service its bonded debt). The "SD" rating remained in full force and effect until all outstanding defaulted obligations were resolved.

[27] A prime example of selective default is the entire series of full faith and credit sovereign obligations issued as the Chinese Government Five Per Cent Reorganization Gold Loan, scheduled to mature in 1960 and which series remains in default as an external payment obligation of the successor government of China (i.e., the People's Republic of China, which was established on October 1, 1949). The People's Republic of China replaced the Republic of China in the United Nations as the recognized government of China on November 23, 1971 and was subsequently recognized as the government of all China. Taiwan publicly renounced any claim to the government of all China in 1991.

[28] This rating classification is appropriate with respect to acknowledging the judicial risk inherent to investment in such obligations arising from the discriminatory treatment of different classes of creditors.

§3.09 Current Credit Ratings Ignore International Law and Comparability Among Creditors

Under international law, the Government of the People's Republic of China is responsible for payment of the sovereign obligations of the predecessor government (i.e., is the obligor for such obligations). The U.S. Foreign Sovereign Immunity Act does not convey protection to debtor governments in sovereign debt defaults and has been interpreted by U.S. courts to define post-default sovereign bond sales as a "commercial activity" which constitutes an exemption from immunity.[29] The continued payment of selected obligations while simultaneously evading payment on an entire series of defaulted full faith and credit sovereign obligations which remain outstanding in default also constitutes a blatant violation of the doctrine of pari passu as interpreted by the Belgian commercial courts and represents a direct contravention of the doctrine of comparability among creditors.[30]

§3.10 Improper Credit Rating Classifications Mislead Investors and Risk Credit Markets Contagion

The deceptive practices perpetrated upon the investing public by the major credit rating agencies in the instance described herein represent an explicit repudiation of the doctrine of comparability of treatment with respect to creditors holding full faith and credit sovereign obligations of the Chinese Government. The outrageously unconscionable conduct of the three major credit rating agencies in this matter demonstrates a willful and deliberate disregard of the objective facts and circumstances and is inconsistent with the important role of the major credit rating agencies as independent evaluators upon which the public-at-large may depend in confidence.[31] The blatant failure of the major credit rating agencies to conduct an objective analysis of the pertinent facts and circumstances, resulting in the assignment of inappropriate and misleading sovereign credit ratings to the long-term foreign currency debt of the People's Republic of China, ignores the existence of outstanding full faith and credit sovereign obligations which have been repudiated through the process of selective default and discriminatory settlement and serves not only to erode the credibility of the agencies but also acts to establish a dangerous precedent for stimulating a credit markets contagion by emboldening unscrupulous issuers to attempt to evade payment of similar obligations. The prevailing and disgraceful situation evidenced by the willful disregard of established rating protocols by the credit rating agencies in concert with lax

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[29] Republic of Argentina v. Weltover, Inc. 504 U.S. 607 (1992). Docket Number: 91-763.

[30] Elliott Associates, L.P., General Docket No. 2000/QR/92 (Court of Appeals of Brussels, 8th Chamber, Sept. 26, 2000). See also, Republic of Nicaragua v. LNC Investments and Euroclear Bank SA (Injunction issued against paying agent by Belgian Commercial Court, Sept. 8, 2003).

[31] See the revealing comment by Indiana University's Dr. Scott Kennedy, who specializes in China's political economy: "If you have any credibility, you would probably be rating everything junk in China." See also the statement: "China doesn't adhere to international accounting standards. To make matters worse, the government issues misleading statistics." According to Mr. Brian Colton, an analyst who rates China's sovereign bonds for Fitch Ratings (Hong Kong): "Sometimes you have a column of figures that don't add up to the total at the bottom. It's that bad." *Wall Street Journal*, January 5, 2004. See also the statement by Mr. Gordon Chang, former partner at Paul, Weiss, Rifkind, Wharton & Garrison in Beijing: "China has less borrowing capacity than many people think; it is not as creditworthy as many people think." *Watch this Space: Beijing Says it Won't Bring Sovereign Bond to U.S. Capital Markets – But For How Long?* Publication no. 01-C31. William J. Casey Institute Center for Security Policy. May 21, 2001.

enforcement of established protocols is highly conducive to the propagation of such a contagion. Immediate corrective action is mandated to restore the integrity of the ratings universe.

SECTION 4

Inadequate Disclosure of Registration Statements and Offering Documents Pertaining to the Offer and Sale of Sovereign Bonds of the Government of the People's Republic of China.

§4.01 Omission of Material Facts and Concealment of Investor Information

Our concerns in this regard involve the grossly inadequate disclosure of investor risk in the bond offering registration statements and offering documents. We note with concern the following two specific failures:

(a) Failure to disclose the existence of a series of full faith and credit sovereign bonds remaining in default and on which the Chinese Government continues to evade payment to the ABF affiliated bondholders as well as to other defaulted creditors in violation of international law; and

(b) Failure to disclose the potential risks associated with settlement of securities transactions involving the issuance and trading of full faith and credit sovereign obligations of the Government of the People's Republic of China.

§4.02 Inadequate Disclosure by the Government of the People's Republic of China

In a letter addressed to the United States Securities and Exchange Commission (the "SEC") dated January 8, 2003, Mr. B. Riney Green, a partner of the law firm of Stites & Harbison articulated specific concerns regarding the extent of disclosure provided pursuant to offerings of securities within the U.S. capital markets by the Government of the People's Republic of China and its state-owned entities.[32] The following issues were brought to the attention of the SEC as examples of inadequate disclosure in securities offering filings and investor documents related to offerings of securities by the People's Republic of China:

1. Misleading Chinese Government economic data;
2. Political instability of the Chinese Government; and
3. Risk of debt repudiation.

§4.03 Material Omissions of Fact Enables the Chinese Government to Circumvent Defaulted Creditors

The issues described above adversely affect the resolution of both the ABF and unaffiliated bondholders' claims since the Government of the People's Republic of China continues to enjoy

[32] Letter dated January 8, 2003 from Stites & Harbison PLLC addressed to the Honorable Harvey L. Pitt, Chairman, U.S. Securities and Exchange Commission and Mr. Alan Beller, Director, Corporate Finance Division, U.S. Securities and Exchange Commission.

unfettered access to the international capital markets without any disclosure of the situation described herein, and thus has little incentive to settle the claims of defaulted creditors. The Chinese Government and its U.S. and European underwriters continue to omit mention of material disclosures related to, among other omissions, the situation described herein. For example, the People's Republic of China sovereign bond offering prospectus filed with the U.S. Securities and Exchange Commission on October 16, 2003 for the offer and sale of $1 billion in ten year debt securities contains no mention or reference to the ABF collection action or to any existing defaulted full faith and credit sovereign debt of the Chinese government.[33]

§4.04 Misleading Statements Appear in the Prospectus Supplement for China's 2003 Global Bond Sale

The following excerpted statements appear in the prospectus and the prospectus supplement of the People's Republic of China dated October 16, 2003 describing the offering of $1 billion of ten year notes:

- Page S-11 of the Prospectus Supplement:

  "China is neither involved in any litigation, arbitration or administrative proceedings which are material in the context of the issue of the notes nor aware of any such litigation, arbitration or administrative proceedings, whether pending or threatened."

  "Except as disclosed in this prospectus supplement and the accompanying prospectus, there has been no significant change in the condition (financial, political, economic or otherwise) or the affairs of China which is material in the context of the issue of the notes since December 31, 2002."

These statements are misleading to prospective investors for the following reasons:

1. The legal counsel to the American Bondholders Foundation has served a formal notice of demand for payment of the defaulted Chinese Government securities to the Minister of Finance of the People's Republic of China in Beijing, as well as to the Embassy of the People's Republic of China in Washington, D.C. This fact constitutes an implied threat of litigation;

2. The prospectus supplement omits mention of the existence of a significant quantity of defaulted full faith and credit sovereign obligations of the Chinese Government;

3. The prospectus supplement omits mention of the Chinese Government's continued discrimination against the ABF affiliated bondholders as well as other defaulted creditors,

[33] People's Republic of China. Securities prospectus dated October 16, 2003. U.S. Securities and Exchange Commission EDGAR web-link:
http://www.sec.gov/Archives/edgar/data/909321/000114554903001347/u98681p1e424b5.htm
The concealment of the existence of a defaulted series of full faith and credit sovereign obligations of the Chinese Government occurred again in 2004, whereby the registration statement and prospectus for the People's Republic of China sovereign bond offering omitted disclosure of the above fact.

and omits reference to the continuing refusal of the Government of China to honor the claims of the ABF affiliated bondholders as well as other defaulted creditors in violation of accepted conventions of international law;

4. The prospectus supplement omits mention of the recent public record testimony on this matter in the United States Congress;

5. The prospectus supplement omits mention of the Congressional Resolution (House Concurrent Resolution 60) introduced in the United States House of Representatives; and

6. The prospectus supplement omits mention of the recent initiation of settlement negotiations by the Chinese Government with citizens of France regarding settlement of the same series of bonds held by French citizens.

The preceding factors are directly related to China's economic affairs.

§4.05 Concealment of Existence of Defaulted Series of Bonds in the Prospectus Supplement

- Page 69 of the Prospectus:

  "Debt Record

  The central government has always paid when due the full amount of principal of, any interest and premium on, and any amortization or sinking fund requirements of, external and internal indebtedness incurred by it since the PRC was founded in 1949."

This statement is misleading to prospective investors for the following reason:

1. The complete omission of the existence of pre-1949 defaulted full faith and credit sovereign obligations of the Government of China, which under accepted conventions of international law, the payment obligation for such indebtedness was incurred by the central government of China in 1949 and on which that government has since settled with British bondholders and is presently in the process of negotiating a settlement with French bondholders, while continuing to exclude the claims of the ABF affiliated bondholders as well as other defaulted creditors.

§4.06 Greater Disclosure Mandated for Chinese Government Bond Sales

The situation described herein, involving a significant amount of outstanding defaulted Chinese Government debt obligations, and the Chinese Government's continuing refusal to acknowledge or honor such obligations in violation of accepted principles of international law, and the related ABF collection action, merits disclosure as a material aspect of any offering of full faith and credit sovereign obligations of the Government of the People's Republic of China.

§4.07 Similar Concerns Expressed by Industry Observers and Watchdog Organizations

Additional concerns regarding inadequate disclosure of the material risks implicit to the offer and sale of securities of the Chinese Government, or instrumentalities thereof, has recently been reiterated by each of the following:

- The Wall Street Journal;
- The Hong Kong Credit and Collection Management Association; and
- The U.S.-China Security Review Commission.[34]

§4.08 Inadequate Disclosure Concerns Corroborated by Findings of U.S. Congressional Commission

Pertinent to this Complaint are certain *"Key Findings"* of the recent U.S.-China Economic and Security Review Commission Report to the United States Congress. The conclusions presented in the section entitled "China's Presence in U.S. Capital Markets" identify serious concerns related to inadequate disclosure of the material risks implicit to the offer and sale of securities of the Chinese Government and instrumentalities thereof. Such concerns are summarized in the following excerpts from the report:

- "The U.S. Government lacks adequate institutional mechanisms to monitor national security concerns raised by Chinese and other foreign entities seeking to raise capital or otherwise trade their securities in the U.S. debt and equity markets. Moreover, Security *(sic)* and Exchange Commission (SEC) reporting requirements for foreign registrants provide insufficient disclosure to the investing public of the national security risks related to certain foreign entities' global business activities, including the material risks associated with entities that do business in terrorist-sponsoring states."

- "Chinese issuers have raised an estimated $20 billion over the past decade from international bond offerings denominated in U.S. dollars."

- "China has also raised significant sums internationally through its sovereign and corporate bond offerings. As shown in Figure 6.2, Chinese sovereign bonds garnered $8.5 billion and corporate bonds raised $26 billion from 1986 through 2001."

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[34] See "China Stocks Evoke the Ghost of Bubble Past", *Wall Street Journal* (January 27, 2004), which stated "Chinese companies, for example, don't adhere to U.S. or international accounting standards. And credit-rating agencies are unable to rate most of the Chinese companies listing overseas because of a lack of transparency and disclosure. Finally, the Chinese Government is involved in one way or another in most of the companies listed on the markets". See also "Credit Ratings in China can be Mere Guesswork", *Wall Street Journal* (January 5, 2004), which stated "But faulty accounting, poor corporate governance and a lack of disclosure hamper the raters' efforts. To make matters worse, the Government issues misleading statistics." For national security concerns posed by inadequate disclosure associated with offerings of Chinese securities in the U.S. capital markets, see Report to Congress of the U.S.–China Security Review Commission: "The National Security Implications of the Economic Relationship Between the United States and China". Chapter Six, *China's Presence in the U.S. Capital Markets*. The U.S.–China Security Review Commission. July 2002.

- "Marc Lackritz, President of the Securities Industry Association, testified that Chinese entities had raised $48.3 billion in equity capital overseas from 1991-2000, and that about 7 percent of this amount – or $3.4 billion – had been raised through targeted U.S. offerings. He further indicated that Chinese issuers of debt raised around $9.7 billion in the U.S. markets during that time period. A report prepared for the Commission on China's fundraising activities in the U.S. equity markets concludes that Chinese firms raised approximately $14.6 billion through IPOs in U.S. capital markets from 1999-2001, representing 73 percent of the $20 billion Chinese firms raised in total through overseas IPOs during that time period."

- "The Chinese Government's bond offerings, which have been purchased by U.S. institutional and other investors, provide scant detail on the use of the proceeds raised from such offerings."[35]

- "The presence of Chinese debt and equity offerings in the U.S. capital markets raises U.S. national security concerns that have not been adequately examined to date. The Commission is concerned about the identities and nature of the Chinese companies accessing the U.S. capital markets. Specifically, the extent to which they have ties to the People's Liberation Army or components of China's defense industry, intelligence services, or are assisting in the proliferation of weapons of mass destruction ballistic missile delivery systems.[36] The Commission is also concerned with those entities operating in U.S.-sanctioned countries, or are otherwise engaged in activities inimical to U.S. interests."

- "The PRC is using U.S. capital markets as a source of central government funding for military and commercial development and as a means of cloaking U.S. technology acquisition efforts by its front companies with a patina of regularity and respectability."

- "Overlaying these specific concerns is the issue of Chinese sovereign debt issuances. Since China's bond prospectuses generally provide little detail as to how the proceeds will be spent, the significant monies raised by these offerings could be finding their way into military spending and other activities that are harmful to U.S. security interests. Because money is fungible, funds raised by China from its general–purpose bonds are

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[35] This specific finding would appear to be at odds with the explicit message of the February 17, 2004 full-page display advertisement in the *Wall Street Journal* by Morgan Stanley, entitled "Look Out World, Here We Come", which aggressively touts the profits to be made in Chinese stocks. See also the recent quarter-page display advertisement in the *Wall Street Journal* by Fred Alger & Company, Inc., distributor of the China Growth Fund, entitled "The Bull. The Bear. And Now The Dragon". This advertisement references China's $1.3 trillion GDP (2003) and China's no. 2 global ranking for purchasing power as reasons to invest in Chinese securities.

[36] See also the recent public statement: "The bond market is going to become the principal funding agency for the proliferation of weapons of mass destruction in the twenty-first century" (statement by the Honorable Roger W. Robinson, Jr., former Senior Director of International Economic Affairs at the National Security Council and presently Commissioner and Vice Chairman of the U.S.–China Economic and Security Review Commission). For an additional example, "Chinese-made missiles capable of penetrating an M1 Abrams tank are being smuggled into Iraq." *Newsweek*. February 16, 2004 (page 33).

just as useful for military and other security-related purposes as funds raised by a PLA-affiliated company."

- "The Commission is concerned about the use of the U.S. capital markets as a source of funding for the Chinese military and intelligence services and for Chinese companies assisting in the proliferation of weapons of mass destruction or ballistic missile delivery systems. This activity not only poses direct security concerns, but raises issues regarding investor transparency and material risk as well. Given this dynamic, the Commission is troubled that neither the U.S. Government nor the U.S. investment community is adequately evaluating security-related risks related to China's fundraising in the U.S. capital markets."

The foregoing conclusions by a bipartisan congressional investigative commission are indicative of the seriousness of the implications regarding inadequate disclosure of risk by Chinese securities issuers including the Chinese Government. Past defaults by the Chinese Government remain outstanding and unresolved. The present practices engaged in by the major credit rating agencies and the bond underwriters pursuant to the offer and sale of newly-issued debt obligations of the Chinese Government pose a significant risk to the investing public.

Thank you for allowing us to express our concerns regarding the grave dangers to the investing public posed by the situation described herein, and to seek your assistance in resolving this matter including restrictions on the offer, sale and trading of recent and newly-issued sovereign bonds of the People's Republic of China until such time as the concerns addressed in this Complaint have been resolved and the appropriate debt rating classifications have been assigned. If I may answer any questions or provide the Division of Market Regulation with additional information, please do not hesitate to contact me directly at (520) 615-4525. Ms. Jonna Z. Bianco, the President of the American Bondholders Foundation, may be contacted at (931) 359-8781.

Sincerely,

Kevin O'Brien
President
KO:jwc

cc: United States House of Representatives Committee on Financial Services
United States House of Representatives Committee on the Judiciary
United States House of Representatives Committee on Appropriations
United States Senate Committee on Banking, Housing, and Urban Affairs
United States Senate Committee on the Judiciary
United States Senate Committee on Appropriations
North American Securities Administrators Association
National Association of Insurance Commissioners
National Association of Attorney Generals
National Association of State Retirement Administrators

National Association of State Auditors, Comptrollers and Treasurers
National Conference on Public Employee Retirement Systems
National Conference of State Legislators
National Council on Teacher Retirement
Mr. David Brown, Investor Protection and Securities Bureau Chief, New York State
Department of Law Office of the Attorney General
Mr. John Petty, President, Foreign Bondholders Protective Council Inc.
Ms. Jonna Z. Bianco, President, American Bondholders Foundation

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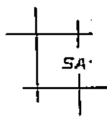

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Wrongful and Injurious Actions of the International Credit Rating Agencies

Certain wrongful actions engaged in by the international credit rating agencies continue the propagation of the tort injury sustained by defaulted creditors holding the Chinese government's defaulted sovereign obligations, including the intentional actions involving publication and distribution of knowingly false and injurious content. These actions are discussed below, beginning with a discussion of the relevant standard of care for publishing a rating and the proximity to injury of the prevailing "investment-grade" international sovereign credit rating classifications assigned to the government of China by the three primary rating agencies, and which agencies collectively control nearly 95% of the total global market, as illustrated in Exhibit 1, below:

Exhibit 1

Global Credit Rating Market
Percentage Market Share (2005) [1]

Credit Rating Agency	(%) Share of Total Market
Standard and Poor's	40%
Moody's Investors Service	39%
Fitch Ratings	15%

As regards the development, assignment, publication and distribution of a debt rating classification, we observe that the "*qualitative* assessment" component of a specific international sovereign credit rating classification is inherently subjective in nature and this metric must not be recklessly applied (e.g., as evidenced by an instance in which the extant facts contradict the stated conclusions of the qualitative assessment, as respects, for example, the *willingness* of a sovereign to repay its debts in the face of a demonstrated and unequivocal unwillingness to pay).

We further observe that the "*quantitative* assessment" component of a specific international sovereign credit rating classification is, by contrast, objective in nature and must not be recklessly applied (e.g., as would be revealed in an instance in which the rating classification is factually incorrect or knowingly inaccurate as in the immediate instance, e.g., the omission of pertinent facts and the contradictory and inconsistent application of published criteria and definitions to existing facts, and which may have the action of causing injury as evidenced, for example, by the inducement of offerees through the misstatement of risk and the taking of rights in contract of defaulted creditors).

An examination of the facts comprising the immediate instance (i.e., the existence of defaulted sovereign debt of the government of China) reveals that the prevailing rating classifications

[1] Source: "*Senate Panel Backs Expansion of Credit-Rating Competition*", industry news article by James Tyson, Bloomberg News (August 3, 2006). The article cites reference to calculations derived from company filings. The article states that according to Senate Banking Committee Chairman Richard C. Shelby, "*By increasing competition, the bill will protect investors by improving ratings quality and providing greater transparency and accountability.*" According to the article, Committee Chairman Shelby further explained, "*The thrust behind all this is competition, which is desperately needed.*"

assigned by the three largest international credit rating agencies, which collectively control nearly 95% of the market, and which ratings track closely together with little variance, fail to conform to their respective published definitions when confronted with the factual evidence, as illustrated in Exhibit 2 and Exhibit 3, and so act to conceal the existence of the defaulted sovereign debt of the Chinese government, upon which that government refuses to honor repayment in violation of the successor government principle of settled international law.[2] The prevailing rating classifications assigned to the government of China are thus provably false by the application of the agencies own criteria and the published definitions of their respective rating classifications.[3] The following exhibit describes the prevailing international sovereign credit rating classifications assigned by the three primary rating agencies to the long-term foreign currency debt of the Chinese government.

Exhibit 2

Prevailing Artificial Sovereign Credit Rating Classifications
Long-Term Foreign Currency Debt of the Chinese Government[4]

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	A2	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 addition of a "2" denotes mid-range ranking within the assigned rating classification.
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 rating classifications with the published definitions maintained by the same agencies as illustrated in Exhibit 3, 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).

[2] Standard and Poor's and Moody's Investors Service collectively control 79% of the market. We note that both the existence as well as the effect of the duopoly enjoyed by the two primary international credit rating agencies was explicitly acknowledged by the U.S. Congress by reference to the title of recently proposed legislation (H.R. 2990 and S.B. 3850) subsequently enacted as Public Law No. 109-291 on September 29, 2006, i.e., the "Credit Rating Agency Duopoly Relief Act of 2006".

[3] Please see, e.g., Exhibit 2, which presents a depiction of the prevailing artificial sovereign credit rating classifications assigned to the long-term foreign currency debt of the government of China by the primary international credit rating agencies, in comparison with the published definitions of the rating classifications as illustrated in Exhibit 3.

[4] Prevailing long-term foreign currency sovereign credit rating classifications assigned to the Chinese government as of August 1, 2006 by the three largest nationally recognized statistical rating organizations.

Exhibit 3

Truthful and Proper (i.e., Non-Injurious) 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 [5]

Agency	Rating	Definition
Standard & Poor's	SD (Selective Default)[6]	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.[7]
Moody's	Ba (high range) Caa (low range)	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.[8]
Fitch	DDD RD (Proposed)	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. Proposed new rating classification: a newly introduced rating of "RD" (Restrictive Default) is proposed for assignment 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.

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[5] According to the United States Foreign Bondholders Protective Council, established by the U.S. Department of State, Department of the Treasury, and the Federal Trade Commission for the purpose of assisting U.S. citizens in recovery of repayment of defaulted obligations of foreign governments, the Communist Chinese government represents the only instance, in over 40 successful settlements of defaulted sovereign debt, of a government refusing to negotiate the settlement of its defaulted sovereign debt.

[6] Recent instances in which Standard and Poor's has assigned an "SD" rating classification to the long-term foreign currency debt of a sovereign issuer include Russia in 1998 (which defaulted on its domestic obligations while continuing to service its eurobonds); Argentina, following its sovereign debt default in December 2001 and subsequent restructuring, including an exchange offer to existing bondholders; and the Dominican Republic in 2005 (which became delinquent on payments owed to commercial bank creditors while continuing to service its bonded debt). The "SD" rating remained in full force and effect until all outstanding defaulted obligations were resolved.

[7] A prime example of "Selective Default" is the series of full faith and credit sovereign obligations issued as the "Chinese Government Five Per Cent Reorganization Gold Loan", scheduled to mature in 1960 and which debt remains in default as an external payment obligation of the successor government of China (i.e., the Communist Chinese government, which was established on October 1, 1949). The Communist Chinese government replaced the Republic of China in the United Nations as the recognized government of China on November 23, 1971 and was subsequently recognized as the government of all China. Taiwan publicly renounced any claim to the government of all China in 1991.

[8] This rating classification is appropriate with respect to acknowledging the judicial risk inherent to investment in such obligations arising from the discriminatory and preferential treatment of selected general obligation creditors.

As illustrated in Exhibit 3, the Communist Chinese government continues to engage in a pattern of discriminatory, exclusionary and preferential practices while refusing repayment of its sovereign obligations for which it is legally responsible as the successor government of all China, and which actions are concealed by the assignment, publication and distribution of false international sovereign credit rating classifications by the three primary rating agencies, the published definitions of which do not conform to the fact pattern comprising the immediate instance.[9] It is the ability of the Communist Chinese government to engage in international debt financing in reliance upon its prevailing rating classifications, and so establish and maintain a sovereign benchmark for the benefit of Chinese corporate issuers, which constitutes the proximate mechanism by which the Chinese government is able to escape its repayment obligation to defaulted creditors. It thus becomes evident that the practices engaged in by the primary international credit rating agencies evidence selective adherence to their respective published definitions, methodologies and criteria in order to attain a predefined result and so avoid an inconvenient truth, to the calculated effect of maximizing their profits.[10]

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[9] See in particular the Communist Chinese government's unwillingness to respect repayment of the defaulted full faith and credit sovereign obligations held by United States citizens, for which the government of China is liable under the successor government convention of settled international law and which convention was invoked by the 1983 *Aide Memoire* in which the Communist Chinese government explicitly attempted to repudiate its obligation to repay the debt. We further note the determination by the United States Foreign Claims Settlement Commission in *Carl Marks & Co.* wherein the Commission found that the unpaid debt represents a general obligation of the government of China. By their published definitions, the prevailing sovereign credit rating classifications assigned to the Communist Chinese government exclude and thereby conceal the fact of selective default, as shown in Exhibit 2 and Exhibit 3.

[10] In this regard, we note the following statement, *"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). See also the statement, *"Reliance by credit rating agencies on issuer fees could lead to a conflict of interest and the potential for rating inflation."* United States Securities and Exchange Commission, Rating Agencies and the Use of Credit Ratings Under the Federal Securities Laws (2003). See also the statement, *"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?"* Danvers, Kreag and Billings, B. Anthony, The CPA Journal (May 2004). For further revealing information concerning the unregulated business practices of the three primary international credit rating agencies, see our letter dated June 21, 2005, addressed to Mr. David Walker, Comptroller General of the United States of America, and in particular, footnotes #14 (at 6), #15(at 6,7), #16 (at 7), #19 (at 8,9), and #20 (at 10). The letter is accessible on the world wide web and may be viewed at the following URL:
http://www.globalsecuritieswatch.org/GAO_LETTER.pdf
Christopher Mahoney, Executive Vice President at Moody's was quoted in a recent article entitled, *"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) published by the Financial Times (June 7, 2005) as stating, *"The fact that a country has defaulted in the past is a credit negative, but it does not preclude ... a high rating today."* This article may be viewed on the world wide web at the following URL:
http://www.globalsecuritieswatch.org/Financial_Times_June_7,2005_.pdf
Mr. Mahoney is silent as regards the critical aspect of the same country continuing to evade repayment of its defaulted debt. Interestingly, in this same article an unidentified international banker is quoted as stating that this matter represents, *"...a sensitive issue"*. In an article entitled, *"US Holders Claim on China for Pre-War Bonds"*, EuroWeek (April 8, 2005), an unidentified Asian ratings analyst is quoted as stating that this same matter represents, *"...a hot potato"*. According to a recent article entitled *"The Ratings Game"* by Martin Mayer (July 1999) published by The International Economy, *"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*

Antitrust Injury Arising from the Wrongful Actions of the International Credit Rating Agencies

Even the most casual observer will note the prevalence of legal and prudential codification of the rating classifications assigned by Standard and Poor's and Moody's Investors Service into investment policies and financial regulations. The extensive and pervasive nature of this practice has acted to empower such ratings with the force of law, and has done so in the absence of regulatory supervision.[11]

The international credit rating industry is described to us by one independent expert as "an absolutely closed shop industry". We also note the statement of the Court in County of Orange v. The McGraw-Hill Companies: *"S&P's position in the securities field may have caused it to assume an independent professional duty enforceable in a tort action"*.[12] The Court further noted that the ratings could be the basis of liability if the plaintiff proved by clear and convincing evidence that Standard and Poor's acted with knowledge that the ratings were false or with reckless disregard of their truth or falsity.[13] The First Amendment does not protect actions which are intentional, knowingly misleading and which cause injury to others. We observe in Jefferson County School District v. Moody's Investors Service that the court reasoned that Moody's

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issue'." In fact, Standard and Poor's own "Selective Default" classification states *"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."* See supra Exhibit 5. We observe that the Chinese government's defaulted sovereign debt, existing unpaid and in a state of default, has come to rest principally in the hands of individual investors as opposed to institutions, and that the agencies and the advisers to the Communist Chinese government therefore anticipated a very minimal risk of objection via a unified voice as respects the assignment of a long-term foreign currency sovereign credit rating to the Chinese Government which has the action of concealing the existence of the Chinese Government's defaulted sovereign debt. When Standard & Poor's first assigned the rating in 1992, it did not reflect the existence of the Chinese Government's defaulted sovereign debt and established a new, and artificial, foundation upon which the Chinese Government could resume international financing without repaying its defaulted sovereign debt, and also constitute the basis upon which to build the rating over the future term.

[11] See numerous municipal investment policies (e.g., the City of Seattle, WA), financial industry regulations, and retirement system portfolio allocation policies. See also the Memorandum dated July 29, 2005 prepared by the Division of Market Regulation, United States Securities and Exchange Commission, as a response to diverse inquiries from Members of the United States Congress in regard to the Complaint filed with the Commission on behalf of defaulted creditors of the Chinese government dated March 31, 2005, wherein the SEC explicitly disclaimed regulatory jurisdiction over the activities of the nationally recognized statistical rating organizations (i.e., the international credit rating agencies), thereby depriving the agencies of an implied immunity defense as respects civil claims for injuries sustained by actions prohibited under the federal antitrust laws. The Memorandum is addressed to Cynthia A. Glassman, Acting Chairman and is endorsed by Annette Nazareth, Director of the Division of Market Regulation. Ms. Nazareth is presently an appointed Commissioner of the United States Securities and Exchange Commission. A copy of the Memorandum is attached hereto as Exhibit A.

[12] County of Orange v. The McGraw-Hill Companies (no. SA CV 96-0765-GLT, 1997 U.S. Dist., LEXIS 22459, C.D. Cal. June 2, 1997).

[13] Id.

publication was protected by the First Amendment because it neither stated nor implied an assertion that was provably false.[14]

We further note that the privileged, exclusive, influential and select position of the three primary international credit rating agencies within the industry, together with the influence of the industry, constitutes such firms in a "gatekeeper" role, comprising the unique ability and responsibility to select which issuers will be admitted into the international financial markets and on what terms. Note that Standard and Poor's, Moody's Investors Service, and Fitch Ratings are each registered with the SEC as Registered Investment Advisers and as such, they are regulated under the Investment Advisers Act of 1940.[15] The fact of registration in conjunction with the position in the industry of (i) Standard and Poor's, (ii) Standard and Poor's and Moody's Investors Service, and (iii) the three major rating agencies collectively, may act to increase the applicable standard of care required of each of the agencies.

The exclusivity of the franchise, constituted as a duopoly, is the mechanism which empowers the rating, and it is the rating which operates to the effect of stimulating, moving and guiding large capital flows in the international financial markets and in the immediate instance, to a debtor government in default under established principles of international law. In this regard, we take particular note of the following statements:

» Statement by Dr. Adam Lerrick, professor of economics at Carnegie Mellon University evidencing the proximity between the effect of misleading ratings and the "taking" of defaulted creditors' enforcement ability:

> *"If large-scale financing was supplied to governments in default, the incentive for the debtor to conclude a deal was destroyed."* [16]

Note that the wrongful assignment of investment grade sovereign credit rating classifications operate to precisely this effect.[17]

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[14] Jefferson County School District No. R-1 v. Moody's Investors Services, Inc. (175 F.3d 848, Tenth Circuit, 1999). An important distinction in the immediate instance is the ability to allege foreknowledge as opposed to asserting knowledge after the fact, as in the event of default. The prevailing artificial sovereign credit rating classifications assigned to the government of China by the three primary rating agencies are provably false by the application of the agencies' own criteria and published definitions. For an instructive discussion of related circumstances in which debt rating agencies may be held liable for erroneous statements, see, e.g., St. Amant v. Thompson, 390 U.S. 727, 731 (1968). Agencies may be held liable in situations where the agency entertained serious doubts about the truth of its publication. See also, e.g., Garrison v. Louisiana, 379 U.S. 64, 74 (1968). Agencies may be held liable in situations where the agency knew that there was a *"high degree of the awareness of the probable falsity"* of its publication. Such is the case in the immediate instance, where extensive publication and constructive notice can both be demonstrated.

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

[16] *"A Leap of Faith for Sovereign Default: From IMF Judgment Calls to Automatic Incentives"*. Lerrick, Adam. Cato Journal. Volume 25, No. 1 (Winter 2005). As a further testament, albeit of an admittedly colloquial nature, to the critical role of rating agencies in establishing marketability of debt instruments, note the widely recognized industry maxim, *"brokers are selling machines when backed by agency ratings"*.

[17] See, e.g., the revealing comment, *"If you have any credibility, you would probably be rating everything junk in China"*. Source: Dr. Scott Kennedy, who specializes in China's political economy at Indiana

» Statements appearing in a scholarly research monograph recently published by Cambridge University Press: [18]

> *"Recent decades have witnessed the remarkable rise of a kind of market authority almost as centralized as the state itself – two credit rating agencies, Moody's and Standard & Poor's. These agencies derive their influence from two sources. The first is the information content of their ratings. The second source is both more profound and vastly more problematic: Ratings are incorporated into financial regulations in the United States and around the world...their ratings are given the force of law. Moody's and Standard & Poor's are based in New York but have an increasingly global reach. Ratings agencies exercise significant and increasing influence over private capital movements (see Sinclair 2005). **No sovereign government would dare to issue debt without being rated by one or both of the agencies.**"* (Emphasis added; note that this statement would appear to memorialize the precept that assignment of an international credit rating is proximate to a sovereign government's ability to resume international financing). *"A small number of rating agencies are literally, and legally, the 'gatekeepers' to the vast U.S. investing public. The U.S. government thus has put these unregulated firms in the position to express their interpretation of good economic policy to sovereign governments through the process of rating them. Issuers came to see the agencies as points of access to international capital flows. In this paper, we seek...to describe the host of problems that arise when their ratings are given the force of law through incorporation into financial and prudential regulation. Given the degree of reliance the markets and regulators place on credit ratings...the major credit rating agencies' fortunes have risen, fallen, and risen again in tandem with private capital flows. From their origin in 1909, the agencies grew as the bond market expanded from railroad bonds to include issues by utilities, manufacturers, and sovereign governments. The agencies' spectacular expansion since the 1970s has, again, effectively mirrored the growth in private capital flows over recent decades. Among the issuers that have taken part in the rapid expansion of the global bond market are a growing number of sovereign governments. The increasingly central role that a small number of prominent rating agencies have come to play in capital markets as they step into the information –gathering role previously played by banks."* [19]

The foregoing statements by recognized experts in the industry serve to cast additional light upon the power, influence and operation of the rating classifications assigned to issuers by the three primary international credit rating agencies and further corroborate the proximity and causality of injury resulting from wrongful publication. The operation of such effect is further described in Exhibit 4 on the following page.

The ability of the Communist Chinese government to purchase an international sovereign credit rating, including the influence and effect of such rating, which deviates from its published definition and for which China paid and then denied seeking, constitutes the proximate

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University. Wall Street Journal (January 5, 2004). See also the statement: *"China doesn't adhere to international accounting standards. To make matters worse, the government issues misleading statistics."* According to Mr. Brian Colton, an analyst who rates China's sovereign bonds for Fitch Ratings (Hong Kong), *"Sometimes you have a column of figures that don't add up to the total at the bottom. It's that bad."* Wall Street Journal, January 5, 2004. See also the statement by Mr. Gordon Chang, former partner at Paul, Weiss, Rifkind, Wharton & Garrison in Beijing: *"China has less borrowing capacity than many people think; it is not as creditworthy as many people think."* William J. Casey Institute of the Center for Security Policy, May 22, 2001.

[18] *"To Judge Leviathan: Sovereign Credit Ratings, National Law, and the World Economy"*. Bruner, Christopher M., and Abdelal, Rawi, Harvard Business School. Cambridge University Press (2005).

[19] Id.

mechanism by which the Communist Chinese government is able to escape its repayment obligation for the Chinese government's defaulted full faith and credit sovereign debt and to engage in a pattern of discriminatory, exclusionary and preferential payments to a select group of its foreign sovereign creditors. This action has the effect of depriving defaulted creditors of their contractual rights in the nature of a "taking" (i.e., an economic tort injury).

We also note that the position of the United States Securities and Exchange Commission as articulated in the Memorandum prepared by the Division of Market Regulation (see supra note 11 and Exhibit A, attached hereto), wherein the Commission disclaimed regulatory jurisdiction over the activities of the international credit rating agencies, has effectively deprived the agencies of an "implied immunity" defense as a response to the prosecution of a claim alleging injury arising from antitrust violation(s).

Exhibit 4

Washington Post Special Feature

Serial Installment Series on the Business Practices of the International Credit Rating Agencies [20]

Monday November 22 2004	Unchecked Power: The world's three big credit-rating companies have come to dominate an important sector of global finance without formal oversight. The rating system has proved vulnerable to subjective judgment, manipulation and conflicts of interest, people inside and outside the industry say. • Moody's Close Connections • When Interests Collide • Graphic: The Rating Game
Tuesday November 23 2004	Shaping the Wealth of Nations: As more countries rely on the bond markets to raise capital, they have been forced to accommodate the three top rating firms. The credit raters often have more sway over foreign fiscal policy than the U.S. government. • Transcript: Post Writer Alec Klein • Smoothing Way for Debt Markets • Graphic: Moody's Expansion
Wednesday November 24 2004	Flexing Business Muscle: Lack of oversight has left the rating companies free to set their own rules and practices, which some corporations say has led to abuses. The credit raters have rated companies against their wishes and ratcheted up their fees without negotiation. • Graphic: Raters' Big Misses

Each of the three primary international credit rating agencies have wrongfully maintained and continue to maintain, periodically upgrade, publish, and distribute the prevailing sovereign credit rating classifications assigned to the government of China and have done so and continue to do so in the face of constructive notice.

When considering the significance of an international credit rating to an issuer's ability to issue debt internationally, and an issuer's inability to engage in international financing in the absence of such rating, and the commanding position in the industry occupied by the three main rating agencies, and the compensation practices endemic to the agencies' conduct of their business (as described in graphic detail in a three-part front page series published by the Washington Post, reference to which is presented herein as Exhibit 4), and the role of Morgan Stanley as the credit

[20] See supra note 10, specifically our letter dated June 21, 2005, addressed to Mr. David Walker, Comptroller General of the United States of America, and in particular, footnotes #14 (at 6), #15(at 6,7), #16 (at 7), #19 (at 8,9), and #20 (at 10). The letter is accessible on the world wide web and may be viewed at the following URL:
http://www.globalsecuritieswatch.org/GAO_LETTER.pdf

rating adviser to the Communist Chinese government in 1988, it is revealed that China intended to acquire an international credit rating in order to resume international debt financing, and did then engage an adviser for such purpose, and did then commission and solicit the assignment of an international credit rating on a compensated basis from the primary provider of such ratings, Standard & Poor's. Standard and Poor's was therefore paid by the Communist Chinese government for the assignment of the initial rating classification which did not reflect the existence of China's defaulted sovereign debt.[21] We may then conclude that the Communist Chinese government, after an absence of approximately fifty years from the international financial markets, and in order to establish a sovereign benchmark to facilitate the emergence of international debt financing by Chinese corporate issuers, purchased an international sovereign credit rating, which it denied seeking, and which rating concealed the fact of the Chinese government's defaulted sovereign debt, and owing to the power and influence of the provider of such rating, operated to effectively extinguish any repayment obligation thereof, including the ability of the defaulted creditors to enforce such repayment obligation. An extensive factual discovery leads to the inescapable conclusion that the international credit rating agencies did knowingly, deliberately and wrongfully act to construct and operate an enterprise which may be accurately described as *"Capitalist China"*. We further observe that the exemption of the international credit rating agencies from regulation under the Exchange Act, and which exemption thereby places such activities outside the purview of the federal securities laws, serves to strengthen a civil RICO claim brought by the injured creditors. We further note that the actions of the international credit rating agencies subject such agencies to an enforcement action brought by the United States Department of Justice alleging violations of the federal antitrust laws.

[21] As previously noted and more thoroughly described in the previous section of this Memorandum, captioned "Wrongful Actions of the International Credit Rating Agencies", and as pertains to injury arising from antitrust violations, the three primary international credit rating agencies control nearly 95% of the market and, in consideration of the extremely prevalent practice of both prudential and regulatory codification referencing their assigned ratings, and which fact gives such ratings the force of law without any regulatory oversight, constitute the proximate mechanism by which the Communist Chinese government is able to escape the repayment obligation for its defaulted sovereign debt. We note that each of the rating agencies has been served constructive notice as regards the specifications described herein.

10

JIM SAXTON
THIRD DISTRICT, NEW JERSEY
WWW.HOUSE.GOV/SAXTON

JOINT ECONOMIC COMMITTEE
CHAIRMAN

RESOURCES COMMITTEE
SUBCOMMITTEES:
FISHERIES AND OCEANS
NATIONAL PARKS

ARMED SERVICES COMMITTEE
SUBCOMMITTEES:
TERRORISM, UNCONVENTIONAL
THREATS AND CAPABILITIES
CHAIRMAN
PROJECTION FORCES
MILITARY PERSONNEL

U.S. House of Representatives

Washington, DC 20515

May 24, 2005

In regards to: Complaint filed on behalf of defaulted creditors of the Government of China, alleging misleading sovereign credit ratings and inadequate disclosure pertaining to the offer, sale and trading of debt securities of the People's Republic of China including violations of international law

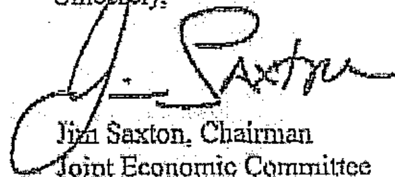
Mr. William H. Donaldson, Chairman
U.S. Securities and Exchange Commission
450 Fifth Street, N.W.
Washington, D.C. 20549

Dear Chairman Donaldson:

I am writing to you in reference to the Complaint (dated March 31, 2005) filed with the Division of Market Regulation, alleging that the Nationally Recognized Statistical Rating Organizations (NRSROs) assigned inappropriate and misleading sovereign credit ratings to the long-term foreign currency debt of the People's Republic of China. Furthermore, the Complaint alleges that the NRSROs should reclassify the sovereign credit ratings of the People's Republic of China.

Since the SEC's Division of Market Regulation regulates the NRSROs, I request that the SEC review the very serious allegations contained in this Complaint in considering a formal investigation. Please keep me informed on the status of this Complaint. I look forward to learning the results. Thank you for your prompt attention to this matter.

Sincerely,



Jim Saxton, Chairman
Joint Economic Committee

cc: Mr. Michael Macchiaroli, Associate Director
SEC Division of Market Regulation

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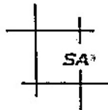

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Via Facsimile and Priority Mail

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 <u>one month after</u> 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:
>
> ... 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:
>
> (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.
>
> ... (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 casę 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.

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[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).

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THE CHAIRMAN

UNITED STATES
SECURITIES AND EXCHANGE COMMISSION
WASHINGTON, D.C. 20549

July 29, 2005

The Honorable Bob Beauprez
U.S. House of Representatives
504 Cannon House Office Building
Washington, DC 20515

Dear Congressman Beauprez,

I am writing in response to your letter dated June 7, 2005, regarding a complaint sent to the Division of Market Regulation on March 31, 2005, on behalf of the American Bondholders Foundation ("ABF"). You request that the Commission review the ABF's allegations that three credit rating agencies assigned inappropriate and misleading sovereign credit ratings to the long-term foreign currency debt of the People's Republic of China. Attached is a staff memorandum relating to your inquiry.

We have forwarded your letter to Moody's, S&P and Fitch for their attention. Please let me know if we can provide further information.

Sincerely,

Cynthia A. Glassman

Cynthia A. Glassman
Acting Chairman

COPY

MEMORANDUM

TO: Cynthia A. Glassman, Acting Chairman

FROM: Annette Nazareth, Director
Division of Market Regulation

RE: Summary of the American Bondholders Foundation's complaint

DATE: July 29, 2005

We received a letter dated March 31, 2005, from Sovereign Advisers on behalf of the American Bondholders Foundation ("ABF"),[1] alleging that three credit rating agencies assigned inappropriate and misleading sovereign credit ratings to the long-term foreign currency debt of the People's Republic of China. The complaint relates to bonds issued before 1949 that, according to the ABF, are now in default. The ABF asserts that these bonds, by their terms, are binding upon the government of China and its successors, but that the People's Republic of China has stated that it has no obligation to repay them.

In its complaint, the ABF states that three of the Nationally Recognized Statistical Rating Organizations ("NRSROs"), Moody's Investors Service Inc., the Standard & Poor's Division of the McGraw Hill Companies, Inc., and Fitch, Inc., have failed to conduct objective analyses of the pertinent facts and circumstances related to the long-term foreign currency debt issued by the People's Republic of China. According to the ABF, this failure resulted in the assignment of inappropriate and misleading sovereign credit ratings to this long-term foreign currency debt. The ABF also complains that misleading statements appear in the prospectus supplement for the People's Republic of China's issuance of sovereign debt in 2003. Moreover, the ABF contends that the actions it describes with respect to credit rating agencies are pertinent to the supervisory and regulatory mandate of the Division of Market Regulation with respect to the operation of the nation's securities markets generally and, specifically, the diligent enforcement of regulations governing the operation of the NRSROs.

The Commission has no express authority to regulate NRSROs as such. As was described in a recent rule proposal, the Commission has the authority to define the term NRSRO for purposes of Commission regulations.[2] The goal of the NRSRO rule proposal is to provide greater clarity and transparency to the process of determining whether a credit rating agency's ratings should be relied on as an NRSRO rating for purposes of Commission rules and regulations. The proposed definition and interpretations are intended to provide credit rating agencies with a better understanding of whether they

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[1] According to the ABF, it is the incorporated national organization representing the consolidated claims of thousands of United States bondholders who are holders of full faith and credit sovereign bonds issued by the Government of China.

[2] *See* Definition of Nationally Recognized Statistical Rating Organization, Release Nos. 33-8570; 34-51572; IC-26834 (April 19, 2005), 17 CFR Part 240 (April 25, 2005).

qualify as NRSROs. The Commission does not, however, have the authority to require an NRSRO to revise a debt rating classification. The NRSROs have asserted that such authority could infringe upon their First Amendment rights.

The ABF letter discusses various areas in which it believes the disclosure in offering documents was inadequate. Commission staff will use this information as we seek to ensure that issuers whose securities are registered with the Commission fulfill their responsibility to provide investors with full and fair information that is material to an investment decision.

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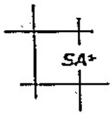

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Website: http://www.sov-advisers.com

Via First Class Mail and Facsimile

August 4, 2005

Honorable Christopher Cox, Chairman
U.S. Securities and Exchange Commission
100 F Street, N.E.
Washington, D.C. 20549

Re: Complaint filed with the Division of Market Regulation on behalf of defaulted creditors of the Government of China.

Dear Mr. Cox:

Please allow me to express my congratulations regarding confirmation of your appointment as SEC Chairman. I firmly believe that market participants as well as the public-at-large will benefit from your appointment. The central purpose of my writing is to respectfully direct your attention to the matter described herein. On March 31, 2005 our firm, acting on behalf of defaulted creditors of the Chinese Government and the public-at-large, filed a complaint with the SEC Division of Market Regulation.[1] The complaint referenced above describes specific concerns involving inadequate disclosure in registration statements and offering documents pertaining to the offer, sale and trading of debt securities of the Government of China and inappropriate and misleading sovereign credit ratings presently assigned to the long-term foreign currency debt of the Government of China by the three major nationally recognized statistical rating organizations (i.e., Standard and Poor's Ratings Service, Moody's Investors Service and Fitch Ratings, collectively referenced herein as "the three major NRSROs").

The issue of inadequate disclosure is addressed in detail in the complaint, and is not reiterated in this letter. The specific concerns pertaining to the inappropriate and misleading sovereign credit ratings presently assigned to the Chinese Government by the three major NRSROs are summarized as follows:

- That under accepted conventions of international law, the Government of China remains in default on full faith and credit sovereign debt of the Chinese Government;

[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." Complaint filed with the SEC Division of Market Regulation (March 31, 2005). Copy of complaint enclosed with this correspondence. Testimony presented at a public hearing conducted by the House International Relations Committee, along with legal memorandums prepared by the law firm of Stites & Harbison PLLC describing the legal authority for U.S. citizens' claims, are accessible on the world wide web at the following URL: *http://www.globalsecuritieswatch.org*

- That the claims of British holders of this series of defaulted debt obligations were settled by the Chinese Government in 1987;

- That the 1987 British settlement excluded from settlement any claims of American bondholders;

- That the Chinese Government continues to evade settlement of claims of American bondholders while continuing to honor payment to other creditors of its sovereign obligations;

- That such practices as described above constitute both selective default and discriminatory settlement against U.S. citizens;

- That such extant facts and circumstances are not reflected in the sovereign credit ratings presently assigned by the three major NRSROs to the Government of China in violation of fiduciary responsibilities implicit to NRSRO status, and which omission constitutes a "reckless" standard of care particularly since each of the three major NRSROs have established rating classifications which describe the extant facts and circumstances (e.g., "selective default" in the case of Standard and Poor's) and failed to act after each was explicitly notified in writing in November 2002 of the existence of defaulted sovereign debt of the Chinese Government;[2]

- That by the willful omission and exclusion of such pertinent and material facts and circumstances, including disregard of the "willingness to pay" metric, the three NRSROs named above have improperly applied their own procedure for establishing a rating, and in so doing have perpetrated a false, manipulative, deceptive, misleading and fraudulent action on the public including concealment of material risk factors. Failure to take into account the extant facts and circumstances in properly assigning the appropriate rating classifications which accurately describe the extant facts and circumstances represents violations of both the rating agencies' internal policies and procedures as well as the Investment Advisers Act of 1940 ("the Advisers Act"), under which the three NRSROs named above are registered as "Registered Investment Advisors";[3]

- That the three major NRSROs should be regulated under the provisions of the Advisers Act under which they are registered as the opinions issued by each of the three major NRSROs are particularly influential and are relied upon by the investing public and should therefore reflect a standard of care upon which the public may depend in confidence;

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[2] 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).

[3] Investment Advisers Act of 1940 as amended. August 22, 1940. 54 Stat. 847, 15 U.S. Code §80b-1 – 80b-21, as amended. For application of the Investment Advisers Act of 1940 in the immediate instance, see specifically Rule 102(a)(4)-1 "Unethical Business Practices of Investment Advisers" (esp. subsection 20), and Section 206 "Prohibited Transactions by Investment Advisers". See also Section 209 "Enforcement of Title" (esp. subsection (a) and subsection (e)(2)(C)(II)). For a description of each of the three major NRSROs' rating classifications describing the state of selective default, see the complaint dated March 31, 2005 filed with the Division of Market Regulation. Copy of complaint enclosed with this correspondence.

- That such practices as described in the complaint (e.g., concealment and omission of material facts in assigning credit ratings to the sovereign debt of the Government of China) directly harm U.S. creditors holding defaulted debt of the Chinese Government by enabling the Government of China to continue to circumvent payment on its full faith and credit sovereign debt without incurring adverse credit ratings;

- That such practices expose the investing public to serious danger and represent a source of potential harm to the public-at-large, which depends upon the diligence of the three major NRSROs in formulating investment decisions; and

- That as Registered Investment Advisers, the three major NRSROs by their actions and conduct in the instance described herein and in the complaint, are subject to enforcement and sanction pursuant to the provisions of the Advisers Act as well as pursuant to other regulatory powers of the Commission.

As of the date of this letter, we have not received any acknowledgement whatsoever from the SEC regarding the complaint filed with the Division of Market Regulation. After a period of almost ninety days from the date that the complaint was filed, and acting in accordance with a sense of the Congress, we have notified Mr. David M. Walker, Comptroller General of the United States, informing the Government Accountability Office of the complaint and the nature of the facts and circumstances described therein.[4]

We respectfully reiterate our request for an investigation by the SEC into the very serious matter referenced herein and more fully described in the complaint and in the letter to Mr. Walker.

Sincerely,

Kevin O'Brien
President
KO:jwc

<u>Attachments in Sequence</u>:

1. Copy of complaint filed March 31, 2005 with the SEC Division of Market Regulation.

2. Copies of letters from members of the 109th United States Congress requesting the SEC to investigate the matter described in the complaint filed with the SEC.

3. Copy of letter dated June 21, 2005 addressed to Mr. David M. Walker, Comptroller General of the United States.

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[4] See various letters addressed to the SEC Chairman by members of the 109th United States Congress including the Honorable Jim Saxton, Chairman of the Joint Economic Committee, requesting the SEC to conduct an investigation into the matter described in the complaint. Copies of several Congressional letters enclosed with this correspondence. See also the letter dated June 21, 2005 addressed to Mr. David M. Walker, Comptroller General of the United States. Copy of letter enclosed with this correspondence.

Attachments in Sequence: (continued)

4. Copy of recent Thomson *FindLaw*® reference to complaint.

5. Copy of letter dated November 27, 2002 addressed to Mr. Clifford L. Alexander, Chairman and Mr. John Rutherfund Jr., President and Chief Executive Officer of Moody's Corporation, describing the existence of defaulted full faith and credit sovereign debt of the Chinese Government.

cc: Members of the 109th United States Congress

Mr. David M. Walker, Comptroller General of the United States
Government Accountability Office

United States Department of Justice

United States-China Economic and Security Review Commission

Honorable Eliot Spitzer, Attorney General for the State of New York
New York State Department of Law, Office of the Attorney General
(Internal Reference No.: 05/001211)

Mr. Michael Macchiaroli, Associate Director
Division of Market Regulation, U.S. Securities and Exchange Commission

Mr. John Petty, President
Foreign Bondholders Protective Council, Inc.

Ms. Jonna Z. Bianco, President
American Bondholders Foundation

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UNITED STATES
SECURITIES AND EXCHANGE COMMISSION
WASHINGTON, D.C. 20549

DIVISION OF
MARKET REGULATION

August 19, 2005

Mr. Kevin O'Brien
Sovereign Advisers
4901 E. Sunrise Drive, Suite 711
Tucson, Arizona 85718

Dear Mr. O'Brien:

We have received your letters dated August 4, 2005 to Chairman Cox and August 1, 2005 to Annette Nazareth. You refer to a letter sent to the Division of Market Regulation on March 31, 2005 on behalf of the American Bondholders Foundation ("ABF")[1] alleging that three credit rating agencies assigned inappropriate and misleading sovereign credit ratings to the long-term foreign currency debt of the People's Republic of China. The March 31 letter refers to bonds issued before 1949 that, according to the ABF, are now in default. The ABF asserts that these bonds, by their terms, are binding upon the government of China and its successors, but that the People's Republic of China has stated that it has no obligation to repay them.

The ABF states that three of the Nationally Recognized Statistical Rating Organizations ("NRSROs"), Moody's Investors Service Inc., the Standard & Poor's Division of the McGraw Hill Companies, Inc., and Fitch, Inc., have failed to conduct objective analyses of the pertinent facts and circumstances related to the long-term foreign currency debt issued by the People's Republic of China. According to the ABF, this failure resulted in the assignment of inappropriate and misleading sovereign credit ratings to this long-term foreign currency debt. The ABF also complains that misleading statements appear in the prospectus supplement for the People's Republic of China's issuance of sovereign debt in 2003.

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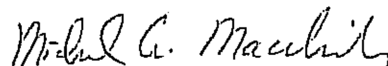
1 According to the ABF, it is the incorporated national organization representing the consolidated claims of thousands of United States bondholders who are holders of full faith and credit sovereign bonds issued by the Government of China.

The Commission has no express authority to regulate NRSROs as such.[2] As was described in a recent rule proposal, the Commission has the authority to define the term NRSRO for purposes of Commission regulations.[3] The goal of the NRSRO rule proposal is to provide greater clarity and transparency to the process of determining whether a credit rating agency's ratings should be relied on as an NRSRO rating for purposes of Commission rules and regulations. The proposed definition and interpretations are intended to provide credit rating agencies with a better understanding of whether they qualify as NRSROs. The Commission does not, however, have the authority to require an NRSRO to revise a debt rating classification. The NRSROs in fact have asserted that such authority could infringe upon their First Amendment rights.

The ABF discusses various areas in which it believes the disclosure in offering documents was inadequate. Commission staff will use this information as we seek to ensure that issuers whose securities are registered with the Commission fulfill their responsibility to provide investors with full and fair information that is material to an investment decision.

Sincerely,



Michael A. Macchiaroli
Associate Director

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2 While Moody's, Standard & Poor's, and Fitch are registered investment advisers under the Investment Advisers Act of 1940 ("Advisers Act"), the ABF does not raise allegations of undisclosed conflicts of interest that could potentially violate the Advisers Act.

3 *See* Definition of Nationally Recognized Statistical Rating Organization, Release Nos. 33-8570; 34-51572; IC-26834 (April 19, 2005), 17 CFR Part 240 (April 25, 2005).

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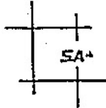

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Via First Class Mail, Electronic Mail and Facsimile

September 21, 2005

Honorable Christopher Cox, Chairman
United States Securities and Exchange Commission

Honorable Annette Nazareth, Commissioner
United States Securities and Exchange Commission

Mr. Michael Macchiaroli, Associate Director
Division of Market Regulation
U.S. Securities and Exchange Commission
100 F Street, N.E.
Washington, D.C. 20549

Re: SEC response to complaint filed with the Division of Market Regulation on behalf of defaulted creditors of the Government of China.

Dear Chairman Cox, Commissioner Nazareth and Mr. Macchiaroli:

We are in receipt of the SEC's response to the concerns expressed in our March 31, 2005 complaint (the "complaint") filed with the Commission on behalf of the American Bondholders Foundation (the "ABF"), and subsequently articulated in our correspondence to Ms. Nazareth and Chairman Cox.[1] Upon reviewing Mr. Macchiaroli's August 19, 2005 letter, we note that although the Commission acknowledges the validity of the concerns expressed in the complaint, the Commission apparently believes that it lacks the express statutory authority to obtain enforcement jurisdiction in the matter referenced, including application of the federal statutes codified as the Investment Advisers Act of 1940 (the "Advisers Act").[2]

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[1] See letter dated August 19, 2005 authored by Mr. Michael Macchiaroli, Associate Director, Division of Market Regulation. In this letter, Mr. Macchiaroli, writing for the Commission, sets forth the position of the SEC that the Standard and Poor's Division of the McGraw Hill Companies, Inc., Moody's Investors Service, and Fitch, Inc. are not subject to SEC oversight and sanction. For a description of specifications against the three major nationally recognized statistical rating organizations ("NRSROs"), 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." Complaint filed with the SEC Division of Market Regulation (March 31, 2005). See also the letter addressed to Mr. David M. Walker, Comptroller General of the United States (June 21, 2005) and the letter addressed to the Honorable Christopher Cox, Chairman of the Commission (August 4, 2005). The foregoing documents along with testimony presented at a public hearing conducted by the House International Relations Committee and legal memorandums prepared by the law firm of Stites & Harbison PLLC describing the legal authority of U.S. citizens' claims are accessible on the world wide web at the following URL: *http://www.globalsecuritieswatch.org*

[2] Investment Advisers Act of 1940 as amended. August 22, 1940. 54 Stat. 847, 15 U.S. Code §80b-1 – 80b-21, as amended. For application of the Investment Advisers Act of 1940 in the immediate instance, see specifically Rule 102(a)(4)-1 "Unethical Business Practices of Investment Advisers" (esp. subsection 20), and Section 206 "Prohibited

Lack of Enforcement Action Sets Dangerous Precedent

From the substance of Mr. Macchiaroli's letter, it also appears to be the position of the Commission that it is content not to investigate the disclosure violations occurring in 2003, and that it will continue to permit the operation of certain business practices by Standard and Poor's Ratings Service, Moody's Investors Service and Fitch Ratings (the "three major NRSROs") which constitute the application of (i) a reckless standard of care with respect to development of their respective ratings classifications assigned to the long-term foreign currency debt of the People's Republic of China, as well as (ii) violations of the Investment Advisers Act pursuant to which the three major NRSROs are duly registered.[3] The Commission's posture in this regard is undoubtedly reassuring to Goldman Sachs, J.P. Morgan Securities, Merrill Lynch, Pierce, Fenner & Smith, Banc One Capital Markets, Citigroup, Credit Suisse First Boston, Daiwa Securities, Hong Kong and Shanghai Banking Corporation Limited, ICEA Securities Limited, Lehman Brothers International, Morgan Stanley & Company and Nomura International, along with the three major NRSROs which in the absence of a lax enforcement policy would be unable to escape culpability for their recent actions. It is regrettable that the Commission's refusal to act forcefully on previous transgressions will no doubt provide encouragement for the continuation of such deceptive practices, including the intentional failure to disclose the existence of defaulted sovereign debt of the Government of China in future registration and offering materials; selective application of established internal rating procedures in developing sovereign ratings for the foreign currency debt of the Government of China; intentional disregard of the "willingness to pay"[4] metric in establishing such ratings; application of a reckless standard of care in developing and publishing ratings including intentional disregard for the doctrine of a successor government's liability for a predecessor government's obligations under accepted conventions of international law (e.g., the payment obligation assumed by the government of the People's Republic of China as the recognized government of China, including "the Taiwan region of China")[5], and continuation of a pattern of conduct which evidences numerous violations of applicable provisions of the Advisers Act as outlined in our letter to Mr. David M. Walker,

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Transactions by Investment Advisers". See also Section 209 "Enforcement of Title" (esp. subsection (a) and subsection (e)(2)(C)(II)).

[3] Through statistical analysis and advanced mathematical modeling techniques, Mellios and Paget-Blanc demonstrate that a prime determinant of sovereign credit ratings is the "willingness to pay" metric and the existence of past defaults (default history). *"Which Factors Determine Sovereign Credit Ratings?"* European Financial Management Association (2005 conference research monograph). The obvious significance of the authors' empirical research in the immediate instance is the revelation of an inexplicable deviation from the normal procedure for establishing a sovereign credit rating, in the case of the Government of China. Inexplicable, that is, unless we consider the existence, and the effect on the development of a rating, of a material undisclosed conflict of interest on the part of the three major NRSROs as pertains to China.

[4] This aspect is particularly revealing with respect to the undisclosed credit risk endemic to sovereign obligations of the Chinese government, which is forecasted to become the world's fourth largest economy by 2010, according to the Organisation for Economic Cooperation and Development ("OECD"). *Financial Times* (September 17, 2005).

[5] See white paper entitled, "China's Endeavors for Arms Control, Disarmament and Non-Proliferation" (September 1, 2005). Ministry of Foreign Affairs of the People's Republic of China. The white paper is accessible on the world wide web at the following URL: *http://www.fmprc.gov.cn/eng/wjb/zzjg/jks/jkxw/t209613.htm*

Comptroller General of the United States.[6] We are incredulous that the Commission apparently believes such egregious conduct by the three major NRSROs to be exempt from regulatory enforcement.

In addition to acting to facilitate China's evasion of payment on its full faith and credit sovereign obligations to American citizens, such a position by the Commission is unfortunate for both the public-at-large as well as for advocates of transparency within both the United States and the international capital markets. To ascertain the probable future consequences of the Commission's lack of enforcement regarding the adequacy of disclosure with respect to Chinese issuers in the United States capital markets, an observer need only look to the China Life initial public offering fiasco which occurred in 2004. We note that the U.S.-China Economic and Security Review Commission appointed by the United States Congress to investigate such issues concurs in expressing serious concerns over the adequacy of disclosure pertaining to offerings by Chinese securities issuers in the United States.[7] The SEC's apparent failure to enforce the provisions of the Advisers Act in the immediate instance, as well as to impose sanctions on the firms responsible for inadequate disclosure in the 2003 prospectus supplement pertaining to the offer and sale of sovereign bonds of the Chinese Government, appears to be directly at odds with the view expressed by the U.S.-China Commission regarding the threat to U.S. investors posed by misleading data.

In regard to certain practices and actions engaged in by the three major NRSROs which constitute violations of the Advisers Act, we note with interest that reference to the June 21, 2005 letter to Mr. David M. Walker is noticeably absent from Mr. Macchiaroli's letter. We find this omission very curious, since a copy of the letter addressed to Mr. Walker (complete with attachments) was provided to persons at the SEC, including Mr. Macchiaroli, and also due to the fact that the aforementioned letter presents a comprehensive description of the practices of the three main NRSROs revealing a pattern of deceptive and manipulative practices in violation of specific provisions of the Advisers Act.

When we first became aware of the existence of defaulted sovereign debt of the Chinese Government, we were astonished to discover that the Government of China enjoys an investment-grade foreign currency credit rating assigned by the three major NRSROs, despite the fact that U.S. creditors continue to be victims of both **selective default** and **discriminatory settlement**, even though U.S. creditors are ranked pari passu with U.K. creditors who were offered settlement of their defaulted claims in 1987.

We subsequently undertook extensive research to determine the complete fact pattern involving the existence of defaulted debt of the Chinese Government. We shared our findings with the chief executive officers of the three major NRSROs in a letter sent in November of 2002.

[6] See letter dated June 21, 2005 addressed to Mr. David M. Walker, Comptroller General of the United States. A copy of this letter including a complete set of attachments was provided to the Securities and Exchange Commission and is also reproduced herein in relevant part.

[7] See the statement by Richard D'Amato, U.S.-China Commission Chairman: "I am concerned that U.S. investors may not have sufficient information to make informed decisions about the risks of these investments". See also the statement "Mr. D'Amato told the FT that he would ask Christopher Cox, the newly installed chairman of the SEC, to look at a variety of issues to prevent what he characterized as a potential 'China Bubble' as damaging to U.S. investors as the dot-com boom and bust". Source: "Rush of Chinese IPOs Poses Threat to U.S. Investors". *Financial Times* (August 12, 2005). See also testimony presented at the U.S.-China Commission public hearing entitled, "Hearing on China and the Capital Markets" (August 11, 2005). Transcripts of testimony presented at this hearing are available on the world wide web at the following URL: *http://www.uscc.gov*

No response or acknowledgement to this letter has been received to date from the three major NRSROs. We subsequently discovered that each of the three major NRSROs are Registered Investment Advisers under the Advisers Act, and are subject to the provisions of the Advisers Act. We discovered that the three major NRSROs are exempt from liability arising from performing activities and engaging in business practices which fail to meet an ordinary standard of care, but may be held liable for performing activities and engaging in business practices which equate with a reckless standard of care.

Upon completion of the discovery process, we drafted a complaint on behalf of defaulted creditors of the Government of China and filed the complaint with the Securities and Exchange Commission on March 31, 2005. After a period of almost ninety days from the date that the complaint was filed and having received no response from the SEC, and acting in accordance with a sense of the Congress we notified Mr. David M. Walker, Comptroller General of the United States, informing the Government Accountability Office of the complaint filed with the SEC and the nature of the facts and circumstances described therein.[8] A copy of the letter addressed to Mr. Walker was also sent to persons at the SEC. The letter to Mr. Walker describes in detail the issue of violations of the Advisers Act in the immediate instance, and is therefore reproduced in relevant part elsewhere in this letter.

Reckless Standard of Care Evident in the Immediate Instance

The existence of defaulted sovereign debt of the Chinese government was entered into the public record during congressional testimony in October 2003. The three major NRSROs were explicitly notified in writing of the existence of defaulted sovereign debt of the Chinese government in November 2002. Immediately subsequent to the congressional hearing in October 2003, Standard and Poor's Ratings Service upgraded the sovereign rating classification for the government of China. Based upon their own procedures, criteria and definitions[9], the three major NRSROs have continued to maintain improper rating classifications for the sovereign debt of the Chinese government with the knowledge that such rating classifications intentionally omit and ignore material facts including (a) the existence of selective default; (b) the existence of a discriminatory settlement[10]; (c) the continuing existence of defaulted full faith and

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[8] See various letters addressed to the SEC Chairman by members of the 109th United States Congress including the Honorable Jim Saxton, Chairman of the Joint Economic Committee, requesting the SEC to conduct an investigation into the matter described in the complaint.

[9] For a discussion of the definitions of the relevant debt rating classifications in the immediate instance, see "Exhibit 3.01 People's Republic of China Long-Term Foreign Currency Sovereign Debt Rating". 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. Complaint filed with the SEC Division of Market Regulation (March 31, 2005).

[10] See the 1987 accord negotiated by the Chinese government with citizens of Great Britain, providing for settlement of claims pertaining to defaulted sovereign debt obligations of the government of China. The British settlement accord excluded the claims of American citizens and other non-U.K. citizens, whom have suffered and continue to suffer default on similar obligations. Although the Chinese government has selectively defaulted on certain sovereign debt obligations and continues to discriminate against certain defaulted creditors including United States citizens, the Chinese government offers periodic interest payments to other creditors holding its recently-issued sovereign debt obligations in violation of the pari passu doctrine of equality of treatment among creditors, creating the risk of interest payments seizure by defaulted creditors of the Chinese government. Such facts and

credit sovereign debt of the Chinese government which China refuses to honor; (d) the assigned rating classifications are inconsistent with accepted conventions of international law; (e) the assigned rating classifications fail to adequately reflect the actual risk endemic to sovereign debt obligations of the Chinese government by failing to properly evaluate the "willingness to pay metric" as evidenced by the extant facts, as well as the exposure to interest attachment[11] by defaulted creditors; (f) the selective application and misapplication of established internal procedures for developing credit rating classifications; (g) the indisputable fact that that the prevailing rating classifications, which are demonstrably misleading, manipulative and deceptive, may be demonstrated to cause economic harm to defaulted creditors of the government of China by enabling the Chinese government to retain access to global capital markets despite the existence of defaulted sovereign debt and thereby circumvent the ability of defaulted creditors to enforce the sovereign debt contract in order to obtain payment. The issue of the application of a reckless standard of care in the immediate instance is more fully examined in the following section.

First Amendment Fails as Defense in the Immediate Instance

In his letter, Mr. Macchiaroli expresses concerns pertaining to the First Amendment rights of the NRSROs to publish their opinions (i.e., rating classifications), deceptive though such opinions may be.[12] We wish to respectfully direct Mr. Macchiaroli's attention to the following statement (referencing the credit rating organizations including the three major NRSROs):

"Finally, I would mention that any suggestion that this legislation infringes on anyone's First Amendment rights is a red herring not to be taken seriously, in my view".[13]

Honorable Michael G. Oxley, Chairman
Committee on Financial Services

The United States Supreme Court has held that "publishers" are not automatically entitled to First Amendment protection.[14] Thus, an NRSROs' status as a "financial publisher" does not necessarily entitle

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circumstances are intentionally excluded from the sovereign credit rating classifications presently assigned to the Chinese government by the three major NRSROs, as described herein and in the complaint, and the three major NRSROs thus intentionally misrepresent the actual risks associated with investment in sovereign obligations of the Chinese government.

[11] For a discussion of the risk of interest attachment by defaulted creditors, see Elliott Associates, L.P., General Docket No. 2000/QR/92 (Court of Appeals of Brussels, 8th Chamber, Sept. 26, 2000). See also, Republic of Nicaragua v. LNC Investments and Euroclear Bank SA (Injunction issued against paying agent by Belgian Commercial Court, Sept. 8, 2003) and Red Mountain Finance, Inc. v. Democratic Republic of Congo and National Bank of Congo, Case No. CV00-0164R (C.D.Cal. May 29, 2001).

[12] We refer to the following statement: "The NRSROs in fact have asserted that such authority could infringe upon their First Amendment rights". Letter authored by Mr. Michael Macchiaroli, Associate Director, SEC Division of Market Regulation (August 19, 2005).

[13] Honorable Michael G. Oxley, Chairman, House Committee on Financial Services. Prepared Opening Statement for the hearing on H.R. 2990 conducted by the Subcommittee on Capital Markets, Insurance, and Government Sponsored Enterprises entitled, "Legislative Solutions for the Rating Agency Duopoly" (June 29, 2005).

it to heightened protection under the First Amendment.[15] It is widely recognized that in the absence of a contract, fiduciary relationship, or intent to cause injury, a newspaper publisher is not liable to a member of the public for a non-defamatory negligent misstatement of an item of news, "unless he willfully...circulates it knowing it to be false, and it is calculated to and does,...result in injury to another person.[16]

In order to ascertain the ability of the three major NRSROs to successfully invoke the protection afforded by the First Amendment, three obvious questions present themselves: (1) whether the three major NRSROs may credibly assert that the business practices in which they engage constitute newspaper publication, (2) whether the actions and business practices engaged in by the three major NRSROs are calculated to and does cause injury to another person, and (3) perhaps of greatest importance, whether the actions of the three major NRSROs as described herein and in the complaint are the result of mere negligence, or are indicative of a reckless standard of care in which event the first two questions are rendered moot.

Let us examine these questions.

(1) With respect to the actions of the three major NRSROs as described herein and in the complaint, we concur with the following statement: "While they communicate a lot of information, and represent much work, it is not immediately obvious that bond ratings were what the framers had in mind when they proposed the First Amendment. If they are protected at all, then bond ratings are the world's shortest editorials."[17] Whether the business practices of the three major NRSROs constitute newspaper publishing is highly uncertain, and a significant degree of doubt exists regarding the validity of such a claim. We note with particular interest that in instances in which "speech" has a profit motive (as is demonstrably the case with each of the three major NRSROs), courts may be less stringent in affording First Amendment protection.[18]

(2) Upon an analysis of the relevant facts and circumstances, it becomes evident that the substantial conflicts of interest which are manifest in the business practices employed by the three major NRSROs

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[14] See, e.g., First Nat. Bank of Boston v. Bellotti, 435 U.S. 765, 802, 55 L. Ed. 2d 707, 98 S. Ct. 1407 (1978) (Burger, C.J., concurring).

[15] See, e.g., the Court's reasoning in County of Orange v. McGraw-Hill Cos., No. SA CV 96-0765-GLT, 1997 U.S. Dist. LEXIS 22459 (C.D. Cal. June 2, 1997) (denying Standard & Poor's motion to dismiss lawsuit arising from its investment grade rating of Orange County's bonds, which later defaulted).

[16] See, e.g., First Equity I, 670 F. Supp. at 117. The Court cited Jaillet v. Cashman, 115 Misc. 383, 384, 189 N.Y.S. 743, 744 (Sup. Ct. 1921), *aff'd mem.*, 202 A.D. 895, 194 N.Y.S. 947 (App. Div. 1922), *aff'd mem.*, 235 N.Y. 511, 139 N.E. 714 (1923). The Court noted that the First Amendment requires a showing of falsity or at least recklessness before a court may constitutionally impose liability on a newspaper for publishing a non-defamatory misstatement.

[17] Source: "What Standard of Care Should Govern the World's Shortest Editorials? An Analysis of Bond Rating Agency Liability". Gregory Husisian. 75 Cornell L. Rev. 411 (January, 1990).

[18] See, e.g., Dun & Bradstreet, Inc. v. Greenmoss Builders, Inc., 472 U.S. 749 (1985). The Court found that, because the speech was for a profit motive (speech which is less likely to be deterred by imposing liability for libel), there was less need to fear the chilling effect on publication.

constitute a reasonable and persuasive premise that such actions may effectively function as "calculated to and does" (cause harm) in that (a) such practices enable defaulted creditors to fail in the enforcement of the sovereign debt contract by the defaulted issuer, whereby such issuer reaps significant economic and political benefits from its ability to retain access to global capital markets by virtue of an artificial sovereign rating classification for which it has paid the rater a significant fee, and which rating does not reflect material facts (e.g., existence of defaulted sovereign debt; discriminatory settlement; et.al.); (b) the defaulted issuer (i.e., the government of China) and all present and future corporates subject to the jurisdiction of the defaulted sovereign issuer benefit significantly from the economic injury sustained by the defaulted creditors' inability to enforce the sovereign debt contract in the face of an artificial sovereign credit rating; and (c) that the three major NRSROs retain the ability to impose rating review and maintenance fees on the defaulted sovereign issuer and corporates subject to its jurisdiction. Any assertion(s) that the proper rating classifications presently exist are provably false by any reasonable standard, including the undeniable existence of defaulted full faith and credit sovereign debt of the Chinese Government under accepted conventions of international law, and which is excluded in the present sovereign credit ratings assigned by the three major NRSROs to the government of China.

It becomes apparent that upon examination and consideration of the extant facts and circumstances, it is not unreasonable to state that the practices of the three major NRSROs constitute a form of debt relief to the government of China through aiding and abetting circumvention of the pre-existing sovereign debt contract, for which the Chinese government gratefully compensates the three major NRSROs for excluding the "willingness to pay" metric from their respective sovereign ratings. As an additional incentive to assign an artificial sovereign benchmark, the three major NRSROs stand to reap potentially very lucrative business revenue from rating the debt of emerging Chinese corporate issuers, which are empowered by an artificial benchmark to raise debt financing in the global capital markets.

(3) A comprehensive examination of the relevant facts and circumstances in the immediate instance also demonstrates beyond a reasonable doubt that the egregious conduct of the three major NRSROs in developing and subsequently "publishing" the rating (e.g., having foreknowledge of the falsity of stating a "default free" record; an awareness of the issuer's continuing evasion of payment of full faith and credit sovereign obligations in violation of accepted standards of international law; a partial settlement of the issuer's defaulted sovereign debt which discriminated against U.S. creditors; and the economic harm inflicted upon defaulted U.S. creditors through the action of a misleading and deceptive credit rating which enables the defaulting issuer to circumvent payment to defaulted U.S. creditors) is willful and in complete disregard of the extant facts which are manifest in the public domain. In the face of such willful actions, the conduct of the three major NRSROs meets the accepted definition of a reckless standard of care, depriving the three major NRSROs of the protection otherwise afforded by the First Amendment.

It is apparent that the temptation to assign and maintain an artificial sovereign benchmark in order to acquire the prospect of additional ratings revenue from the "huge potential of China's corporate bond market"[19] has prompted the three major NRSROs to "cross the line" and deviate from their established credit rating procedures in pursuit of the significant business opportunity offered by the Chinese corporate market and the fear of retaliation arising from assignment of a proper credit rating reflecting the extant

[19] See article entitled, "Huge Potential of China's Corporate Bond Market". Consulate General of the People's Republic of China in New York. The article is accessible on the world wide web at the following URL: *http://www.nyconsulate.prchina.org/eng/xw/t31429.htm* See also, the analogous statement: "Senior investment bankers complain that, in private, Asian companies often put pressure on them to tame analysts with the veiled (or explicit) threat to take their prized equity and mergers and acquisitions business elsewhere." *Financial Times* (September 2, 2005).

facts. The three major NRSROs have failed to duly consider contraindicative information made available through both explicit notification[20] as well as the extensive presence of relevant facts in the public domain. Accordingly, each of the three major NRSROs had foreknowledge that the information underpinning the Chinese government sovereign rating classifications which they disseminated was false due to the omission of material facts and the resultant rating classifications are the product of intentional misapplication of internal procedures for developing a rating. Each of the three major NRSROs subsequently issued, and continue to maintain, a sovereign credit rating classification which is inconsistent with the extant circumstances with the knowledge that it was and remains false or with reckless disregard of whether it was and remains false. Such practice equates with a reckless standard of care. The existence of defaulted sovereign debt of the Chinese government under accepted conventions of international law and the existence of a discriminatory settlement are provable facts which are contraindicative of the present sovereign credit rating classifications assigned to the Chinese government by each of the three major NRSROs as described according to their own published criteria, definitions and procedures (i.e., assertions by the three major NRSROs which are provably false). The foregoing situation is indicative of either flawed systems for developing ratings or the intentional misapplication of established procedures. Either explanation equates with a reckless standard of care. Thus, by their respective actions, the three major NRSROs are denied protection otherwise afforded by the First Amendment.[21]

In light of the foregoing, we find it remarkable that the Commission apparently chooses to ignore the omission or exclusion of extant and material facts with respect to (a) registration statements and offering materials and (b) the development of rating classifications (e.g., empirically-evident deviation from established rating procedures and intentional misrepresentation of sovereign default risk based upon published definitions) which a reasonable observer would conclude collectively constitutes a reckless standard of care as well as violations of the Advisers Act, which is within the SEC's enforcement mandate. Apparently, judging from the response we received from the Division of Market Regulation, the Commission considers such practices as unworthy even of investigation.

NRSROs Subject to Civil RICO Action

We note that the recurring pattern of deceitful and manipulative practices as described herein and in the complaint renders the three major NRSROs subject to enforcement and sanction pursuant to the provisions of the Racketeer Influenced and Corrupt Organizations ("RICO") Act.[22] The practices of the

[20] See letter dated November 27, 2002 sent to the chief executive officers of each of the three major NRSROs, describing the existence of defaulted full faith and credit sovereign debt of the government of China.

[21] See the established doctrine which holds that the First Amendment does not afford protection in circumstances involving statements made with the knowledge that the statement was false or with reckless disregard for whether or not it was true. Hustler Magazine v. Falwell, 485 U.S. 46, 56, 99 L. Ed. 2d 41, 108 S. Ct. 876 (1988). For a discussion of related circumstances in which bond rating agencies may be held liable for erroneous statements, see, e.g., St. Amant v. Thompson, 390 U.S. 727, 731 (1968). Agencies may be held liable in situations where the agency entertained serious doubts about the truth of its publication. See also, e.g., Garrison v. Louisiana, 379 U.S. 64, 74 (1968). Agencies may be held liable in situations where the agency knew that there was a "high degree of awareness of the probable falsity" of its publication.

[22] 18 U.S.C. §1961-68. Section 1964(c) of the Racketeer Influenced and Corrupt Organizations ("RICO") Act allows civil claims to be brought by any person injured in their business or property by reason of a RICO violation.

three major NRSROs in the immediate instance in conjunction with their use of the mails and other means of interstate commerce to disseminate various communications, if held to constitute a reckless standard of care, may also be demonstrated to have caused significant harm to defaulted creditors of the Government of China with respect to their lawful attempts to enforce payment of a sovereign debt contract, thereby exposing the three major NRSROs to civil RICO proceedings.

Investment Advisers Act Prohibits Registrants from Engaging in Certain Business Practices

Each of the three major NRSROs are registered under the Advisers Act. As registrants pursuant to the Advisers Act, the three major NRSROs are be required to comply with the provisions of the Advisers Act and are subject to regulation thereunder. We are particularly alarmed by the apparent unwillingness of the Commission to enforce the provisions of the Advises Act in the immediate instance. Are we to therefore understand that it is the SEC's position that the three major NRSROs are not subject to the Advisers Act under which each is registered? If we correctly understand the SEC's position in this regard, we are confronted with concerns of an even greater magnitude then previously expressed. We therefore reproduce herein an excerpt of our June 21, 2005 letter to Mr. David M. Walker, Comptroller General of the United States, and request that the following information and specifications be incorporated into the complaint filed with the Commission on behalf of the ABF and other defaulted creditors of the Government of China.

[The following section is an excerpt from our letter addressed to Mr. David M. Walker, Comptroller General of the United States (June 21, 2005) wherein we describe the applicable provisions of the Advisers Act in the immediate instance. Please note that the sequence of page numbering and the sequence of footnote numbering in the reproduced section will differ from that of the original letter]

Dissemination of misleading, fraudulent or deceptive rating classifications derived through the misapplication of internal procedures, failure to apply an acceptable standard of care, or transgressions of specific provisions the Advisers Act may have acted to create, and continue to create, violations of the federal mail and wire fraud statutes, thereby creating civil liability pursuant to the RICO Act. With respect to prohibition of fraudulent, deceitful and manipulative practices, see applicable provisions of the Advisers Act which prohibit fraudulent, deceitful and manipulative practices. Defaulted U.S. creditors as a class have suffered, and continue to suffer serious economic harm from the actions of the three major NRSROs including the application of a reckless standard of care and violations of the Advisers Act. With respect to establishing a pattern of fraudulent, deceitful and manipulative practices in the immediate instance, see the letter dated June 21, 2005 addressed to Mr. David M. Walker, Comptroller General of the United States (relevant sections reproduced herein).

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).[23]

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".[24]

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".[25]

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[23] 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).

[24] 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.

[25] 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 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.

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).[26]

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.[27] 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.[28]

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

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[26] 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*

[27] 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.

[28] 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).

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").[29] As registered investment advisers, the rating activities and professional conduct of these three NRSROs are subject to SEC review and sanctions.[30] 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 <u>Rule 102(a)(4)-1 Unethical Business Practices of Investment Advisers</u> 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:
>
> ... 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".[31]

The language of <u>Section 206 Prohibited Transactions by Investment Advisers</u> 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:
>
> (1) To employ any device, scheme, or artifice to defraud any client or prospective client;

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

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

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

> (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".[32]

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.
>
> ... (e) (2) (C) (II) Such violation directly or indirectly resulted in substantial losses or created a significant risk of substantial losses to other persons".[33]

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...clients.... 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.[34]

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

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

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

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

three firms due to their unique NRSRO designation.[35] 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.[36]

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[35] 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).

[36] 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 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).

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.[37] 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.[38]

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

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[37] 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).

[38] 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, 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).

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[39]

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).[40]

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.

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

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

Attachment:

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.[41]

(End of excerpt)

[Letter of September 21, 2005 continues on following page]

[41] 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).

We have previously noted that in the event a recurring pattern of reckless, deceitful and manipulative practices may be proven to exist, such pattern of conduct renders the three major NRSROs subject to enforcement and sanction pursuant to the provisions of the Racketeer Influenced and Corrupt Organizations ("RICO") Act.[42] The practices of the three major NRSROs in the immediate instance, if held to constitute a reckless standard of care, may also be demonstrated to have caused significant harm to defaulted creditors of the Government of China, thereby exposing the three major NRSROs to civil RICO proceedings. In addition to requesting an investigation by the Commission into the concerns expressed herein and in the complaint, in conjunction with an appropriate enforcement response, we believe that it is appropriate at this time to refer the matter for review for a possible civil RICO tort class action.

Existence of Undisclosed Conflicts of Interest

Numerous experts have testified publicly attesting to the vulnerability of the business model employed by the three major NRSROs to the effects of conflicts of interest. In the immediate instance, the significant influence exerted by the promise of China's emerging corporate bond issuance activity and the commensurate potential for improperly affecting development of rating classifications cannot be overstated. The potential for improper development of rating classifications is magnified by the prospect of initial public offerings of shares by China's largest banks which are expected to occur in the fourth quarter of 2005 and during 2006. The importance of the sovereign benchmark to the ratings industry revenue model and the three major NRSROs' dependency on issuer fees create an implied motivation to enable an increasing quantity of corporate entrants into the bond market and may reasonably be expected to result in artificially inflated credit ratings to facilitate revenue growth (i.e., the "sovereign ceiling" aspect discussed previously).[43] Compounding this aspect is the fact that China's largest banks are sovereign-supported entities, as well as subject to the sovereign benchmark with respect to their individual credit ratings. When confronted by such motivations, concerns regarding the existence and effects of potential and undisclosed conflicts of interest can be neither overstated nor easily dismissed.[44]

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[42] 18 U.S.C. §1961-68. Section 1964(c) of the Racketeer Influenced and Corrupt Organizations ("RICO") Act allows civil claims to be brought by any person injured in their business or property by reason of a RICO violation. Dissemination of misleading, fraudulent or deceptive rating classifications derived through the misapplication of internal procedures, failure to apply an acceptable standard of care, or transgressions of specific provisions the Advisers Act may have acted to create, and continue to create, violations of the federal mail and wire fraud statutes, thereby creating civil liability pursuant to RICO. With respect to prohibition of fraudulent, deceitful and manipulative practices, see applicable provisions of the Advisers Act which prohibit fraudulent, deceitful and manipulative practices. Defaulted U.S. creditors as a class have suffered, and continue to suffer serious economic harm from the actions of the three major NRSROs including the application of a reckless standard of care and violations of the Advisers Act.

[43] See the statement: "An investment grade credit rating has become an absolute necessity for any company that wants to tap the resources of the capital markets.... The government, through hundreds of laws and regulations, requires ratings. Corporate bonds...must be rated if they are to be considered appropriate investments for institutional investors". Source: *Rating the Raters: Enron and the Credit Rating Agencies.* Hearing before the Senate Committee on Governmental Affairs (107th Congress, 2002). Statement of Sen. Joseph Lieberman, Chairman.

[44] The three major NRSROs generally acknowledge that they correlate their ratings of China's banks to the sovereign debt ratings of the government's bonds. For a comparative perspective which provides the basis for thoughtful consideration of the existence of potential conflicts in the immediate instance, see the revealing comment

The existence of undisclosed conflicts of interest is the only rational explanation for why each of the three major NRSROs have assigned and continue to maintain investment grade rating classifications for a sovereign issuer which refuses to honor its defaulted sovereign debt in violation of international law. In seeking to validate an explanation to account for this apparent paradox, we again take notice of the revenue model employed by the three major NRSROs, whereby the majority of revenue is derived from fees paid by issuers in exchange for the assignment of a credit rating.

From even a cursory examination of the revenue model, it becomes reasonably evident that a strong motivation exists on the part of the three major NRSROs to assign an artificial sovereign benchmark in an attempt to maximize revenue. In the immediate instance, it becomes evident that a failure to conform to the expectations of the rated sovereign issuer as well to create an environment conducive to expanded debt issuance by corporates subject to the sovereign's jurisdiction, may reasonably be expected to result in retaliation, loss or decline of the NRSRO's ratings franchise and a commensurate loss of potential revenue opportunity for the NRSRO.

We note that such conflicts of interest are endemic to the business practices engaged in by the three major NRSROs and are in fact predictive of the present situation, which suggests that undisclosed conflicts of interest account for the most likely explanation for the present sovereign credit rating classifications assigned to the Chinese government by the three major NRSROs. To the extent that such conflicts are admitted to by the three major NRSROs and have therefore been disclosed, we question the adequacy of such disclosure.

Please note that we do not intend to suggest that the SEC attempt to compel the NRSROs to revise their rating classifications as suggested by Mr. Macchiaroli in his letter.[45] On behalf of defaulted creditors of the Government of China including United States citizens affiliated as the American Bondholders Foundation, we seek to amend the complaint to incorporate each of the specifications and allegations contained herein, including the addition of the specification of undisclosed conflicts of interest in violation of the Advisers Act, and respectfully reiterate our request that, rather than ignoring the extant facts in the immediate instance, the SEC conduct an investigation into the matter in order to determine (a) whether an appropriate standard of care has been applied in developing and disseminating the rating classifications in the immediate instance (including whether an arbitrary or selective application of established procedures or standards for developing a credit rating classification may in fact account for the present rating classifications); and (b) whether violations of specific provisions of the Advisers Act

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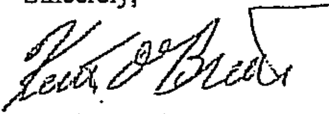
by Indiana University's Dr. Scott Kennedy, who specializes in China's political economy: "If you have any credibility, you would probably be rating everything junk in China." See also the statement: "China doesn't adhere to international accounting standards. To make matters worse, the government issues misleading statistics." *Wall Street Journal* (January 5, 2004). Please note that it has recently come to our attention that certain Chinese state-owned banks are alleged to have engaged in business relations or transactions with the government of North Korea and its state-sponsored enterprises. We are concerned about the possible implications arising from such allegations, pending investigation, and the effect such practices, if proven to exist, would have on any public offerings of shares in the U.S. capital markets by potential issuers who have engaged in transactions which are prohibited by entities subject to U.S. jurisdiction.

[45] We refer to the following statement: "The Commission does not have the authority, however, to require an NRSRO to revise a debt rating classification". Letter authored by Mr. Michael Macchiaroli, Associate Director, SEC Division of Market Regulation (August 19, 2005).

may have occurred and may possibly be continuing to occur with respect to the issues presented herein, including the existence of undisclosed conflicts of interest. Such issues are within the jurisdiction and enforcement mandate of the Commission.[46] An investigation is particularly warranted since numerous institutional investors codify reliance on credit rating classifications developed by the three major NRSROs into their official investment policies.[47]

Sincerely,



Kevin O'Brien
President
KO:jwc

Attachments in Sequence:

1. Copy of article published in the Foreign Policy News section of *The Hill – The Newspaper for and about the U.S. Congress* entitled, "China's Unfair Advantage: How China's Artificial Credit Rating Hurts U.S. Manufacturers – Improper Sovereign Benchmark Gives Chinese Companies Cheap Access to Foreign Capital".

2. Copy of article published in the *Financial Times* entitled, "Rush of Chinese IPOs Poses Threat to U.S. Investors".

cc: ***In re Legislative Affairs:***

Members of the 109th United States Congress

Honorable Richard D'Amato, Chairman
United States-China Economic and Security Review Commission

In re Federal and State Regulatory Enforcement:

Mr. David M. Walker, Comptroller General of the United States
Government Accountability Office

Mr. Walter Stachnik, Inspector General
United States Securities and Exchange Commission Office of the Inspector General

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[46] See, e.g., the statement, "Therefore, NRSRO designation is a component of securities law and should be analyzed in that context." Source: "Private Ordering of Public Markets: The Rating Agency Paradox". Steven L. Schwarcz. U. Ill. L. Rev. 1 (2002).

[47] See, e.g., City of Seattle Investment Policy, which mandates investment portfolio allocations based upon credit rating issued by at least two NRSROs.

Honorable Michael Garcia, United States Attorney for the Southern District of New York
United States Attorney's Office for the Southern District of New York

Honorable Eliot Spitzer, Attorney General for the State of New York
New York State Department of Law, Office of the Attorney General
(Internal Reference No.: 05/001211)

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

In re Inter-Creditor Proceedings:

Mr. Michael Straus, Esq.
Straus & Boies, LLP

In re Civil RICO Tort Class Action:

Request for Review re Tort Claim Analysis / PSLRA:
Mr. David N. Kelley, Esq.
Cahill Gordon & Reindel, LLP

Mr. Patrick J. Coughlin, Esq.
Lerach Coughlin Stoia Geller Rudman & Robbins, LLP[48]

Request for Review re Civil RICO Claim Analysis:
Mr. Jeffrey E. Grell, Adjunct Professor of Law
The University of Minnesota Law School

Request for Review re First Amendment Analysis:
Mr. Jerome A. Barron, Harold H. Greene Professor of Law
The George Washington University Law School

Request for Review re Class Action Analysis:
Robert H. Klonoff, Professor of Law
Kansas City School of Law, University of Missouri

In re Defaulted American Creditors:

Mr. John Petty, President
Foreign Bondholders Protective Council, Inc.

Ms. Jonna Z. Bianco, President
American Bondholders Foundation

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[48] Under separate cover, inquiring as regards the possibility of prosecuting a private tort class action claim, and query regarding the applicability of SEC Rule 10b and 10b(5) in the immediate instance.

Mr. B. Riney Green, Esq.
Stites & Harbison, PLLC

In re News Media:

Ms. Gillian Tett, Capital Markets Editor
Financial Times

16

DIVISION OF
MARKET REGULATION

UNITED STATES
SECURITIES AND EXCHANGE COMMISSION
WASHINGTON, D.C. 20549

October 11, 2005

Mr. Kevin O'Brien
Sovereign Advisers
4901 E. Sunrise Drive, Suite 711
Tucson, Arizona 85718

Dear Mr. O'Brien:

The Commission staff received your letter, dated September 21, 2005, to Chairman Cox, Commissioner Nazareth and Michael Macchiaroli, Associate Director, in which you raise questions with respect to our letter dated August 19, 2005.

The staff has carefully considered the arguments made in your most recent letter; however, we have not altered our position as articulated in our previous response.

Sincerely,

Robert L.D. Colby
Deputy Director

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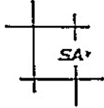

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October 11, 2005

Mr. Walter Stachnik, Inspector General
Office of the Inspector General
United States Securities and Exchange Commission
100 F Street, N.E.
Washington, D.C. 20549-1107

Re: Failure by the U.S. Securities and Exchange Commission to Enforce the Federal Securities Laws in the Following Matter:

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.

Dear Mr. Stachnik:

We write on behalf of the American Bondholders Foundation (the "ABF") and the affiliated U.S. bondholders holding defaulted full faith and credit sovereign obligations of the Chinese Government. The ABF is the incorporated organization representing over five thousand U.S. citizens who are holders of full faith and credit sovereign obligations of the Government of China, on which that government has defaulted and continues to evade payment in violation of accepted conventions of international law.[1] The bondholders have suffered both selective default and discriminatory settlement by the actions of the Chinese Government, and continue to suffer economic injury in their attempt to recover payment on the defaulted obligations of the Chinese Government as a result of the willful and tortious actions of the three major international credit rating agencies (i.e., the Standard and Poor's Division of the McGraw Hill Companies, Inc., Moody's Investors Service, and Fitch, Inc.), designated by the U.S. Securities and Exchange Commission (the "Commission") as nationally recognized statistical rating organizations (referred to collectively herein as the "three major NRSROs"), which have acted in blatant disregard of the extant facts and have assigned and continue to maintain investment-grade credit ratings for the sovereign debt of the Government of China in a manner which constitutes fraudulent, deceitful, and manipulative business practices, and which rating classifications do not conform to the respective agencies' established criteria for developing a rating.

[1] See the complete set of memorandums prepared by the law firm of Stites & Harbison PLLC, describing the legal authority for defaulted U.S. creditors' claims and affirming U.S. creditors' claims under established conventions of international law (copies attached).

Recently, members of the United States Congress have requested the Commission to investigate a complaint[2] filed by our firm on behalf of the ABF against the three major NRSROs regarding their misleading, deceptive, manipulative and deceitful practice of maintaining investment-grade sovereign credit ratings for the Government of China in the face of the existence of outstanding defaulted sovereign debt of the Chinese Government.[3] The U.S. Congress has become involved in the resolution of this matter as a result of testimony presented at hearings conducted by both the House International Relations Committee and the World Bank.[4] In responding to the Congress, the Commission has adopted the position that the three major NRSROs are not subject to regulation under the federal securities laws, and that the Commission has no express statutory authority to impose sanctions on the agencies.[5]

When we first became aware of the existence of defaulted sovereign debt of the Chinese Government, we were astonished to discover that the Government of China enjoys an investment-grade foreign currency credit rating assigned by the three major NRSROs, despite the fact that U.S. creditors continue to be victims of both **selective default** and **discriminatory settlement** even though U.S. creditors are ranked pari passu with U.K. creditors who were offered settlement of their defaulted claims in 1987.

We subsequently undertook extensive research to determine the complete fact pattern involving the existence of the defaulted sovereign debt of the Chinese Government. We shared our findings with the ABF president, who subsequently apprised the chief executive officers of the three major NRSROs of the existence of defaulted sovereign debt of the Government of China in a letter dated November 27, 2002. No response or acknowledgement to this letter has yet been received by the ABF from the three major NRSROs. We subsequently discovered that each of the three major NRSROs is registered with the Commission as a "Registered Investment Adviser" pursuant

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[2] See complaint dated March 31, 2005 filed with the Division of Market Regulation of the United States Securities and Exchange Commission on behalf of defaulted creditors of the Government of China (copy attached), and subsequently amended and enlarged through incorporation by reference to include the additional specifications described in the letter dated June 21, 2005 addressed to Mr. David M. Walker, Comptroller General of the United States (copy attached), and the additional specifications, including undisclosed conflicts of interest described in the letter dated September 21, 2005 addressed to the Honorable Christopher Cox, Chairman, the Honorable Annette Nazareth, Commissioner, and Mr. Michael Macchiaroli, Associate Director, Division of Market Regulation, United States Securities and Exchange Commission (copy attached), and the additional specifications described in this letter, collectively referred to herein as "the complaint" or "the complaint (as amended)".

[3] See various letters addressed to the former Chairman of the Commission by members of the 109th United States Congress including the Honorable Jim Saxton, Chairman of the Joint Economic Committee and the Honorable Jerry Lewis, Chairman of the House Appropriations Committee, requesting the Commission to conduct an investigation into the matter described in the complaint (copies attached).

[4] See transcript of testimony presented to the World Bank on September 23, 2005 (copy attached). A transcript of testimony presented to the House International Relations Committee on October 21, 2003 is accessible on the world wide web at the following URL:
http://www.globalsecuritieswatch.org

[5] See memorandum dated July 29, 2005 which sets forth the Commission's position on the matter (copy attached).

to the Investment Advisers Act of 1940 (the "Advisers Act"), and each of the three major NRSROs is therefore subject to compliance with, and regulation under, the provisions of the Advisers Act.[6] We also discovered that the three major NRSROs have engaged in wrongful actions and deceptive business practices evidencing a reckless standard of care, which has caused injury to defaulted U.S. creditors of the Government of China.

Upon completion of the discovery process, we drafted a complaint on behalf of defaulted creditors of the Government of China, describing the wrongful actions and deceptive business practices engaged in by the three major NRSROs, and filed the complaint with the Securities and Exchange Commission on March 31, 2005. After a period of almost ninety days from the date that the complaint was filed and having received no response from the Commission, and acting in accordance with a sense of the Congress, we notified Mr. David M. Walker, Comptroller General of the United States, informing the Government Accountability Office of the complaint filed with the Commission and the nature of the facts and circumstances described therein.[7] A copy of the letter addressed to Mr. Walker was also sent to persons at the Commission. The letter to Mr. Walker describes in detail the issue of violations of the Advisers Act in the immediate instance.

We also assert that the three major NRSROs have received, or agreed to receive or solicit money because of, or with an intent to be influenced with respect to, their actions, decisions, or other duties or obligations, and have engaged, and continue to engage in an enterprise which affects interstate commerce and includes the use of the U.S. Mail system and the telephone system to falsely inform their clients and the investing public. By their actions as described in the complaint and summarized herein, the three major NRSROs have knowingly and willingly executed and continue to execute a scheme or artifice to obtain money by means of false representations, and have engaged in a "racketeering" activity as defined pursuant to the Racketeer Influenced Corrupt Organizations ("RICO") Act.[8]

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[6] Investment Advisers Act of 1940 as amended. August 22, 1940. 54 Stat. 847, 15 U.S. Code §80b-1 – 80b-21, as amended. For application of the Investment Advisers Act of 1940 in the immediate instance, see specifically Rule 102(a)(4)-1 "Unethical Business Practices of Investment Advisers" (esp. subsection 20), and Section 206 "Prohibited Transactions by Investment Advisers". See also Section 209 "Enforcement of Title" (esp. subsection (a) and subsection (e)(2)(C)(II)).

[7] See letter dated June 21, 2005 addressed to Mr. David M. Walker, Comptroller General of the United States (copy attached).

[8] 18 U.S.C. §1961-68. Section 1964(c) of the Racketeer Influenced and Corrupt Organizations ("RICO") Act allows civil claims to be brought by any person injured in their business or property by reason of a RICO violation. The dissemination of misleading, fraudulent or deceptive rating classifications derived through the misapplication of internal procedures, the application of a reckless standard of care resulting in injury, and multiple transgressions of specific provisions the Advisers Act may constitute violations of the federal mail and wire fraud statutes, thereby creating civil liability pursuant to the RICO Act. With respect to establishing a pattern of fraudulent, deceitful and manipulative practices, see applicable provisions of the Advisers Act which prohibit fraudulent, deceitful and manipulative practices. Defaulted U.S. creditors as a class have suffered, and continue to suffer serious economic harm from the actions of the three major NRSROs including the application of a reckless standard of care and violations of the Advisers Act. With

Summary of Complaint (as Amended)

In this section, we present a summary of the complaint (as amended) filed with the Commission on behalf of the defaulted creditors of the Government of China affiliated with the American Bondholders Foundation. The primary specifications of complaint which we assert against the three major nationally recognized statistical rating organizations, namely the Standard and Poor's Division of the McGraw Hill Companies, Inc., Moody's Investors Service Inc., and Fitch, Inc. include the following:

- That the three major NRSROs have acted, and continue to act willfully and with foreknowledge of the existence of defaulted sovereign debt of the Chinese Government under established conventions of international law in developing and maintaining credit rating classifications;
- That the three major NRSROs did intentionally develop and subsequently assign credit rating classifications to the long-term foreign currency sovereign debt of the Government of China which are provably false by the application of the agencies' own criteria and definitions to the extant facts (e.g., selective default and discriminatory settlement);
- That the actions of the three major NRSROs constitute fraudulent, deceptive, and manipulative business practices in violation of the Advisers Act, under which the three major NRSROs are registered;
- That the actions of the three major NRSROs may be explained as a result of certain conflicts of interest which are endemic to the business practices of the three major NRSROs and which predict the present situation;
- That an examination of the extant facts in comparison with the criteria published by the respective agencies which describes the subject rating classifications evidences the application of a reckless standard of care in the development of the subject rating classifications;
- That the actions of the three major NRSROs have caused, and continue to cause economic injury to defaulted creditors of the Government of China in their attempt to enforce the sovereign debt contract;
- That the actions of the three major NRSROs have created a tort claim on the part of defaulted creditors of the Government of China;
- That repetitive upgrades and continued maintenance of provably false credit rating classifications assigned to the Chinese Goverment by the three major NRSROs constitute a pattern of deceitful and harmful actions and, in conjunction with the use of the mails and other means of interstate commerce by the three major NRSROs to disseminate their ratings, constitute violation(s) of the Racketeer Influenced Corrupt Organizations Act;

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respect to establishing a pattern of fraudulent, deceitful and manipulative practices, see the letter dated June 21, 2005 addressed to Mr. David M. Walker, Comptroller General of the United States.

- That the actions of the three major NRSROs (e.g., application of a reckless standard of care, foreknowledge of contrary facts, intentional deviation from established procedures, infliction of injury on defaulted creditors, and violations of the Advisers Act under which the three major NRSROs are registrants) deprive the three major NRSROs of the protection otherwise afforded by the First Amendment; and

- That an examination of the extant facts demonstrates that immediate enforcement action is appropriate and mandated by the United States Securities and Exchange Commission.

In the following sections, we include an expanded discussion of certain aspects of the complaint.

Application of a Reckless Standard of Care

Under established conventions of international law, full faith and credit sovereign debt of the Government of China exists in a state of both selective default and discriminatory settlement. The three major NRSROs received explicit notification of this fact in a letter dated November 27, 2002, and despite having explicit foreknowledge of the extant facts comprising the immediate instance which contradict an investment-grade credit rating pursuant to the agencies' own rating classification definitions[9], and in developing their respective sovereign credit ratings for the Chinese Government, the three major NRSROs willfully ignored and continue to willfully ignore both the existence of defaulted full faith and credit sovereign debt of the Chinese Government and established conventions of international law governing the payment obligation of this debt. The resultant rating classifications do not conform to the respective agencies' own criteria for the definition of the respective rating classification.[10] Such egregious conduct evidences the application of a reckless standard of care in developing their respective sovereign credit rating classifications for the long-term foreign currency debt of the Government of China.

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[9] For a discussion of the definitions of the relevant debt rating classifications in the immediate instance, see "Exhibit 3.01 People's Republic of China Long-Term Foreign Currency Sovereign Debt Rating". 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. Complaint dated March 31, 2005 filed with the Division of Market Regulation of the United States Securities and Exchange Commission. The sovereign credit ratings presently assigned to the long-term foreign currency debt of the Government of China do not conform to the criteria and definitions promulgated by each of the three major NRSROs when confronted by the extant facts in the immediate instance, and are provably false by a comparison of the extant facts with the respective agencies' rating classification definitions and criteria.

[10] See, e.g., the statement by Mr. Raymond McDaniel, President and Chief Operating Officer, Moody's Investors Service: "We have a codification of all of our methodologies which are available publicly and there is a requirement that those methodologies be followed and we avoid concentration of fees from issuers." Source: "The Credit Rating Agencies' Conflict of Interest". *Nightly Business Report* (produced by NBR Enterprises, a division of WPBT Television and distributed by the Public Broadcast Service ("PBS"). February 8, 2005. Transcript of broadcast is accessible on the world wide web at the following URL: *http://www.nbr.com/transcript/2005/transcript020805.html#story3*

Wrongful Actions and Deceptive Practices Inflict Tort Injury on Defaulted Creditors

Defaulted U.S. creditors have suffered and continue to suffer economic injury by the willful and intentional actions of the three major NRSROs, which have acted and continue to act with the foreknowledge of the falsity of their publications, and with the reasonable expectation that such wrongful actions and deceptive practices may reasonably be expected to cause harm to defaulted U.S. creditors in their attempt to enforce the sovereign debt contract, and which actions did cause and continue to cause injury to in excess of five thousand affiliated persons, whom have sustained and continue to sustain serious tort injury as a class by the wrongful and deceptive actions of the three major NRSROs, whose wrongful and deceptive actions have served to weaken, and continue to weaken, the ability of defaulted U.S. creditors to enforce the sovereign debt contract under established conventions of international law. The Chinese Government has relied on the investment-grade sovereign credit rating assigned by the three major NRSROs to issue sovereign bonds in the global capital markets, most recently in 2003, and again in 2004. In both instances, the Chinese Government was empowered to raise substantial sums of capital while continuing to escape the payment obligation on its defaulted sovereign debt. This was aided and abetted to a significant degree by the wrongful assignment of a provably false, misleading and deceptive investment-grade sovereign credit rating by the three major NRSROs to the long-term foreign currency debt of the Government of China. By their actions, the three major NRSROs may be shown to have caused serious injury to defaulted U.S. creditors.

Conflicted Business Practices in Violation of the Advisers Act

The three major NRSROs each derive revenue directly from, and are compensated by, the Government of China and its numerous related entities, which seek to avoid payment of defaulted sovereign debt and are able to a significant degree to escape such obligation by the willful acts of the three major NRSROs in ignoring the existence of such defaulted debt in circumvention, disregard, variance, and departure from their own published criteria for developing a rating classification. The actions of the three major NRSROs in the immediate instance may be reasonably interpreted to have been calculated to enable the Chinese Government to evade payment on its defaulted sovereign debt at the expense of defaulted U.S. creditors, and at the profit of the three major NRSROs. As a result of the business practices employed by the three major NRSROs, each derives or may reasonably be expected to derive significant revenue directly from the Chinese Government and its state-owned enterprises ("SOEs"), which revenue is directly influenced by the ability of the Chinese Government and its SOEs to issue debt in the international credit markets. The ability of the Chinese Government and its SOEs to issue such debt, and thus the ability of the three major NRSROs to acquire incremental revenue growth, is directly linked to the sovereign rating classification assigned by the three major NRSROs. Each of the three major NRSROs may reasonably be expected to derive significantly greater future revenue as a result of an increase in issuance of debt by Chinese corporations, which ability is directly linked to the sovereign credit rating assigned to debt issued by the Chinese Government (the "sovereign benchmark"). It may be reasonably demonstrated that it is in the interest of the three major NRSROs to maintain a sovereign credit rating classification for the Chinese Government which facilitates (a) evasion of payment of its defaulted sovereign debt, and (b) the

increased issuance by Chinese corporations of debt in the international credit markets, thereby maximizing revenue for the three major NRSROs. Such business practices act to create an incentive for maintaining an artificial rating classification which is contradicted by the extant facts in the immediate instance, and when confronted by such facts, fails to conform to the definitions promulgated by each of the three major NRSROs. As a result, the present rating classifications significantly deviate from, and remain at variance with, the agencies' own definitions, internal procedures, as well as established conventions of international law.

The Advisers Act, under which the three major NRSROs are registered, prohibits unethical business practices, including engaging in any act, practice or course of business which is fraudulent, deceptive, or manipulative.

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:
>
> ... 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".[11]

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:
>
> (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".[12]

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

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

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.
> ... (e) (2) (C) (II) Such violation directly or indirectly resulted in substantial losses or created a significant risk of substantial losses to other persons".[13]

The willful exclusion and 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 ...". The willful disregard or exclusion of material fact(s) in determining a rating classification for an issuer who is in default (and which fact is evident from an examination of information widely disseminated and available in the public domain) may reasonably be construed to constitute a reckless standard of care and a breach of fiduciary duty to clients, as well as a deliberate attempt to deceive and manipulate 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.[14] By the willful exclusion and omission of pertinent and material facts and circumstances, including the intentional disregard of the "willingness to pay" metric, the three NRSROs named above have improperly applied their own procedure for developing a rating, and in so doing have perpetrated a false, manipulative, deceptive, misleading and fraudulent action on the public including

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

[14] 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 defaulted series of full faith and credit sovereign obligations of the Chinese government. Copy of letter enclosed with this correspondence. See also, the previously referenced statement by Mr. Raymond McDaniel, President and Chief Operating Officer, Moody's Investors Service: "We have a codification of all of our methodologies which are available publicly and there is a requirement that those methodologies be followed and we avoid concentration of fees from issuers." See also, 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).

concealment of material risk factors. Failure to take into account the extant facts and circumstances in properly developing the appropriate rating classifications which accurately describe the extant facts and circumstances represents violations of both the rating agencies' internal policies and procedures as well as the Advisers Act, under which each of the three major NRSROs is registered as a "Registered Investment Adviser".

Tortious Actions Not Protected by First Amendment

We note firstly that as registrants pursuant to the Advisers Act, such registration modifies the freedom of expression which may be otherwise available under the First Amendment to the three major NRSROs, to a manner and standard which is fully compliant with the provisions of the Advisers Act. As described in our June 21, 2005 letter to Mr. Walker, the Advisers Act explicitly prohibits certain expressions which are knowingly deceptive and misleading. It is provable by the extant facts in the immediate instance to demonstrate beyond dispute that the three major NRSROs are, by their actions in the immediate instance, in violation of certain provisions of the Advisers Act, including prohibitions against such actions.

Second and even more importantly, the wrongful actions of the three major NRSROs in the immediate instance, which evidence the application of a reckless standard of care and which are calculated to,[15] and do cause injury to an entire class of defaulted creditors, are not afforded protection pursuant to the first amendment. The rating classifications developed by the three major NRSROs for the sovereign debt of the Chinese Government are, by the application of the agencies' own respective criteria, provably false when confronted by the extant facts and can be shown to have caused injury. Such actions deprive the three major NRSROs of protection of freedom of expression otherwise afforded by the First Amendment.

Deceptive Business Practices and Tortious Actions Subject to Civil RICO Proceedings

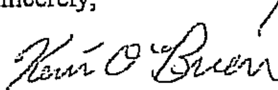
We assert that the intentional, wrongful and tortious actions perpetrated by the three major NRSROs, including their conflicted and deceptive business practices, constitute a recurring theme or pattern, and in conjunction with their use of the U.S. Mail system and other means of interstate commerce, acts to create civil liability pursuant to the RICO Act, as described previously.

[15] See preceding section entitled, "Conflicted Business Practices in Violation of the Advisers Act" for a description of the conflicts of interest which may reasonably be expected to motivate the three major NRSROs to conspire to acquire revenue growth and to enable the Chinese Government to evade payment on defaulted sovereign debt, through the relationship between the revenue models employed by the three major NRSRO's and the Chinese Government's sovereign benchmark.

Regulatory Enforcement Necessary and Mandated

For the reasons stated herein and articulated further in the enclosed materials, including the complaint dated March 31, 2005, we respectfully request that the Office of the Inspector General conduct a formal investigation to determine whether the response we received from the Commission with respect to the complaint (as amended, including the incorporation of additional specifications as referenced herein) filed with the Division of Market Regulation represents a failure by the Commission to enforce the federal securities laws in the immediate instance.

Sincerely,



Kevin O'Brien
President

KO:jwc

Attachments in Sequence:

1. Copy of complaint dated March 31, 2005 filed with the United States Securities and Exchange Commission on behalf of defaulted creditors of the Government of China affiliated with the American Bondholders Foundation.

2. Copies of various letters sent by members of the United States Congress to the former Chairman of the United States Securities and Exchange Commission, requesting an investigation into the matter described in the complaint.

3. Copy of letter dated June 21, 2005 addressed to Mr. David M. Walker, Comptroller General of the United States, United States Government Accountability Office.

4. Copy of letter dated August 4, 2005 addressed to the Honorable Christopher Cox, Chairman, United States Securities and Exchange Commission.

5. Copy of letter from the Commission dated July 29, 2005 addressed to the Honorable Robert Beauprez, Member of Congress, and copy of memorandum dated July 29, 2005 addressed to the Honorable Cynthia Glassman, Acting Chairman, received from the United States Securities and Exchange Commission in response to complaint dated March 31, 2005 filed with the Commission.

6. Copy of letter dated September 21, 2005 addressed to the Honorable Christopher Cox, Chairman, the Honorable Annette Nazareth, Commissioner, and Mr. Michael Macchiaroli, Associate Director, Division of Market Regulation, United States Securities and Exchange Commission.

7. 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.

8. Copies of legal memorandums prepared by the law firm of Stites & Harbison PLLC, describing the legal authority for defaulted U.S. creditors' claims and affirming U.S. creditors' claims under established conventions of international law.

9. Transcript of testimony presented to the World Bank by Ms. Jonna Bianco, President of the American Bondholders Foundation (September 23, 2005).

10. Copy of article published in the Foreign Policy News section of *The Hill – The Newspaper for and about the U.S. Congress* entitled, "China's Unfair Advantage: How China's Artificial Credit Rating Hurts U.S. Manufacturers – Improper Sovereign Benchmark Gives Chinese Companies Cheap Access to Foreign Capital" (July 25, 2005).

11. Copy of article published in the *Financial Times* entitled, "Rush of Chinese IPOs Poses Threat to U.S. Investors" (August 12, 2005).

12. Copy of companion articles published in the *Financial Times* under the subject heading, "Sovereign Credit Ratings" entitled, "China's Pre-War Bond Default Stirs U.S. Anger" and, "People's Republic Called to Account" (June 7, 2005).

cc: Members of the 109th United States Congress

United States – China Economic and Security Review Commission

United States Department of Justice

United States Government Accountability Office

Honorable Christopher Cox, Chairman, United States Securities and Exchange Commission

Honorable Eliot Spitzer, Attorney General for the State of New York (Internal Reference No. 05/001211)

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COPY

November 1, 2005

Mr. Walter Stachnik, Inspector General
Office of the Inspector General
United States Securities and Exchange Commission
100 F Street, N.E.
Washington, D.C. 20549-1107

Re: Failure by the U.S. Securities and Exchange Commission to Enforce the Federal Securities Laws in the Following Matter:

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.[1]

Dear Mr. Stachnik:

We recently wrote to the Office of the Inspector General on behalf of the American Bondholders Foundation (the "ABF") and the affiliated U.S. bondholders holding defaulted full faith and credit sovereign obligations of the Chinese Government.[2] The ABF is the incorporated organization representing over five thousand U.S. citizens who are holders of full faith and credit sovereign obligations of the Government of China, on which that government has defaulted and continues to evade payment in violation of accepted conventions of international law. The bondholders have suffered both selective default and discriminatory settlement by the actions of the Chinese Government, and continue to suffer economic injury in their attempt to recover payment on the defaulted obligations of the Chinese Government as a result of the willful and tortious actions of

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[1] For a description of specifications against the three major nationally recognized statistical rating organizations ("NRSROs"), 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." Complaint filed with the SEC Division of Market Regulation (March 31, 2005). See also the letter addressed to Mr. David M. Walker, Comptroller General of the United States (June 21, 2005) and the letter addressed to the Honorable Christopher Cox, Chairman of the Commission (August 4, 2005). The foregoing documents along with testimony presented at a public hearing conducted by the House International Relations Committee and legal memorandums prepared by the law firm of Stites & Harbison PLLC describing the legal authority of U.S. citizens' claims are accessible on the world wide web at the following URL: *http://www.globalsecuritieswatch.org*

[2] See letter dated October 11, 2005 addressed to the Office of the Inspector General.

the three major international credit rating agencies (i.e., the Standard and Poor's Division of the McGraw Hill Companies, Inc., Moody's Investors Service, and Fitch, Inc.), designated by the U.S. Securities and Exchange Commission (the "Commission") as nationally recognized statistical rating organizations (referred to collectively herein as the "three major NRSROs"), which have acted in blatant disregard of the extant facts and have assigned and continue to maintain investment-grade credit ratings for the sovereign debt of the Government of China in a manner which constitutes fraudulent, deceitful, and manipulative business practices, and which rating classifications do not conform to the respective agencies' established criteria for developing a rating.

We now respectfully direct your attention to the following document (copy enclosed with this correspondence):

"Report on the Role and Function of Credit Rating Agencies in the Operation of the Securities Markets".

The above document is dated January 2003 and was prepared by the U.S. Securities and Exchange Commission pursuant to the requirements of Section 702(b) of the Sarbanes-Oxley Act of 2002.

In reference to our previous letter to you describing the Commission's failure to enforce the federal securities laws in the matter set forth in our complaint, we refer to the following language which appears in the document named above:

> "C. **Recognition of NRSROs**
>
> ...
>
> 1. NRSRO Recognition Criteria
>
> ...
>
> The single most important factor in the Commission staff's assessment of NRSRO status is whether the rating agency is "nationally recognized" in the United States as an issuer of credible and reliable ratings by the predominant users of securities ratings. The staff also reviews the operational capability and reliability of each rating organization. Included within this assessment are: ...; **(5) the rating organization's rating procedures (to determine whether it has systematic procedures designed to produce credible and accurate ratings)**; ..." (emphasis added).[3]

[3] See pages 9-10, "Report on the Role and Function of Credit Rating Agencies in the Operation of the Securities Markets". U.S. Securities and Exchange Commission (January 2003).

Presumably, the NRSROs are required to continue to comply with the recognition criteria established by the Commission, in the conduct of their business practices subsequent to recognition by the Commission as an NRSRO. Accordingly, the Commission has failed to enforce any such requirement as regards maintenance of NRSRO status by the three credit rating agencies referenced herein. We are concerned in instances wherein the three major NRSROs collectively and intentionally engage in the selective application of established procedures and criteria to develop sovereign rating classifications, and which misapplication of established procedures and criteria causes and continues to cause the defaulted creditors to suffer economic injury through the impairment of the defaulted creditors' ability to enforce the debt contract in the face of sovereign rating classifications which are the product of intentional misapplication of established procedures and criteria, and in which circumstances the Commission fails to take enforcement action to uphold and enforce its own standards, including an order of cessation of publication of injurious and tortious falsehoods.

For the reasons stated herein (as further described in the enclosed document), and in our letter dated October 11, 2005, and as stated in the complaint dated March 31, 2005, we respectfully reiterate our request that the Office of the Inspector General conduct a formal investigation to determine whether the response we received from the Commission with respect to the complaint (as amended, including the incorporation of additional specifications as referenced herein) filed with the Division of Market Regulation represents a failure by the Commission to enforce the federal securities laws in the immediate instance.[4]

Sincerely,

Kevin O'Brien
President

KO:jwc

Enclosure

cc: Honorable Christopher Cox, Chairman, U.S. Securities and Exchange Commission

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

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

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[4] It would also be interesting, and possibly quite revealing, to discover whether any of the three major NRSROs presently provide, or contemplate the provision of, advisory services to the Government of China, any of its state-owned enterprises, or any Chinese private sector corporations (e.g., potential debt issuers). If such relationships are proven to exist, the NRSROs are subject to additional requirements as described in the relevant sections of the enclosed document.

19

OFFICE OF
INSPECTOR GENERAL

UNITED STATES
SECURITIES AND EXCHANGE COMMISSION
WASHINGTON, D.C. 20549

October 27, 2005

Kevin O'Brien
President
Sovereign Advisors
4901 E. Sunrise Drive
Suite 711
Tucson, AZ 85718

Dear Mr. O'Brien:

We have reviewed your October 11, 2005 letter, along with other letters and materials you provided to us, concerning your representation of creditors holding defaulted bonds of the Government for the People's Republic of China. In that letter, and in a complaint filed with the Securities and Exchange Commission (Commission), you allege that three major credit rating agencies acted fraudulently in continuing to maintain an investment-grade credit rating for this debt.

In your October 11 letter to me, you request that the Office of Inspector General (OIG) conduct a formal investigation to determine whether the Commission's Division of Market Regulation's response to your complaint presents a failure to enforce the federal securities laws. That response stated, among other things, that the Commission has no authority to require the credit rating agencies to revise a debt rating classification.

The investigative role of the OIG is limited to investigating allegations of misconduct by Commission staff and contractors. The OIG does not act as an appellate body. As a consequence, there does not appear to be any role for the OIG in this matter.

Sincerely,

Walter Stachnik
Inspector General

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Summary of Complaint

Filed with the U.S. Securities and Exchange Commission on Behalf of Defaulted U.S. Creditors

Defaulted Sovereign Debt of the Government of China

American Bondholders Foundation

October 5, 2005

Summary of SEC Complaint (as Amended)

The primary specifications of complaint which we assert against the three major nationally recognized statistical rating organizations ("NRSROs"), namely the Standard and Poor's Division of the McGraw Hill Companies, Inc., Moody's Investors Service Inc., and Fitch, Inc. (the "three major NRSROs") include the following:

- That the three major NRSROs have acted, and continue to act willfully and with foreknowledge of the existence of defaulted sovereign debt of the Chinese Government under established conventions of international law in developing and maintaining credit rating classifications;

- That the three major NRSROs did intentionally develop and subsequently assign credit rating classifications to the long-term foreign currency sovereign debt of the Government of China which are provably false by the application of the agencies' own criteria and definitions to the extant facts (e.g., selective default and discriminatory settlement);

- That the actions of the three major NRSROs constitute fraudulent, deceptive, and manipulative business practices in violation of the Investment Advisers Act, under which the three major NRSROs are registered;

- That the actions of the three major NRSROs may be explained as a result of certain conflicts of interest which are endemic to the business practices of the three major NRSROs and which predict the present situation;

- That an examination of the extant facts in comparison with the criteria published by the respective agencies which describes the subject rating classifications evidences the application of a reckless standard of care in the development of the subject rating classifications;

- That the actions of the three major NRSROs have caused, and continue to cause economic injury to defaulted creditors of the Government of China in their attempt to enforce the sovereign debt contract;

- That the actions of the three major NRSROs have created a tort claim on the part of defaulted creditors of the Government of China;

- That repetitive upgrades and continued maintenance of provably false credit rating classifications assigned to the Chinese Governent by the three major NRSROs constitute a pattern of deceitful and harmful actions and, in conjunction with the use of the mails and other means of interstate commerce by the three major NRSROs to disseminate their ratings, constitute violation(s) of the Racketeer Influenced Corrupt Organizations ("RICO") Act;

- That the actions of the three major NRSROs (e.g., application of a reckless standard of care, foreknowledge of contrary facts, intentional deviation from established procedures, infliction of injury on defaulted creditors, and violations of the Advisers Act under which the three major NRSROs are registrants) deprive the three major NRSROs of the protection otherwise afforded by the First Amendment; and

- That an examination of the extant facts demonstrates that immediate enforcement action is appropriate and mandated by the United States Securities and Exchange Commission.

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SOVEREIGN CREDIT RATINGS

China's pre-war bond default stirs US anger

By Gillian Tett in London, Richard Beales and Andrew Parker in New York and Andrew Yeh in Beijing

A group of US politicians has written to the Securities and Exchange Commission complaining about the way US credit rating agencies treat Chinese debt.

The politicians are angry that Beijing has allegedly failed to settle claims made by US citizens holding pre-war Chinese bonds, while acknowledging UK claims.

"The [rating agencies] should reclassify the sovereign credit ratings of the People's Republic of China [to reflect this]," argues Jim Saxton, chairman of the Senate Joint Economic Committee, in a letter to the SEC, which describes the allegations of China's default as "very serious".

Politicians will also file a resolution in the US Senate this week supporting these letters and calling for China to be excluded from US capital markets until the issue is resolved.

China has hitherto ignored demands for repayment, which have been bubbling in the US for several years, backed by a small group of senators and congressmen.

However, the latest move suggests these complaints are now being raised a notch – not least because of mounting irritation in Washington at China's economic activities, which could give the issue more political resonance than before.

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.

The complaint about the Chinese bonds centres on a swathe of securities issued before 1949, when the Communist regime came to power. The most prominent was a £25m ($45m) sterling bond issued in 1913, indexed to the price of gold, which was due to mature in 1960 before China defaulted.

In 1987 Beijing settled outstanding claims with UK investors holding pre-war assets – including the 1913 bond – at a steep discount. The American Bondholder Foundation, which claims to represent 5,000 US investors holding these bonds, says it is entitled to a settlement as well. It claims the current value is about $120bn.

Officials with China's central bank and the China Banking Regulatory Commission last week denied knowledge of the issue. Most observers consider Beijing unlikely to act without external pressure.

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 & Poor's.

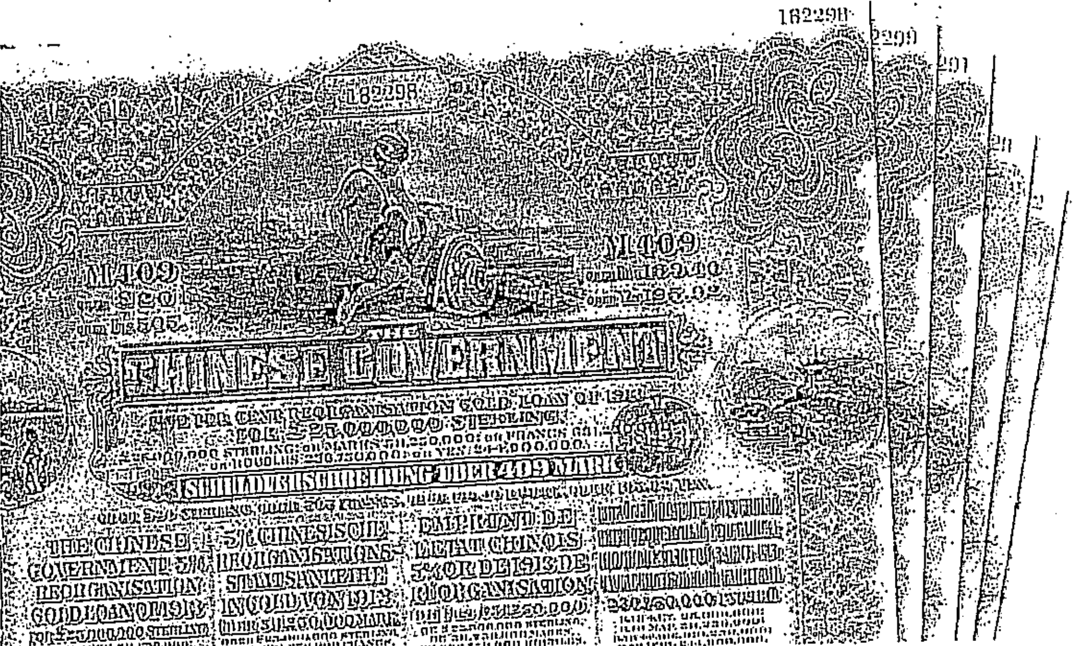
These three, which currently give China a mid-level investment grade rating, have not commented. However, Christopher Mahoney, executive vice-president of Moody's, said: "The fact a country has defaulted in the past is a credit negative, but does not preclude ... a high rating today."

Brian Coulton, senior director at Fitch, said: "[These complaints] are not something we take any account of in our rating of the PRC."

Some US politicians have suggested the bonds be sold at a discount to third countries, such as Iraq, to use to repay debts to China.

People's Republic called to account

US groups want compensation for non-payment of bonds from the Qing Dynasty, write Gillian Tett, Richard Beales and Andrew Yeh



When the People's Republic of China decided 20 years ago to start issuing eurobonds, it ran into an embarrassing diplomatic hitch. Before the UK government would let Beijing sell debt in London, it insisted that China first settle its outstanding pre-war claims with British investors.

After protracted wrangling, China finally caved in: in 1987, it quietly paid a £20m ($36.4m) lump sum to compensate Britons who had lost their assets when China's Communists took power – ranging from defaulted sovereign bonds to debentures on the pre-war Shanghai cricket club.

Now, however, this odd episode of financial history is gaining a new geopolitical life.

In recent weeks, a group of US senators and congressmen has written to the SEC, pointing out that China has failed to make any similar settlement with US investors. And in light of that alleged "default", these politicians want the SEC to take action against the US rating agencies, for their alleged failure to recognise the issue when they issue judgments on the creditworthiness of Chinese bonds.

Thus far, it is unclear how the SEC will respond. And legal experts in China argue that it is unlikely that Beijing will cave in again.

"In my opinion it is possible for China to reject the American bondholders under international rules," says an expert in International Law at Wuhan University in Central China.

But as the argument rumbles on, it could yet add more grist to the mill of Washington's current China-bashing – and highlight a long-running diplomatic headache for the rating agencies as well.

"It's a sensitive issue for agencies," says one international banker, who points out that the matter is doubly delicate because it is unclear whether responsibility for these bonds lies with China or Taiwan.

The issue revolves around a group of bonds that were mostly issued in the early 20th century by the late Qing Dynasty to foreign countries such as US and UK.

Back then, the government was hungry to fund projects such as the construction of railways. However, the practice created huge local resentment in China.

Consequently, when the Communists took power in 1949, these instruments went into default and in subsequent years, the bonds were largely deemed worthless, except to collectors.

But after the Chinese government settled with the UK in 1987, some US bondholders took note: five years ago they created an organisation, known as the American Bondholders Foundation, which started to press the Chinese for a settlement as well.

Some observers suspect the American pressure group stands less chance of success than the UK investors. One reason is that US domestic legal precedent on the issue is not entirely supportive.

Another problem is that the ABF is being very ambitious: whereas the UK bondholders settled their claims at a very steep discount, the ABF insists that China should pay the full, present-day value of the bonds, allegedly some $120bn.

However, a third factor is that the ABF has an unusual support base, at least by the standards of international finance. The main spokeswoman, Jonna Bianco, is a Tennessee cattle rancher, who claims to represent about 5,000 US bondholders.

Some of these apparently bought the bonds many decades ago; others may have acquired them more recently and opportunistically, hoping to cash in.

Either way, there is a strong Mid-West flavour to the group: in addition to winning the backing of Mid-Western politicians, the ABF's backers also include groups such as the Traditional Values Coalition, a Christian organisation.

Nevertheless, the letters to the SEC suggest that the group now enjoys a reasonable degree of political support in Washington – not least because the ABF is keen to capitalise on the current anti-China climate. And though there is no evidence that the Treasury is backing their efforts, the group is trying to exert more pressure on Beijing by using the controversial bonds in third-country so-called "offsets".

In particular, the group claims it is now negotiating with a group of Middle Eastern countries – including Iraq – to sell them the bonds at a discount. The idea is that these countries then use these instruments to repay their own debts to China. "We have both Republicans and Democrats backing us here – the issue [of Chinese bonds] now generates quite a bit of emotion," says Ms Bianco, who claims that the group will unveil some more news on these so-called offsets "in the next few weeks".

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China's Unfair Advantage

How China's Artificial Credit Rating Hurts U.S. Manufacturers – Improper Sovereign Benchmark Gives Chinese Companies Cheap Access to Foreign Capital

TUCSON, Ariz., July 25 -- It's not just low wages that gives China a major competitive advantage over U.S. manufacturing companies. U.S. manufacturers are also hurt by the assignment of an improper and artificial investment-grade sovereign credit rating to the government of China, which enables Chinese companies to raise foreign capital for expansion of operations more cheaply than would be the case if the Chinese government's credit rating reflected the existence of China's defaulted sovereign debt. According to a 2002 report issued by the U.S.-China Commission, Chinese corporations raised an estimated $20 billion over the past decade from international bond offerings denominated in U.S. dollars, including approximately $9.7 billion from U.S. markets. In an aggressive bid to set the stage for a fresh round of debt issuance by Chinese corporations and secure additional ratings business, Standard & Poor's Rating Service last week raised China's sovereign credit rating from "BBB+" to "A-."

Sovereign Advisers, a private financial research and investment analysis firm, recently filed a complaint with the U.S. Securities and Exchange Commission Division of Market Regulation and the Committee of European Securities Regulators, pertaining to the inappropriate and misleading sovereign credit ratings assigned to the People's Republic of China (http://www.globalsecuritieswatch.org/SEC.pdf). The complaint, predicated upon the existence of defaulted full faith and credit sovereign obligations of the Chinese government, was filed on behalf of U.S. bondholders and has begun to draw the attention of the U.S. Congress. The Chairman of the Congressional Joint Economic Committee has rightfully demanded that the SEC open an investigation into this very serious matter, which also has broad implications with respect to both CNOOC's financing of its unsolicited takeover bid for Unocal as well as to U.S. manufacturing companies facing competition from Chinese companies.

In commenting on the complaint and the prospect of an SEC investigation into the matter, Mr. Christopher Mahoney, Executive Vice President of Moody's Investors Service, was recently quoted as stating that a country's past default "does not preclude ... a high rating today." Mr. Mahoney's statement presupposes that the past default was cured through discharge or settlement of the debt. Such is not the case in the instance described in the complaint, wherein the defaulted debt was settled in the U.K. but neither settled nor discharged in the U.S., where it has been left outstanding and continues to be evaded by the government of China. According to Mr. John Petty, president of the Foreign Bondholders Protective Council, "Mr. Mahoney selectively disregards this discrimination against U.S. citizens. This kind of behavior by Moody's and S&P- ignoring an issuer's defaulted obligations when assigning a credit rating-hurts Americans who have been discriminated against in foreign government bond defaults."

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The "nationally recognized statistical rating organization" status enjoyed by Fitch Ratings, Moody's and Standard & Poor's entails a very high degree of responsibility to the investing public. Unfortunately, such diligence is not evident in their respective China sovereign credit ratings. Statements such as those offered by Mr. Mahoney, which dismiss an obvious fact, do nothing to enhance the overall credibility of the rating agencies. This aspect is described in detail in a letter prepared by Sovereign Advisers and delivered to Mr. David M. Walker, Comptroller General of the United States (http://www.globalsecuritieswatch.org/GAO_LETTER.pdf).

China's "Willingness to Pay" Ignored in Setting Benchmark Rating

China possesses a reported $691 billion in foreign exchange reserves, yet continues to shamefully evade payment of its defaulted sovereign debt in violation of international law. Such behavior is blatantly inconsistent with the "willingness to pay" metric implied in an investment-grade rating. As Richard Brookhiser stated in his recent article on Alexander Hamilton, entitled "Alexander the Great" (Wall Street Journal, June 30th), "Mr. Hamilton knew that if the United States started picking and choosing among its creditors, its credit would go back into the outhouse." This same standard need not apply to the government of the People's Republic of China so long as the three major rating agencies continue to aid and abet China's evasion of payment on its defaulted sovereign debt through artificially inflated credit ratings.

China's Defaulted Sovereign Debt: Selective Default vs. Investment Grade

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." In fact, S&P's own "Selective Default" classification states "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." Unfortunately, S&P selectively ignores that fact that a prime example of selective default is the Chinese government's refusal to honor the series of full faith and credit sovereign obligations issued as the Chinese Government Five Per Cent Reorganization Gold Loan, scheduled to mature in 1960 and which remains in default under international law as a payment obligation of the People's Republic of China as the successor government. Failure to assign a "Selective Default" rating to the Chinese government represents a violation of S&P's own internal policy. Commenting on last week's upgrade, Sovereign Advisers president Kevin O'Brien stated "an investment-grade sovereign rating is not warranted for China, given the existence of defaulted sovereign debt of the Chinese government. Last week's upgrade by S&P is a transparent attempt to protect its China ratings franchise in the face of anticipated competition resulting from new legislation (H.R. 2990) introduced by Representative Mark Fitzpatrick (R-PA) which will open up the credit rating industry to new entrants."

China's Artificial Credit Rating Hurts U.S. Manufacturers

The assignment of the proper rating classification for sovereign debt of the Chinese government (i.e., "Selective Default") would effectively function to prevent bond-financed takeovers of U.S. corporations by Chinese state-owned enterprises, since a "default" rating of the Chinese sovereign benchmark (which generally acts as the international credit rating ceiling for all Chinese corporations) would no longer permit Chinese corporations to access international debt financing at an artificially-subsidized cost until such time as the sovereign default is cured. Such a ratings adjustment to reflect the existence of defaulted obligations of the Chinese government would help to level the playing field for American businesses in competition with Chinese manufacturers, which enjoy cheap access to capital as a result of the Chinese government's investment-grade sovereign rating.

Congress Takes Action on China's Defaulted Sovereign Debt

The U.S. Congress is finally taking action to remedy this inequity. In addition to Rep. Fitzpatrick's legislation, the chairmen of both the Joint Economic Committee and the House Appropriations Committee, along with influential members of several other key Congressional committees have written to the SEC calling for the agency to investigate the conduct of the credit rating agencies in setting the sovereign credit rating for China (http://www.globalsecuritieswatch.org/congress.html). Congress is also poised to take further action pending introduction of anticipated legislation intended to halt the issuance of new Chinese government securities in the U.S. capital markets until the Chinese government cures its defaulted sovereign debt.

As holders of full faith and credit sovereign obligations of the government of China, U.S. bondholders continue to suffer from both selective default and a discriminatory settlement (i.e., the 1987 settlement with British bondholders which excluded U.S. citizens). There is no excuse for the major international credit rating agencies to continue to pretend otherwise. China's credit ratings should reflect evasion of payment on the country's defaulted sovereign debt. It is unfortunate that the prospect of losing a significant share of the Asian corporate ratings business would sway S&P, Moody's and Fitch Ratings to assign an investment-grade rating to a government in default. It is also interesting to note that Goldman Sachs and JP Morgan, which have pledged $3 billion in bridge financing for CNOOC's takeover bid, would find it difficult to sell bonds to investors if China's credit rating reflected the existence of defaulted sovereign debt. In a similar vein, perhaps the Chinese government should cure its defaulted debt before allowing its state-owned enterprises to launch takeover attempts on U.S. companies.

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http://www.globalsecuritieswatch.org/chairman_saxton_demand_for_investigation.pdf

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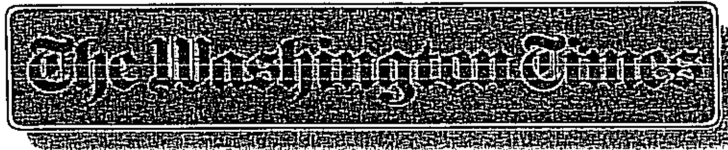
June 29, 2007



Editorial

Hats off to Frank Gaffney for his excellent and incisive analysis of how Communist China operates to exploit the current administration's ruinous trade policies ("China's double standard," Commentary, Tuesday).

Now we learn that in addition to supplying weapons and ammunition to Taliban fighters and Iraqi insurgents with which to kill American soldiers ("China arming terrorists," Inside the Ring, June 15), China is garnering a share of post-liberation Iraq's oil. In mid-2003, our firm prepared a briefing circular that warned of the dangerous consequences to U.S. national security of leaving Iraq's Saddam Hussein-era sovereign debt owed to the Communist Chinese government outstanding. A copy of our brief was provided to both Karl Rove and Condoleezza Rice, who then was the president's national security adviser, and in it we predicted the eventuality of China's gaining access to Iraq's national petroleum reserves through a negotiated debt-cancellation scheme. The administration took no action, with the result that Communist China enjoys enhanced energy security at the cost of the lives of many hundreds of U.S. servicemen and women who fought to liberate Iraq.

Even the most casual observer has to wonder whether it is the permissive stance of this administration toward China's refusal to honor repayment of its defaulted sovereign obligations held by Americans that directly encourages the Chinese government to write its own rules of international conduct. According to the president of the U.S. Foreign Bondholders Protective Council, in more than 40 settlements involving defaulted national debt, the Communist Chinese government is the only nation that steadfastly has refused to negotiate the settlement of its defaulted sovereign debt held by Americans.

We consider the present situation to be nothing short of outrageous. The president, proudly bestowing upon himself the title of "war president," supports trade policies with China that actively undermine the national security interests of the United States and our armed forces. The existing policies only serve the interests of the Chinese government, certain multinational corporations and a select few Wall Street institutions. In this regard, we should not fail to note that under the administration's prevailing trade policies, America's chief export to China consists of U.S. jobs, which are disappearing at an estimated rate of 2,250 per day.

It also is revealing to note the shift in policy recently announced by Treasury Secretary Henry M. Paulson Jr., who stated that the emphasis is shifting away from China's currency manipulation, which constitutes the most proximate cause for the dislocation of U.S. jobs and entire industries, and toward the lessening of restrictions on outbound investment from mainland China. This policy shift may be expected to further the erosion of the U.S. employment base while assisting certain Chinese actors in recycling profits earned from the U.S.-China trade imbalance into U.S. assets. The recent acquisition of 9.9 percent of the U.S. buyout fund Blackstone is just the precursor of the change in ownership of U.S. assets for which the stage is being set hastily.

We join with Mr. Gaffney in urging readers to actively express their support to Congress in favor of H. Con. Res. 160 and similar legislation in an attempt to reform the prevailing policy of coddling Communist China while selling out America.

KEVIN O'BRIEN

President

Sovereign Advisers

Tucson, Ariz.

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Front Page
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Washington Post
Special Investigative Series

Business Practices of the International Credit Rating Agencies

Date	Article
Monday November 22 2004	**Unchecked Power**: The world's three big credit-rating companies have come to dominate an important sector of global finance without formal oversight. The rating system has proved vulnerable to subjective judgment, manipulation and conflicts of interest, people inside and outside the industry say. • **Moody's Close Connections** • **When Interests Collide** • **Graphic: The Rating Game**
Tuesday November 23 2004	**Shaping the Wealth of Nations**: As more countries rely on the bond markets to raise capital, they have been forced to accommodate the three top rating firms. The credit raters often have more sway over foreign fiscal policy than the U.S. government. • **Transcript: Post Writer Alec Klein** • **Smoothing Way for Debt Markets** • **Graphic: Moody's Expansion**
Wednesday November 24 2004	**Flexing Business Muscle**: Lack of oversight has left the rating companies free to set their own rules and practices, which some corporations say has led to abuses. The credit raters have rated companies against their wishes and ratcheted up their fees without negotiation. • **Graphic: Raters' Big Misses**

Wall Street Journal

How the Business Practices of the Credit Rating Agencies Fueled the Global Subprime Meltdown

Date	Article
Wednesday August 15 2007	**How Rating Firms' Calls Fueled Subprime Mess: Benign View of Loans Helped Create Bonds, Led to More Lending**
Friday September 7 2007	**Ratings Firms' Practices Get Rated**

Borrowers Find System Open to Conflicts, Manipulation

By Alec Klein
Washington Post Staff Writer
Monday, November 22, 2004; Page A01

In the months leading to the collapse of WorldCom Inc., its shares were in a nose-dive, traders were selling its bonds at junk levels and its chief executive was forced out. But not until investors lost several billion dollars did Congress and others begin to rivet attention to a little-known player in this unfolding drama: the credit raters.

WorldCom rose to prominence through voracious acquisitions, including the bold 1998 purchase of MCI, the District-based long-distance telephone company. And it couldn't have done it without the rating companies. WorldCom borrowed money through the sale of bonds, which the rating firms approved by giving them good grades, a signal that they were relatively safe investments.

As it turned out, nothing could have been further from the truth. But the rating firms were among the last to recognize it. It wasn't until weeks before WorldCom disclosed massive fraud and filed the biggest bankruptcy in U.S. history in 2002 that the credit raters finally cut the firm's debt to junk status.

The rating companies say they are not in the business of detecting fraud; rather, they say they give an opinion of the creditworthiness of a company, municipality or nation. But some critics say the WorldCom case highlights a broader problem: that the world's big three credit raters -- Moody's Investors Service, Standard & Poor's and Fitch Ratings -- have become some of the most important gatekeepers in capitalism without the commensurate oversight or accountability.

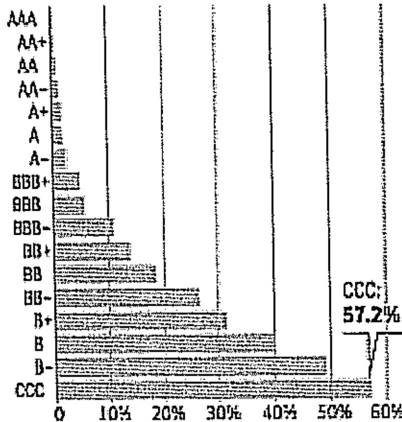
From their Manhattan offices, they can, with the stroke of a pen, effectively add or subtract millions from a company's bottom line, rattle a city budget, shock the stock and bond markets and reroute international investment. Without their ratings, in many cases, factories can't expand, schools can't get built, highways can't be paved. Yet there is no formal structure for overseeing the credit raters, no one designated to take complaints about them, and no regulations about employee qualifications.

The big three ostensibly function as a disinterested priesthood. When a company, town or entire nation wants to borrow money by selling bonds, the market almost always requires that the rating companies bless the move by running a kind of credit check. Bonds they deem safe get a good rating. The higher the rating, the lower the interest rate the borrower must pay.

The Raters' Defense

S&P and other rating companies say among the strongest indications of the effectiveness of their ratings are their default studies. They show the higher the rating, the lower the risk of default.

10-year cumulative average default rate, 1981-2002



SOURCE: Standard & Poor's THE WASHINGTON POST

But at the heart of the increasingly profitable business is a conflict: The rating companies get the bulk of their revenue from the fees they charge to the very entities they are rating. Industry insiders say the desire of a rater to hold on to a paying client -- or recruit a new one -- at times has interfered with the objectivity of a rating.

Dozens of current and former rating officials, financial advisers and Wall Street traders and investors interviewed by The Washington Post say the rating system has proved vulnerable to subjective judgment, manipulation and pressure from borrowers. They say the big three are so dominant they can keep their rating processes secret, force clients to pay higher fees and fend off complaints about their mistakes.

Many of those interviewed declined to criticize the credit raters publicly, saying they did not want to anger those who hold so much sway over their financial fortunes.

Those who disagree with a rating have little recourse. Lawsuits generally have been unsuccessful because courts have upheld the rating companies' argument that they are publishers of opinions, like newspapers, and that their views are protected by the First Amendment.

With little public debate about the industry, the rating business has eluded a series of reforms that have been imposed on other parts of the U.S. financial system. For example, while hundreds of companies and institutions, such as the New York Stock Exchange, have eliminated potential conflicts on their boards, Moody's directors continue to serve on the boards of companies that also are Moody's clients. (Moody's officials say that their directors play no role in ratings decisions.)

And even as accounting firms have curtailed offering consulting services to their clients to avoid conflicts, some credit raters have begun to sell their own consulting services, raising concerns that clients may feel pressured to buy them.

For their part, the credit raters say they ably manage potential conflicts. They say they adhere to strict codes of conduct, such as prohibiting any link between the pay and bonuses of their rating analysts and the fees that come in from the companies those analysts rate. The rating companies also say they perform a public service by allowing investors to compare the relative risk of buying bonds from almost any seller.

And the credit raters say their success over time shows the ratings process works, and that their ratings bring stability to the markets, giving companies and countries access to

capital. "Our ratings are essentially a public good," said Frances G. Laserson, a Moody's spokeswoman.

Laserson also said that The Post was raising questions about a small number of cases among thousands of Moody's ratings.

Million-Dollar Decisions

The rating companies say they do their job without regard to the impact, basing their ratings largely on statistical calculations of a borrower's likelihood of default. Subjective factors sometimes come into play, rating officials say, given that there are some two dozen categories ranging from the best, "AAA," to a low of "C" or "D."

That subjectivity can be costly. For a borrower, the difference of a single rating notch could mean millions of extra dollars in interest payments.

Few question the need for a credit-rating system, but many argue that the big rating firms have become too powerful and insulated. In the past decade, the industry has been scrutinized by regulators and policymakers, but no action has been taken to strengthen oversight.

"Here we have a huge issue that has a significant impact on the U.S. economy and the global economy, and nobody seems to be paying attention," said James A. Kaitz, chief executive of the Association for Financial Professionals, which represents more than 14,000 U.S. corporate finance officials.

The association and its counterparts in Britain and France issued a statement in April saying investors have lost confidence in the credibility and accuracy of the big three's ratings and called for a new global code of conduct.

Last year, the Investment Company Institute, whose members include more than 8,000 mutual funds and other investment firms, recommended to regulators that the major rating companies disclose conflict-of-interest policies.

The rating companies officially fall under the purview of the Securities and Exchange Commission. But even as the SEC has clamped down on accountants, stock analysts and investment bankers, the regulator has not imposed rules on the rating companies. The SEC, which declined to comment for this article, said it continues to study the issue.

The SEC made one regulatory move that enhanced the credit raters' power. In the mid-1970s, after the raters failed to anticipate a major railroad default, investors grew nervous about the debt markets. The SEC decided to require that brokerage firms maintain a certain amount of cash, bonds and other assets. How much depended in part on the quality of those bonds.

Regulators weren't sure how to assess those bonds. So the SEC created a category of credit raters called Nationally Recognized Statistical Rating Organizations, or NRSROs. The SEC initially recognized Moody's, S&P and Fitch.

Investors have come to consider the designation as the U.S. government's stamp of approval, and it is used by institutions, such as mutual funds, as a main criteria for investing only in bonds approved by such rating companies. That has helped the big three secure their monopoly, their critics say.

Last year, the government added to its list a fourth company, Dominion Bond Rating Service Ltd., a small Canadian firm. Competing rating companies have complained about their failure to achieve the designation because there are no laws or regulations explaining how to qualify.

Despite their complaints, the industry has received little public attention largely because its workings are complex and its clients are institutions rather than people. (The creditworthiness of consumers is rated by a different set of companies, which operate under extensive federal and state regulation.) But after the collapse of such companies as WorldCom and Enron Corp., Congress ordered the SEC to consider whether new rules were needed. During a 2002 hearing, Annette L. Nazareth, the SEC's market regulation director, wrestled with that question, saying the industry lacks transparency. The debt markets, she said, are "the dark corner" of the securities industry.

A Private Vote

The big three credit-rating firms wield power through letter grades they hand out. They explain their ratings approach in pamphlets and on their Web sites. But the process itself has remained a mystery of finance.

Committees of rating analysts, headed by one lead analyst, meet privately to weigh the financial strengths and weaknesses of those who want to sell bonds. Then, they emerge to give the bond a rating, announcing it to the world. The companies don't say who voted or how the vote broke down.

Over the decades, the rating companies and their supporters say, the system has proved its value and integrity.

"S&P has, in fact, been very successful in flagging deterioration in credit of companies, and that is why our opinions continue to be highly valued information to investors," said Vickie A. Tillman, executive vice president of the company's credit market services. S&P cited several examples of ratings that anticipated problems, at such companies as US Airways Group Inc., AT&T Corp. and France Telecom SA. Moody's also furnished examples, including its work on Air Canada and Conseco Inc.

The rating companies say they get their ratings right most of the time, pointing to their own studies showing that the higher the rating, the lower the rate of default. Out of 98

defaults in 2003, S&P said, only three were companies that had in the past 12 months held investment-grade ratings, which are considered relatively safe for investors. Still, since only a tiny fraction of all bond issuers ever default, the odds of being right are very high, some critics point out.

Tillman said that because it takes a majority of the committee to approve a rating, no one person can skew the process. Those familiar with the process, however, say the committee usually follows the lead analyst because the others often don't have the time to review the work as closely.

The lead analyst's recommendation is "the basis on which everything is turning" and is upheld about 80 percent of the time, said Hans van den Houten, a former Fitch and Moody's executive who also served as an outside recruiter for S&P until earlier this year.

That can sometimes tempt the lead analyst to let personal feelings influence the review of a client's finances. This happened to a former Moody's analyst rating a company at which one executive was a close friend from a previous job.

"I bent over backward to come up with the best result because I care for this person," said the analyst, who spoke on the condition that neither he nor the company he was rating be identified. Later, after the company's performance sagged, the analyst came to see that he had rated it too high.

If an analyst's feelings go the other way, it can cost a company money. Computer Associates International Inc., which has had recent run-ins with U.S. authorities about its accounting, earned a tough reputation for the way it deals with rating analysts. "They were definitely aggressive and abrasive and engendered a combative response from the rating agency," a former rating analyst said.

Computer Associates, which declined to comment, held a rating last year barely at investment -grade. Based on financials alone, it would likely have been higher, but its combative executives alienated some analysts. The company's rating ended up lower than expected, costing it potentially millions in extra interest payments. "Maybe a full notch is [due to] their personality," the former analyst said.

Analysts say it's reasonable to use their judgment to assess how well a company's executives make business decisions. But reservations about management will not necessarily show up in the rating firm's public report.

"You don't want to say you don't like these guys," another former rating official said. "You have nothing to point to, but it was discussed in the committee."

Moody's president, Raymond W. McDaniel Jr., declined to discuss specific cases. "The ratings process is produced by human beings, and human beings have views and emotions about certain things," he said, adding that Moody's tracks the quality of its ratings.

"We do not deny there are latent or inherent conflicts of interest in our business," McDaniel said. "The important thing is, how do we manage those conflicts?"

Credit raters say that other industries, including newspapers, have to cope with similar conflicts. "Our practice is no different from The Washington Post who will run ads from Ford, AT&T, Merrill Lynch or dozens of other companies while at the same time reporting on them every day," Fitch said in a written response to questions.

Some rating companies cited a 2003 study by two economists who work for the Federal Reserve who found "no evidence" that ratings are affected by conflicts of interest, but rather that credit raters "appear to be relatively responsive to reputation concerns and so protect the interests of investors."

At the Water Cooler

Because the major rating companies juggle tens of thousands of debt issues at any given time, many are given cursory attention, according to current and former rating analysts and those they rate. An analyst will cover as many as 55 borrowers at once. And in recent years, the credit raters say analyzing debt has become more complicated, involving more financial provisions.

"You can't monitor all those companies," one former rating analyst said.

So why don't raters hire more analysts? "It would cut into their profitability," he said.

The credit raters say they have a sufficient number of analysts to cover companies throughout the world. Still, at Moody's at least, according to some current officials and former analysts, committee meetings on occasion are hastily arranged, include only two analysts and last minutes, or seconds.

"We had a colloquial term for that," said W. Bruce Jones, a former Moody's official who works for a small competitor, Egan-Jones Ratings Co. "We called it a 'water cooler rating.' "

One meeting that took only minutes involved Omnicare Inc., a supplier of pharmaceutical services to nursing homes, when it announced plans to acquire competitor NCS HealthCare Inc. in 2002, according to another former Moody's analyst.

As soon as the deal, worth more than $400 million, looked imminent, the analyst said he dropped into a supervisor's office and quickly explained that he assumed Omnicare would sell bonds to make the acquisition. As a result, he was going to put its rating on review for a potential downgrade.

He didn't need to explain why: By carrying more debt, the company would become a bigger credit risk. The supervisor promptly gave the analyst approval to proceed.

That was the committee meeting.

Within about a half-hour, the decision flashed to some 5,000 news services around the globe. About six months later, however, Moody's took Omnicare's credit off review. The company planned to use stock, not just loans, to buy its competitor. That meant Omnicare's debt wouldn't be as large as the Moody's analyst had anticipated.

McDaniel of Moody's said his company works diligently to provide well-researched ratings. "We treat the ratings committee process very seriously," he said, but added, "We don't want to waste people's time."

The rating companies said they already have strong internal controls designed to minimize mistakes or conflicts, including codes of conduct at S&P and Moody's.

Moody's, for instance, instructs employees to do nothing that "might, or might appear to, compromise the integrity" of the rating process. The credit raters say they also conduct ethics training in-house.

Still, some lawmakers -- Republicans and Democrats -- say the system is flawed. In a House hearing last year, Rep. Paul E. Kanjorski (D-Pa.) said the credit raters' failure to identify problems at WorldCom and other major companies "ultimately resulted in the loss of billions of dollars for American investors who little understood the true credit risks."

Staff researcher Richard Drezen contributed to this report.

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Moody's Board Members Have Ties to Clients

Firm Says Such Links Have No Impact on Ratings

By Alec Klein
Washington Post Staff Writer
Monday, November 22, 2004; Page A09

A slew of corporate scandals in recent years has prompted hundreds of companies to eliminate the appearance of conflicts of interest on their boards of directors. A notable exception: Moody's Corp.

Most of its board members serve as directors of companies it rates. The higher the rating, the cheaper it is for these companies to borrow money by issuing bonds.

One case that illustrates the potential conflict involves Clifford L. Alexander Jr., former chairman of Moody's, parent of Moody's Investors Service, its rating division. He spent 19 years on the board of MCI Communications Corp., staying as a director through the long-distance company's growth and absorption by WorldCom Inc.

Alexander resigned from WorldCom's board in December 2001, about six months before it went bankrupt. Moody's had long maintained a solid investment-grade rating on WorldCom, which has since reverted to its old name, MCI. Even while bond traders were selling WorldCom at "junk" levels, an indication of financial trouble, Moody's continued to give the telephone giant a high rating about four months after Alexander's departure.

Moody's cut the telephone company to junk status that May. About a month later, WorldCom fired its chief financial officer after discovering nearly $4 billion in improper accounting. WorldCom subsequently filed the largest bankruptcy in U.S. history, and stock and bond investors lost several billion dollars.

In 1999, Alexander exercised stock options in the company worth more than $1.7 million, according to public records. At the same time, he sold shares worth nearly $692,000. Alexander said he also lost $460,000 in WorldCom investments last year. In October 2003, Alexander retired from Moody's.

Alexander said he played no role in WorldCom's ratings. "At no time did I in any way talk to anyone or do anything that would attempt to influence any rating," he said in an interview.

Moody's president, Raymond W. McDaniel Jr., said: "The board has nothing to do with our professional ratings practices. They are not involved in individual rating actions."

As proof, Moody's analyzed its ratings in response to questions from The Washington Post. In cases where its directors serve on companies rated by Moody's, the credit rater

found its ratings are in line with industry trends. Moody's also said its ratings are higher than S&P in five cases, lower in two and the same in eight.

Some industry observers say the board's affiliations present at least an appearance of a conflict of interest.

"We have some concerns about the effectiveness of the board," said Nell Minow, chairwoman of the Corporate Library, a research firm that assesses corporate governance. She said board conflicts turn on the question: "How do they handle it?"

Standard & Poor's and Fitch Ratings, the other two major rating companies, are not subject to the same clear-cut questions of board conflicts because they are units of larger diversified companies.

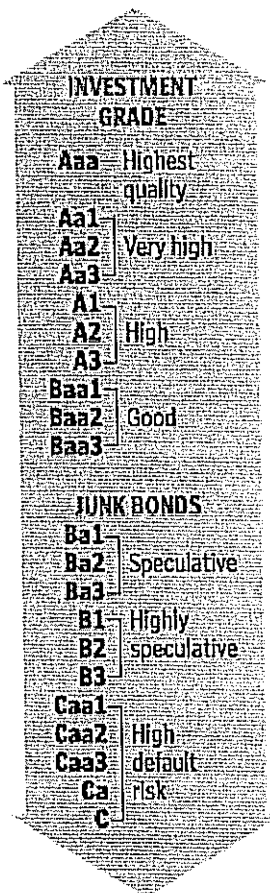
Alexander, the former Moody's chairman, also serves on the board of another firm it rates -- Wyeth, the pharmaceutical giant. He joined the board of Wyeth, then called American Home Products Corp., in 1993, the same year he was appointed a director of Dun & Bradstreet Corp., which then owned Moody's Investors Service. In 2000, Alexander sold Wyeth shares worth $297,600, according to public filings.

Wyeth's financial fate depended to some degree on Moody's, as well as S&P. Last year, the drug company sold $1.8 billion in notes, which contained "step up" language tied to its credit ratings, which were investment grade, or high quality. What that meant was, each ratings downgrade, by Moody's or S&P, would raise its interest rate by 0.25 percent, up to 2 percentage points, according to its public filings. Each downgrade would cost Wyeth about $4.5 million in additional annual interest expenses.

"The fact that Mr. Alexander once served on Moody's had absolutely no impact on Wyeth's credit rating," Wyeth spokesman Lowell Weiner said.

Alexander also is president and founder of Alexander & Associates Inc., a firm that helps Fortune 500 companies recruit women and minorities. Alexander declined to disclose his clients, or the fees they pay, but he said, "I'm sure at some point they must have been" clients that were also rated by Moody's. He said, however, to call such an association a conflict is "really a stretch."

John Rutherfurd Jr., Moody's chief executive who assumed the chairmanship after Alexander's retirement, is a member of the board of governors of the National Association of Securities Dealers. The association polices virtually all brokerage houses and securities dealers in the United States -- about 5,400 firms. As part of NASD's enforcement power, it can impose fines or expel individuals and firms from the industry.



Robert R. Glauber, another Moody's director, is NASD's chairman and chief executive.

Nancy Condon, an NASD spokeswoman, said enforcement actions are done at the "staff level," which are separate from Rutherfurd's and Glauber's positions.

Moody's directors Henry A. McKinnell Jr., Mary Johnston Evans, Connie Mack III, Basil L. Anderson, John K. Wulff and Ewald Kist also serve on boards of companies, or units of companies, rated by Moody's.

Some current and former members of Moody's board concede the appearance of conflicts of interest but say they are unavoidable. They argue there is a limited field of directors from which to choose and that Moody's is seeking those most qualified. "Since we rate the largest corporations and financial institutions in the country," McDaniel said, "that is naturally a place we would find some of the best thinkers."

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When Interests Collide

Credit Raters Subject To Client Pressure

By Alec Klein
Washington Post Staff Writer
Monday, November 22, 2004; Page A09

When Allied Signal Inc., the big aerospace company, acquired rival Grimes Aerospace in 1997, it seemed like a simple thing. But then there was the question of how to deal with the rating companies.

Allied sought to pay off $125 million in Grimes debt, which was held in unrated bonds because Grimes was privately held. Investors were willing to sell their bonds to Allied to retire the debt, but they wanted the major rating companies to grade the securities to help set the right price.

A rating likely would have raised the bonds' value, increasing Allied's cost to buy them. So an Allied official called one of the rating companies, warning it not to rate the debt, according to Edwin P. Dean, a bond analyst representing some of the investors. Dean said he got the story directly from the rating official whom Allied called. Allied said it "would be very unhappy if that agency rated Grimes," Dean recalled in an Aug. 17, 1998, letter to another rating firm he was considering hiring.

Dean, of the investment firm First Albany Cos., wrote that the rating company told him it feared losing the fees that it charged Allied, whose debt it already rated; as a result, it backed off from rating Grimes.

"That rating agency said candidly that Allied was a source of rating income and they would not jeopardize the relationship," he said in his letter, which The Washington Post obtained from another source. In a recent interview, Dean said he had approached Moody's Investors Service, Standard & Poor's and Fitch Ratings to get the bonds rated. "What the rating agencies were saying was, 'I'm not going to [tick] this guy [Allied] off,' " Dean recalled. They told him, "Allied was a good customer."

Dean said he holds no grudge against the rating companies. "Customers always have some leverage," he said.

The recipient of Dean's letter, Sean J. Egan, managing director of Egan-Jones Ratings Co., a small competitor of the three major credit raters, differs.

What happened with Allied "should be illegal," Egan said. By catering to Allied, he said, the credit-rating companies ignored the basic reason for their ratings: to serve the investing public. When the major raters declined to rate Grimes's debt, Dean hired Egan's firm to do a rating. Egan-Jones gave Grimes a "BBB+" rating, a solid grade.

Honeywell International Inc., which merged with Allied in 1999, declined to comment.

Vickie A. Tillman, S&P's executive vice president of credit market services, said in a written statement to The Post: "Standard & Poor's would never compromise its objectivity and reputation by choosing not to rate an entity out of deference to an issuer."

Fitch said in an e-mail, "Fitch goes to great efforts to assure that our receipt of fees from issuers does not affect our editorial independence."

Moody's declined to comment on Allied, but Raymond W. McDaniel Jr., Moody's president, said that in general, if a borrower does not furnish enough information about its debt, it can make it difficult for Moody's to rate it.

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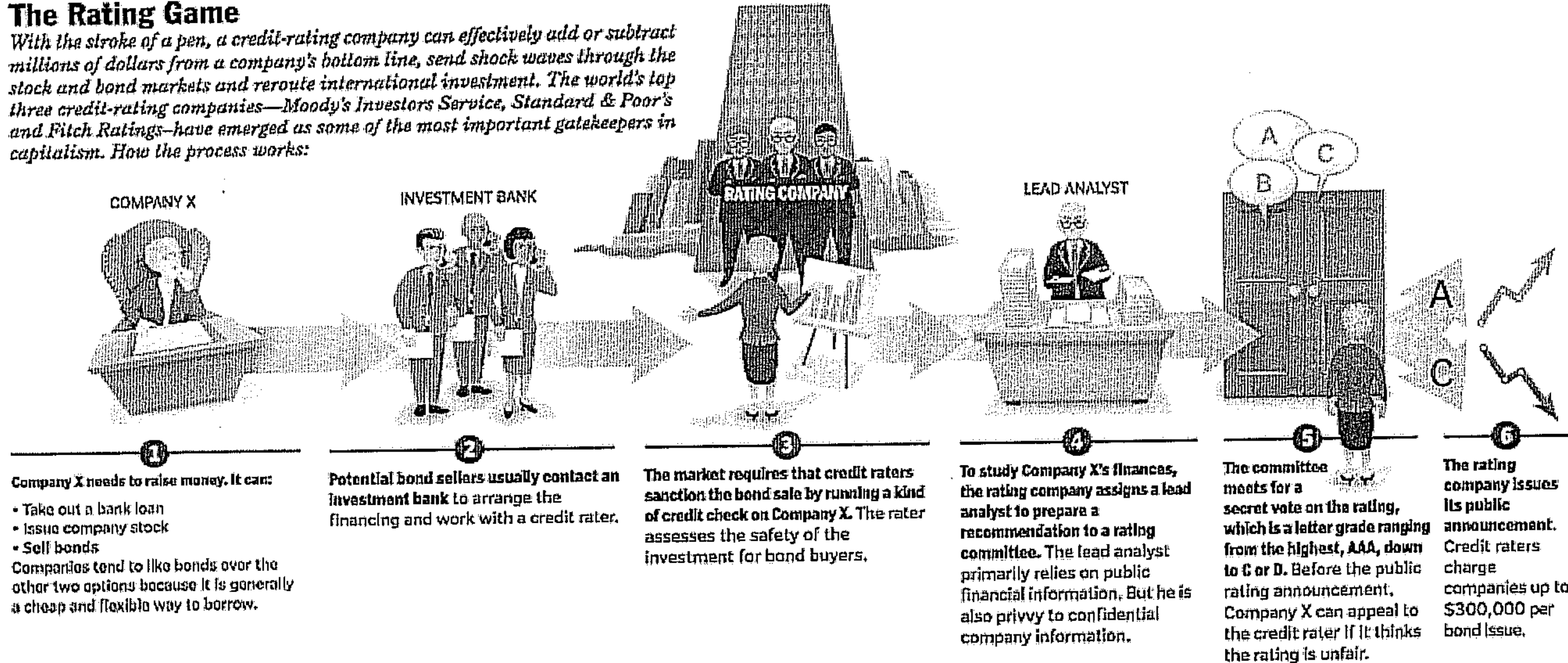
The Rating Game

With the stroke of a pen, a credit-rating company can effectively add or subtract millions of dollars from a company's bottom line, send shock waves through the stock and bond markets and reroute international investment. The world's top three credit-rating companies—Moody's Investors Service, Standard & Poor's and Fitch Ratings—have emerged as some of the most important gatekeepers in capitalism. How the process works:



1 **Company X needs to raise money. It can:**

- Take out a bank loan
- Issue company stock
- Sell bonds

Companies tend to like bonds over the other two options because it is generally a cheap and flexible way to borrow.

2 **Potential bond sellers usually contact an investment bank** to arrange the financing and work with a credit rater.

3 **The market requires that credit raters sanction the bond sale by running a kind of credit check on Company X.** The rater assesses the safety of the investment for bond buyers.

4 **To study Company X's finances, the rating company assigns a lead analyst to prepare a recommendation to a rating committee.** The lead analyst primarily relies on public financial information. But he is also privy to confidential company information.

5 **The committee meets for a secret vote on the rating, which is a letter grade ranging from the highest, AAA, down to C or D.** Before the public rating announcement, Company X can appeal to the credit rater if it thinks the rating is unfair.

6 **The rating company issues its public announcement.** Credit raters charge companies up to $300,000 per bond issue.

What is a bond?

A bond is a **certificate of debt sold by a government or company.** The bond seller raises money by borrowing a specific amount and promising to pay it back at a fixed time to bond buyers, who are usually institutional investors. The bond seller also agrees to make regular interest payments until its debt is paid off.

There are several kinds of bonds, including **corporate bonds, municipal bonds** and **Treasury bonds.**

Bonds can be traded, but when they mature at the end of their term, the principal is repaid to the bond owners. If a company goes bankrupt, bond holders generally are the first in line to be repaid.

Power of the Rating

A high rating can lower the interest rate a company pays to borrow money. A low rating can trigger a massive stock sell-off or a drop in bond price. It can also make it more expensive for the company to borrow money in the future.

GRAPHICS BY KAREN YOURISH AND LAURA STANTON—THE WASHINGTON POST

Credit Raters Exert International Influence

By Alec Klein
Washington Post Staff Writer
Tuesday, November 23, 2004; Page A01

Second of three articles

Canada's finance minister was fuming.

On the 21st floor of the government complex in Ottawa, Paul Martin glared at his aides and demanded: "Who the hell are they to pass judgment on us?"

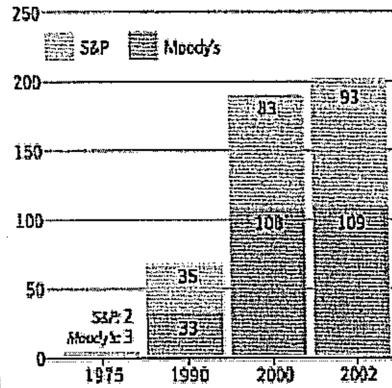
The target of Martin's anger: Moody's Investors Service, which had just made an announcement that stunned the financial markets. Moody's, one of the world's major credit-rating companies, had placed Canada's debt "on review for a possible downgrade" -- a signal that it was concerned about the country's finances.

News spun around the world. Almost instantly, the Canadian dollar dropped by about a half-cent against the U.S. dollar. The central bank didn't announce it, but behind the scenes it scrambled to stop the slide by buying back several hundred million dollars of its money. Investors dumped Canada's bonds and drove their interest rates higher, which would cost the government hundreds of millions of dollars.

The warning by Moody's in late February 1995 -- not even the downgrade itself, which came later -- was enough to roil financial markets and send a major sovereign nation scurrying to restore order.

Martin, now Canada's prime minister, acted quickly to allay Moody's main concern. According to government officials present at the time, he inserted stronger language into his budget speech to emphasize the need to attack the nation's debt, using such sturdy terms as putting "our fiscal house in order" and citing the "dangers of the deficit."

At the time, nations were just beginning to awaken to the widening influence of credit-rating companies. Since the Canadian clash, changes in the global economy have further strengthened the gatekeeping role of Moody's and its main competitors, Standard & Poor's and Fitch Ratings. The flow of international capital has surged, and nations that want to borrow their share have been forced to accommodate the big three rating firms.



With the credit raters' stamp of approval, nations borrow about $20 trillion -- about 40 percent of the debt floating worldwide -- to build roads, schools and other projects that help to define a society. But access doesn't come cheap. From Canada to the Dominican Republic, many have complained bitterly when their bonds were graded lower than they thought they should have been and their cost of borrowing rose accordingly.

For the credit-rating companies, there's an incentive to rate as many nations as possible: They make money by directly billing each country for the service. At Moody's, for instance, international operations, which include sovereign ratings, accounted for about a third of its total revenue last year, and grew by 32 percent -- nearly double the growth rate of Moody's U.S. operations.

The expansion abroad is having a tangible effect as credit raters often have more sway over foreign fiscal policy than the U.S. government. Last year, for example, American politicians accused China of keeping its currency artificially low to maintain an advantage over American manufacturers. But when President Bush tried to marshal international pressure on China to revalue its currency, rating firms took the wind out of the U.S. campaign by saying it would jeopardize China's credit rating.

Publicly, the rating companies say their international clout is overstated, but privately, officials take note of their growing global importance. About a year ago, when S&P issued a report anticipating more downgrades of European companies, "immediately my phone lights up like a Christmas tree," recalled one S&P official, who spoke on condition she not be identified. "The bond market traded down. I'm not necessarily proud of that, but there's an influence there. We have an immediate impact. Prices get hit across the board."

Other major players in the global financial markets have power, too, though not in the same way. Banks wield much influence through their lending and dealmaking, but there are many of them from many nations, all jostling in a competitive marketplace -- and in many countries they operate under tight banking laws. The International Monetary Fund, World Bank and United Nations have vast economic reach as well, but they are ultimately accountable to their member nations. The big three rating companies are regulated by no international bodies, checked by no significant competition.

Jochen Sanio, president of Germany's financial regulator, BaFin, said the major rating companies generally do a good job, but they nevertheless have become "uncontrolled world powers." He said there are "only three rating agencies who dominate the market,"

and they do so without international regulations "to guarantee independent and transparent rating procedures."

Regardless of regulations, the rating companies say their integrity depends upon being disinterested. If they abused their role, they say, investors would soon stop using their services. They also say their global reach allows more nations and companies to raise money by issuing bonds at reasonable rates.

"We've played an invaluable role in terms of the growth of the capital markets," said Vickie A. Tillman, S&P's executive vice president. That includes "countries being able to raise capital so they're able to invest in their businesses, expand their businesses, create infrastructure projects" such as roads and schools.

Fitch declined to make its officials available for comment, but spokesman James Jockle said in an e-mail, "We believe that if ratings begin to disappoint investors, they will stop using them as a tool to assess credit risk."

Moody's President Raymond W. McDaniel Jr. said his company's work has "benefited both investors and market efficiency. That is a verifiable track record."

A Quiet Power Broker

Martin wasn't the only Canadian in 1995 wondering who was behind the questioning of his country's finances. The press went looking, too. They found Vincent J. Truglia.

Until then, Truglia was an obscure Moody's employee in his forties, a Bronx native and one of hundreds of credit analysts based at headquarters in New York. But soon Canada's news media were calling him more powerful than the prime minister. Interest in Truglia, the lead analyst on Canadian debt, got so intense that reporters tried without success to learn the color of his eyes. (Brown.) But in keeping with the stance of Moody's and other credit companies, who like to keep their analysts in the background, Truglia declined to reveal much about himself. (He remains reticent today. Moody's declined to show his office to outsiders and wouldn't allow his photograph to be taken.)

Perhaps for good reason: Moody's made a lot of Canadians mad. When the credit rater considered cutting Canada's debt, and its interest rate rose, the government suddenly faced the prospect of about $300 million in added payments on its bonds.

While just a fraction of Canada's overall debt, it was a significant cost for a cash-strapped government about to lay off 45,000 employees. The government, for example, spent about $300 million on the annual compensation of about 5,000 civil servants and the same amount on the yearly pensions of about 50,000 senior citizens.

Making matters worse, the finance minister thought Moody's got it wrong. Indeed, in a news conference just after his budget speech, the finance minister took the credit rater to

task, saying, "It doesn't take a stroke of genius to understand that we have broken the back of the deficit and, in fact, that the rating agencies should have no concerns."

Moody's was unmoved. That April, the credit rater pulled the trigger, downgrading Canada's domestic debt rating to "Aa1," a notch below the coveted "AAA." S&P had a different take, affirming Canada's triple-A domestic rating, but it did revise its outlook on Canada's foreign-currency debt, changing it to "negative" from "stable."

Whether Moody's was right remains debatable. This much isn't: It took Canada more than seven years to get that triple-A rating back in May 2002. Martin declined to comment about Canada's rating.

Truglia played down the impact of the credit rater. "We're the metaphor for the market," he said. "There's definitely an influence, but I think it's greatly exaggerated."

Some governments disagree, especially those of poorer nations that often depend on tapping the debt markets to fund growth. "It is sometimes joked that the most important event for a developing country is having an official from a rating agency come visit them," the Financial Policy Forum, a nonprofit educational institute, said in a report last year.

The visit comes at a price. Governments usually pay six-figure annual fees for their sovereign ratings, plus $30,000 to $220,000 for each bond offering, according to rating and government officials. What a nation gets in return is an assessment of the government's ability -- or willingness -- to pay its debts.

Dominican Difficulties

Rating nations is similar to analyzing companies; whether the borrower is a government or corporation, it usually goes to an investment bank to arrange its financing. The bank also typically picks the rating companies it wants to grade the debt offering.

But sovereign ratings come with more unknowns, such unpredictable things as poverty, recessions, social unrest, wars and coups.

Many developing nations, in particular, have a love-hate relationship with credit raters. They often prefer to borrow money on the open market by selling bonds rather than raising taxes or cutting spending as a condition of borrowing from the IMF and other international organizations. As a result, an increasing amount of rating revenue is coming from developing nations, and some critics argue that puts even more global power in the hands of the rating companies. Indeed, bond offerings have become so popular that they recently surpassed bank lending as a source of private capital to developing nations, according to the Financial Policy Forum.

But countries sometimes resent putting their financial fate in the hands of foreign influences. That is certainly the case in the Dominican Republic.

During the 1990s, it had one of the fastest-growing economies in Latin America. But building projects often went neglected for decades, overshadowed by the social needs of a nation with more than half of its 9 million people living in poverty on an island about 1 1/2 times the size of Maryland.

The Dominican Republic debuted its first international bond in September 2001, raising $500 million in a five-year issue with a 9.5 percent interest rate. Moody's rated the nation "Ba2," a slightly speculative grade. S&P, using its own grading system, gave it essentially the same score. Dominican officials said they have paid about $100,000 to each credit rater.

Andres Dauhajre was frustrated with the nation's rating. The head of an economic think tank in the Dominican capital, Dauhajre was hired by the government to handle its debt offering on Wall Street. The rating companies, which he said spent about a week visiting his country, focused largely on the central bank's relatively low levels of foreign cash reserves while overlooking a decade of economic strength, he felt.

S&P said its analysts visit the Dominican Republic at least once a year, but the company did not provide details of those visits. Moody's also declined to describe the extent of its visiting.

Things got worse last year when the nation was rocked by a banking scandal that cost the country more than $2 billion. People began stuffing money in their mattresses. The peso went south. And the cost of paying the nation's debt in foreign currency went north. Moody's and S&P downgraded the nation. By the fall of 2003, the Dominican Republic was languishing with the unenviable tag of "very speculative."

Since then, economic conditions have become even worse, and the major rating companies downgraded the Dominican Republic again this year, saying the government may default. Still, some economic experts say the rating companies have acted too quickly.

"The economy is in moderately bad shape, but I wouldn't say it's in the worst position compared to other countries," such as Argentina, said Claudio Loser, the IMF's former director of the Western Hemisphere who is now a senior fellow at the Inter-American Dialogue, a Washington think tank.

Argentina defaulted on $82 billion in foreign debt -- the largest default in history -- in 2001. Economic experts do not expect anything in the Dominican Republic on a par with Argentina's meltdown even if conditions deteriorate further. But rating companies "tend to overreact and, if a country is in a difficult situation, they may aggravate the situation and make it worse," Loser said.

Painful Choices

Economists say it is all but impossible to isolate the impact of a ratings downgrade from other factors influencing a nation's financial fortunes -- elusive things such as pecuniary politics and monetary policy that indirectly touch the lives of a country's people.

But in the case of the Dominican Republic, some of the nation's choices after the downgrade were painful. Among the first things to go were road building and repairs. On a recent trip, visitors were greeted by the smooth asphalt of Las Americas Highway, which snakes from the airport to the capital, Santo Domingo, but ends in a mass of concrete slabs and steel roads. The government was supposed to finish the 12-mile-long road but work halted this year when the borrowing stopped.

Road repair also stopped in the heart of the Neiba region near the Haitian border, where farmers like Rigoberto Caesar Jimenez felt the consequences. To reach Jimenez's grape farm, produce trucks must navigate a dirt road with a ditch along one side. When government crews stopped coming around to fix the road, it became even more of a problem. "Sometimes, I use people who transport grapes by basket on foot," he said.

The government also dropped plans for water-purification projects in impoverished rural areas about 200 miles west of the capital. In one dusty hamlet carved out of the sugar cane fields, the only source of drinking water remained a polluted stream. Altagracia Gonzalez and her family run a pipe from the stream into a concrete pit near their hut. She pours Ajax Cloro, a disinfectant, into the murky, gray puddle to make it drinkable.

But, she said, "I don't know how clean the water is." Sometimes she carries her 18-month-old niece several miles to a public hospital for a stomachache that won't go away.

Many others have claimed hardships resulting from rating downgrades. When Malaysia's credit rating was cut in 1998, the government immediately put the brakes on a $2 billion bond offering that was aimed at helping to resurrect its economy. In recent years, Japan and South Korea have complained about the economic effects of downgrades as well. And in a 2002 IMF working paper, the author wrote that rating companies have been criticized for "precipitous downgrades that exacerbate already stressed situations."

The rating companies say their opinions aren't the cause of economic problems, but rather a reflection of them, as in the Dominican Republic. And yet, Truglia, now the managing director who oversees Moody's sovereign rating unit around the world, isn't sure whether the recent downgrades have compounded the country's economic woes. "It's hard," he said, "to separate it out."

Staff researcher Carmen E. Chapin contributed to this report.

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Credit Ratings

Alec Klein
Washington Post Staff Writer
Tuesday, November 23, 2004; 2:00 PM

Washington Post reporter **Alec Klein** was online **Tuesday, Nov. 23, at 2 p.m. ET** to talk about his three-part series on the enormous power wielded by Wall Street's three major credit-rating firms -- **Moody's Investors Service, Standard & Poor's** and **Fitch Ratings**.

In Part I of the series, titled "Unchecked Power," Klein looked at how the three firms have come to dominate an important sector of global finance without formal oversight. Part II focused on how the credit-rating firms influence the ability of nations to borrow capital, and Part III will look at the firms' business practices, which some corporations say has led to abuses.

A transcript of the discussion is below:

Editor's Note: Washingtonpost.com moderators retain editorial control over Live Online discussions and choose the most relevant questions for guests and hosts; guests and hosts can decline to answer questions.

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washington, d.c.: Enjoying the series. After reading today's installment I wondered why more international organizations haven't objected to the power of the rating companies. Are they too frightened to challenge them?

Alec Klein: Good question. Many companies, both domestic and international say they are too afraid to speak out against the rating companies because the credit raters hold so much sway over their financial fortunes. But some sovereign nations--from Japan to Canada--have complained bitterly about what they perceive as unfair or inaccurate ratings. Various international organizations also have called for industry reform. But so far, there's been no action. The Securities and Exchange Commission, which oversees the industry, has studied the issue for more than a decade, and it says it continues to look into it.

Fairfax, VA: Excellent work ! In the first two article you folks have explained the issue very well. But other than insistence of "some regulatory oversight" I did not see any concrete suggestion for any solution. Problem stated without potential solution is just a "complaint". I suppose in the third article I would see some potential solutions. My suggestio is UN version of GAO can solve many problem uncluding this one.

Keep up the good work.

Alec Klein: Thanks. If regulatory solutions are to emerge, they will likely come from Congress or the SEC--or from regulators abroad. All have expressed serious misgivings about the credit rating business. Republicans and Democrats have been especially disturbed by what they see as the credit raters' failure to anticipate such meltdowns as Enron and WorldCom. At the SEC, officials are looking at such issues as conflicts of interest, access to confidential data and potential anticompetitive practices.

Arlington, Va.: Are we really to believe that the directors of these rating companies, who sit on boards of companies that get rated, have no influence on ratings?

Alec Klein: Moody's says that its board members have no involvement in the ratings of companies on which its board members serve. But the situation raises at least the appearance of a conflict of interest, according to industry critics. Moody's, for its part, says that it has little choice because it wants the best people to serve on its board, and it believes that some of those people come from the companies it rates. It stands in contrast to much of the reform sweeping across corporate America, but so far, Moody's board hasn't been challenged by regulators.

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washingtonpost.com:

The Series:
Day One: Borrowers Find System Open to Conflicts, Manipulation
Day Two: Credit Raters Exert International Influence
Day Three (Wednesday): **Flexing Business Muscle** -- Lack of oversight has left the rating companies free to set their own rules and practices, which some corporations say has led to abuses. The credit raters have rated companies against their wishes and ratcheted up their fees without negotiation.

Rockville, MD: Mr. Klein: Why do you think the credit rating companies have operated under the radar for so long? I guess I used to think they were some kind of government-created agencies. I was surprised to discover they are profit making companies.

Alec Klein: Given the raters' power, it is indeed remarkable that the industry has operated under the radar. Some of it has to do with the fact that it's a complicated business that many don't understand. Also, it's clients are businesses, not individuals. In addition, until Enron and WorldCom and other corporate meltdowns, there was little

political pressure for Congress to take action. Even when there has been a call to reform the industry, it hasn't lasted.

Madison, Wisconsin: Good Morning,

I found your articles on the rating agencies to be very well done. As a CIO for a life insurance company its nice to finally find someone who is willing to look at the reality of the rating process and not just the outcomes. My question, comment, or gripe is as follows:

The rating agencies are susposed to do two primary things; (1) rate companies and entities over the business cycle and (2)understand the business models of the entities they rate. This means that a rating should be stable (predictable) and reasonable as compared to other entities with the same rating.

I see neither of this by either of the big two agencies. When you did your research did you discuss rating volitility? After 9/11 and post Enron, the rating agencies (an analyst in general)showed their ignorance in understanding business models and helped to create a situation where many good companies were endangered of not being able to roll debt over. They have done the same thing with "insurance" post Marsh Mclean - they didn't understand the business model and now the insurance industry has ratings risk. When 40% of M/M earnings are tied to commission rebates, I view this as material information and someting a rating agency/analyst would be aware of. Its not their view - today!

Bottom Line: The rating agencies look at default ratios. I think a more telling graph is the number of rating changes per year. Rating agencies do track up/downgrades, but they don't look at rating changes as a problem. As an investor, this is my biggest issue. Their ratings should be stable for the long-term, because the debt instruments they are rating are long-term contracts. Also, the rating agencies are using possitive and negative outlooks to bias the investment community on situations without ever making changes. In other words, if they don't change the rating and something goes wrong they "speak about the negative outlook" and if something doesn't go wrong or then they say they didn't change the ratings.

Thanks,
Bob

Alec Klein: Thanks. You're describing a situation that I've heard from others in the corporate world. There's a palpable sense among many I've interviwed that the rating companies have it both ways. They serve, on the one hand, an almost regulatory function by approving the bond sale of companies and countries alike, and yet the raters themselves are virtually unregulated. Few, however, have come forward to publicly complain to federal regulators.

Jeddah, Saudi Arabia: 1. Do credit rating companies use uniform standards that facilitate the comparisons of their rates?

2. Do governments (e.g. U.S. government) have any influence on the outcome of the rating?

Thank you

Alec Klein: The rating companies say that they assess the finances of companies and countries through a combination of qualitative and quantitative factors. It's not simply a matter of punching in a series of numbers and coming out with a letter grade, they say. So, to that extent, their work differs. And yet, for the most part, their ratings tend to be similar. As for your second question, government officials throughout the world say they wish they had more of a say in the ratings process, and many say they are concerned that the rating companies in some cases have more influence on economic policy within their own borders.

Monterey, CA: Please forgive my lack of information...

Do these firms rate the credit-worthiness of the US Government? I know they rate states.

Have they downgraded any national, state, or local government's financial viability to a dangerous level yet?

Is that something that could happen sooner than later?

Alec Klein: Good questions, all. The first--yes, they do rate the U.S., along with scores of other sovereign nations. And yes, they have downgraded nations and municipalities to the extent that some have complained that the credit raters' have hindered their ability to raise money to deal with significant economic problems. Officials of the Dominican Republic, for one, say that its economic woes have been compounded by rating downgrades, and now it's in jeopardy of defaulting. Such complaints come from various corners of the globe.

Rockville, MD: What impact do the credit rating agencies have on people like me who have a significant amount of retirement savings in pensions, 401k and IRAs? Are there other ways in which "typical Americans" can be hurt by the oligopoly power held by Moody's and S&P?

Alec Klein: A good question. At a recent hearing, Congressman Kanjorski made the point that investors little understood the risks associated with such companies as Enron and WorldCom because they had been given strong ratings by the credit raters. The result, he pointed out, is that investors lost billions of dollars. Such losses would potentially impact retirement savings and other investment accounts of investors across the world.

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rochester, ny: No question the rating agencies are powerful and far from omniscent. To me, it seems your series blames them. But shouldn't investors bear the responsibility? Who says investors have to listen to the agencies?

Alec Klein: Investors do have responsibilty. But what sometimes confuses the issue is that the federal government has given a select number of rating companies a national designation, and investors have come to view that as the U.S. government's stamp of approval. Now, various mutual funds and other investment portfolios will only invest in bonds given good ratings by those credit raters given that national designation. When they miss big financial meltdowns at Parmalat, among others, it at least raises the question about that national designation. There are, for instance, no regulations or laws about how a rating agency can get the designation.

Boston, MA: Seems like you fault the agencies for being too slow in some instances (Worldcom, Enron), and too quick and harsh in other instances (Canada, Dominican Republic). How do you propose this "can't-win" situation be remedied?

Alec Klein: That's what the rating companies say. They feel they get criticized for being too quick to react to problems, or too slow. They say they serve the public by giving investors a sense of the creditworthiness of a company or other entity. But their business model has raised questions. The big three rating companies get paid fees by the very entities they are rating, and some critics say that has proven to influence the process.

Washington, D.C.: It seems that big companies are worried that rating firms -- even individuals at the firms -- hold their destinies in the palms of their hands, potentially subject to the slightest whims. But they don't complain because they're terrified of offending the raters. Why do they put up with it? These are people who are willing to send lobbyists into the halls of government to spit in some senator's eye.

Alec Klein: In interviews, some companies say they simply can't afford to alienate the credit raters when they depend on the ratings to access the debt markets and issue bonds to fund their growth. In some cases, companies and municipalities say they have been punished with what they call a hostile rating--a lower rating than they say they deserve--

because they did not want to cooperate with the rating companies. They say they feel the impact in real terms: If the rating companies lower a company's ratings, it can raise its interest raise and cost it potentially millions in additional payments.

Princeton, NJ: Since Moody's rates virtually every publicly listed corporation, who would you propose should serve on their Board of Directors who would not have a current or past relationship with a rated entity?

Alec Klein: Moody's makes a similar point. They say they want to have the most qualified people on its board, and they believe they tend to come from the corporate world it rates. And yet, some industry observers believe that there enough qualified candidates outside of the rater's realm of ratings. Board conflicts have become paramount in many circles, as the New York Stock Exchange can attest.

Silver Spring, MD: You have described many troubling issues associated with the big three credit-rating agencies. Is the SEC--who I see didn't comment for your articles--really that interested or concerned about the performance of Standard & Poors, Moody's, and Fitch? I remember hearing about them studying this issue ten years ago without them acting. If the government is not interested, are there other organizations that are trying to identify the solutions?

Alec Klein: Good memory. Over the past decade, the SEC has periodically studied the rating industry, but taken no action. Usually, the regulators have stepped up their activity in the wake of a particular corporate meltdown. But when the issue dies down, so it appears does the scrutiny. The SEC, it's fair to point out, has been busy with a host of major corporate issues. But it says it is studying the issue now and hopes to make recommendations relatively soon. If the SEC doesn't act, some members of Congress have said they might take matters into their own hands to try to reform the industry. That includes Rep. Kanjorski of Pennsylvania and Rep. Baker of Louisiana.

Hyattsville, MD: Are there specific formulae involved in how credit ratings are assigned? How much rationale is made public? If an individual applies for a bank loan, for example, the bank is furnished with a detailed credit history report, not just a number. If the individual sees errors in the report, she can (arduously) work to get these corrected. Do firms and countries rated by Moody's, S&P, or Fitch's have similar access to their records? Is there any process for appeal?

Alec Klein: The rating companies say they make their methodologies publicly available through pamphlets and the Web, but many companies, nations and those on Wall Street say that the ratings process remains largely a mystery. The rating companies do not

reveal who within their firms voted on borrower's rating. They don't reveal how the vote broke down. They do, however, publish their results, including the letter grade and the rationale for the rating. Still, the big rating companies say that their deliberations remain a private matter, and how they come up with a conclusion is a mixture of qualitative and quantitative factors.

Virginia: If all the big companies pushed for reform, wouldn't they get it? Do they benefit in some way from an unregulated rating industry?

Alec Klein: There has been a quiet but growing call for regulatory action. The Association for Financial Professionals, which represents thousands of corporate financial officials in the United States, has done various surveys that show its members are unhappy with the accuracy and timeliness of their ratings. Counterparts in Great Britain and other parts of Europe have made similar complaints and called for similar action. Other complaints have emerged from Asia and Latin America. It still remains to be seen, however, how the SEC will respond to these concerns.

Rockville, MD: To what extent are the models open for these ratings? I'm sure the consumers of this information in the financial markets like the ratings but they're sort-of a synical lot (working in the equities research part of the industry myself). Does Fitch, Moody's or S&P license the underlying data elements and weighting or just the end-result ratings?

Alec Klein: The rating companies they their models are generally open, and in some cases, they do sell some proprietary financial models. But many in the corporate world say the basic ratings process remains too opaque; many say they would like to see how the raters handle conflict of interest issues and how they handle the use of confidential corporate data.

Alexandria, VA: How do these companies stand up to standards they check? Do they have AAA credit ratings?

Alec Klein: Moody's does give an investment-grade rating to S&P's parent company, McGraw-Hill. The rating companies, however, say they have little interaction with each other otherwise.

Washington, D.C.: Recently, a Northern Virginia political leader advised that the reason Virginia's AAA bond rating was in peril last year was because Gov. Warner forced the

rating agency to do that - Warner wanted to use that as a reason for his propposed tax increases. I seriously doubt that the agencies could give a damn about political leaders. Do you think that partisan politics ever plays a role in ratings?

Alec Klein: Hard to speculate, but I've interviewed others who have explained how governments have at least sought to state their case to the credit raters. The raters say they do not allow such political pressure to influence their ratings.

Washington, DC: Mr. Klein: I've missed your reporting. Glad to see you've been working on such an important issue. What made you decide to tackle this particular subject? Jennifer Sheffield

Alec Klein: Thanks; credit goes to my editor, Larry Roberts, who asked that I look into this little-known industry.

Fairfax, VA: If these rater rate US, then how come US Congress and SEC regulators will not create "conflict of interest" situation ?

Alec Klein: It's a persistent question among many on Wall Street and throughout the world. The question, though, remains largely unanswered as regulators continue to study the issue.

Jeddah, Saudi Arabia: You mentioned in the first article that a company may appeal its rating with the respective rating company. This may be reasonable for companies in the US since they have the chance to dispute the rating through the judicial system. However, for sovereign nations to appeal their rating with a company may not be appropriate and in most cases they would not have access to the same courts. What are your views on this issue? and is there any other proposed mechanism to handle disputes internationally?

Thank you.

Alec Klein: Many government ask the same question. In the United States, the credit raters have successfully defended their rating as opinions protected by the First Amendment. Overseas, many governments have complained that the credit raters are outside influences trying to dictate their own national policies. So far, there is no recourse. But in Europe, especially, regulators are beginning to band together to see if there's a way to confront the issue.

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washingtonpost.com:

Thank you all for your questions. The third day of Alec's series will appear in Wednesday's paper and online at http://www.washingtonpost.com/wp-dyn/business.

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Smoothing the Way for Debt Markets

Firms' Influence Has Grown Along With World's Reliance on Bonds

By Alec Klein
Washington Post Staff Writer
Tuesday, November 23, 2004; Page A18

The credit-rating business was the creation of a young man who got his start at a Wall Street bank in 1890 as an errand boy for $20 a month.

Dreaming of becoming a millionaire, John Moody had an epiphany one morning while reading the newspaper. With so little known about a growing number of corporate securities, someone was bound to publish an industrial manual offering financial information to investors. "When it comes," he recalled thinking in his autobiography, "it will be a gold mine."

In 1909, Moody started mining. He published a book about railroad securities, using letter grades to assess their risk. Investors looking for more certainty liked the idea, and the Moody business took off. So did Poor's Publishing Co., which began rating corporate debt in 1916, according to its successor company, Standard & Poor's. Standard Statistics Co. followed suit in 1922. Fitch entered the rating business in 1924.

In the ensuing decades, corporate America has increasingly turned to credit raters to smooth the way for its loans. As recently as the 1980s, companies did about half of their borrowing from banks. Now, the vast majority comes from the debt markets, which offer lower rates.

Over the past 30 years, the credit raters have also made significant inroads overseas, rating sovereign governments. In the 1970s, S&P rated only the United States and Canada; Moody's Investors Service added a third, Australia. None was a risk. That began to change when sovereign ratings took off in the 1980s and 1990s. By the year 2000, the major companies were rating about 100 nations each.

By most measures, the influence of the rating companies has continued to grow along with the size of the market for bonds and other debt, which is about $52 trillion worldwide. In the United States alone, about $21 trillion in debt was in the market in 2003 -- about 50 percent more than the value of all shares of stock being traded in the U.S. markets -- and almost none of that money could flow without a rating.

Today, as many as 150 credit rating agencies operate worldwide. But effectively, only two -- possibly three -- matter.

Wall Street confirms this fact when brokers buy or sell a bond for a client. When they call up the issue on the computer screen, the screen almost always has only two or three spots for credit ratings. Investors expect ratings from Moody's and S&P, each of which controls

about 40 percent of the market. "You basically have to go to Moody's and S&P," said Dessa Bokides, a former Wall Street banker. "The market doesn't accept it if you don't go to both of them."

Third-ranked Fitch Ratings, which has about a 14 percent market share, sometimes is used as an alternative to one of the other majors.

"You're talking about an oligopoly," said Lawrence J. White, a former bank regulator and now economics professor at New York University's Leonard N. Stern School of Business. "Somebody who wants to buy wheat in the wheat market has a whole lot more choice than someone who wants to get a rating on a bond. There's three to choose from, and if you need more than one [rating], then you have to select two out of three, which in essence means you have one degree of freedom."

Staff researcher Meg Smith contributed to this report.

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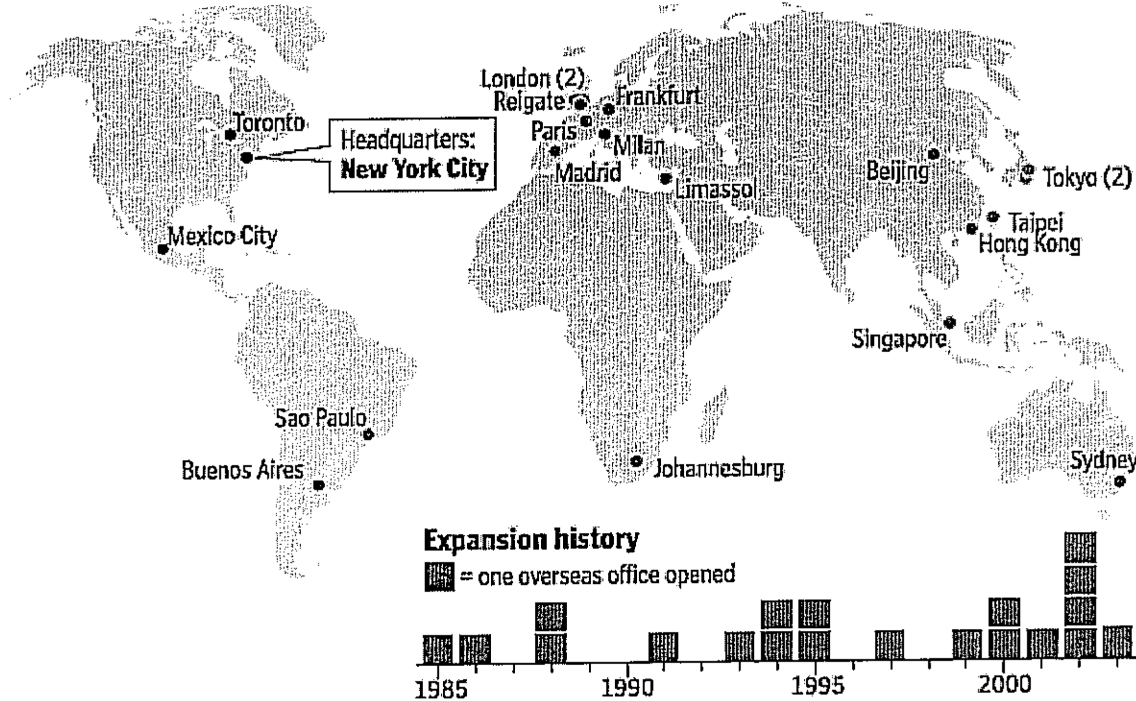
Moody's Overseas Expansion

Moody's overseas expansion began in earnest in 1985 when it opened its Tokyo office. Two decades later it has 20 overseas offices.



SOURCE: Moody's and public filings.

THE WASHINGTON POST

Credit Raters' Power Leads to Abuses, Some Borrowers Say

By Alec Klein
Washington Post Staff Writer
Wednesday, November 24, 2004; Page A01

Last of three articles

The letter was entirely polite and businesslike, but something about it chilled Wilhelm Zeller, chairman of one of the world's largest insurance companies.

Moody's Investors Service wanted to inform Zeller's firm -- the giant German insurer Hannover Re -- that it had decided to rate its financial health at no charge. But the letter went on to suggest that Moody's looked forward to the day Hannover would be willing to pay.

In the margin of the letter, Zeller scribbled an urgent note to his finance chief: "Hier besteht Handlungsbedarf."

We need to act.

Hannover, which was already writing six-figure checks annually to two other rating companies, told Moody's it didn't see the value in paying for another rating.

Moody's began evaluating Hannover anyway, giving it weaker marks over successive years and publishing the results while seeking Hannover's business. Still, the insurer refused to pay. Then last year, even as other credit raters continued to give Hannover a clean bill of health, Moody's cut Hannover's debt to junk status. Shareholders worldwide, alarmed by the downgrade, dumped the insurer's stock, lowering its market value by about $175 million within hours.

What happened to Hannover begins to explain why many corporations, municipalities and foreign governments have grown wary of the big three credit-rating companies -- Moody's, Standard & Poor's and Fitch Ratings -- as they have expanded into global powers without formal oversight.

The rating companies are free to set their own rules and practices, which sometimes leads to abuse, according to many people inside and outside the industry. At times, credit raters have gone to great lengths to convince a corporation that it needs their ratings -- even rating it against its wishes, as in the Hannover case. In other cases, the credit raters have strong-armed clients by threatening to withdraw their ratings -- a move that can raise a borrower's interest payments.

And one of the firms, Moody's, sometimes has used its leverage to ratchet up its fees without negotiating with clients. That's what Compuware Corp., a Detroit-based business software maker, said happened at the end of 1999.

Compuware, borrowing about $500 million, had followed custom by seeking two ratings. Standard & Poor's charged an initial $90,000, plus an annual $25,000 fee, said Laura Fournier, Compuware's chief financial officer. Moody's billed $225,000 for an initial assessment, but didn't tack on an annual fee.

Less than a year later, Moody's notified Compuware of a new annual fee -- $5,000, which would triple if the company didn't issue another security during the year to create another Moody's payment. Fournier said Moody's didn't do anything extra to earn the fee. But the company paid it anyway -- $5,000 in 2001; $15,000 a year later.

"They can pretty much charge the fees they want to," she said. "You have no choice but to pay it."

Moody's declined to comment on Compuware, but the firm said it now charges an annual flat fee of $20,000 for monitoring a corporate borrower to remove any confusion.

Dessa Bokides, a former Wall Street banker who founded a ratings advisory group at Deutsche Bank AG, said rating firms are continually finding new circumstances to extract fees. Frequently, she said, they charge clients for many different securities, even if the ratings all amount to the same thing: an assessment of a company's finances.

"They are rating every [bond issue] and charging for each [bond issue], but in reality, they're only rating the corporate" health, Bokides said. "It's a great business if you can get it."

For Moody's, the numbers add up: It rates more than 150,000 securities from about 23,000 borrowers, whose debt amounts to more than $30 trillion. Its revenue more than doubled in four years, to $1.25 billion in 2003, while its profit jumped 134 percent in that time.

The company said a rating costs between $50,000 and $300,000 for corporate borrowers. Moody's declined to provide a fee schedule, but according to a list obtained by The Washington Post, if it is the applicant's first rating in the past 12 months, there's an additional $33,000 fee. Then there's the monitoring fee ($20,000), a "rapid turnaround fee" ($20,000) and a cancellation fee (at least $33,000). For $50,000 more, a client can get an initial confidential rating.

S&P's fees are similar, according to a price list obtained by The Post.

The former finance chief of a major telecommunications firm was stunned when Moody's and S&P sent their initial bills. Each was six figures, not counting the annual maintenance fee. "I remember thinking their fees were outrageous," said the former

executive, who spoke on the condition of anonymity for fear of angering the rating firms. When he asked his banker about the fees, the banker said, "You've got to pay S&P and Moody's."

So he paid.

"Yeah, it's expensive for a few phone calls and a little analysis," the former executive said. "But guess what? Especially when you're a public company, your options are limited. Really, you've only got S&P and Moody's."

Many schools and cities take the same view. The credit companies rate their debt as well, but charge much less, typically in the thousands or tens of thousands, depending on the size of the bond offering. Still, every fee seems to count.

Louis J. Verdelli Jr., a financial adviser to school districts and other localities, knows as much. A municipality dissatisfied with a credit rater can have a difficult time getting rid of it, said Verdelli, a managing director of Public Financial Management Inc. of Philadelphia.

If, for example, a municipality stops paying a rating fee, the credit company may remove its ratings on previous bonds, which could raise questions in investors' minds and make it harder for the municipality to sell new bonds.

One investment banker in the Southwest said he encountered such a situation. Several years ago, he began representing a cash-strapped school district. Things had gotten so bad, the district raised the price of school meals.

To save money, the banker suggested that the district drop one of its two credit ratings. That would save less than $10,000, but would be better than cutting textbooks. Moody's fee was lower, so the banker decided to drop S&P. That is, until he heard from S&P. The credit rater gave him an option: Pay $5,000 for S&P's service, or it would pull all of its ratings.

The investment banker said he had no choice: He decided to pay for both ratings, which the school district continues to do. "We're just paying off Standard & Poor's, and we're costing taxpayers an additional $5,000, because we're concerned that the negative association of their pulling the rating would cost more than $5,000," he said. He spoke on the condition of anonymity, declining to identify the school district for fear of angering the credit raters.

Vickie A. Tillman, S&P's executive vice president, said, "We reserve the right to withdraw our opinion" when the firm does not have enough information to reach a conclusion, and S&P would never "compromise its objectivity and reputation" by withdrawing it for any other reason.

Unsolicited Opinions

Some U.S. lawmakers have raised another area of concern: The credit raters have a privilege but little responsibility under a government rule that gives them access to confidential information from a company being rated.

The rating companies say they need such inside data. But when they miss financial meltdowns such as Enron Corp., WorldCom Inc. and the Italian dairy company Parmalat Finanziaria SpA, the raters argue that despite having had insider access in many cases, they can't be blamed for investor losses because they can't detect fraud. "The job of insuring the accuracy of those source materials belongs to auditors and regulators," said Frances G. Laserson, a Moody's spokeswoman.

Rating companies sometimes give yet another perspective about inside information. When rating a company without its cooperation, the credit raters occasionally say they don't need non-public information. They call such ratings "unsolicited"; others in the industry call it a hostile rating.

Moody's estimates that less than 1 percent of its ratings are unsolicited. Tillman said S&P rarely does unsolicited ratings, and generally only if a company borrows more than $50 million, explaining that the credit rater considers it a public service to rate major offerings. James Jockle, a Fitch spokesman, said that more than 95 percent of the companies it rates "agreed to pay our fees."

However, corporate officials, investment bankers and others familiar with the rating firms' strategies say there's a reason unsolicited ratings don't appear common: Companies approached that way by credit raters usually agree to pay a fee rather than risk a weak rating made without their cooperation.

An S&P executive, who spoke on the condition of anonymity because the firm hadn't authorized her to comment, said that S&P maintains a sales force -- what it calls an "origination team" -- whose goal is to improve revenue by finding companies to rate and charge a fee. "Some of it is cold calling," she said.

Northern Trust Corp., the big Chicago -based bank, said in a recent letter to the SEC that it "has been sent bills by rating agencies for ratings that were not requested by Northern, and for which Northern had not previously agreed to pay." In his letter, James I. Kaplan, then the bank's associate general counsel, continued, "On occasion, we have paid such invoices in order to preserve goodwill with the rating agency, but we feel that this practice is prone to abuse." Northern Trust declined to elaborate.

In 1996, the Justice Department looked into similar unsolicited practices by Moody's. At about the same time, a Colorado school district sued Moody's, claiming it got an unsolicited negative rating -- a hostile rating -- because the district had refused to buy the Moody's service. The Colorado case was dismissed in 1997, after a judge ruled the rating firm's statements about the school district were opinions protected by the First Amendment. Justice took no action, but did fine Moody's $195,000 in 2001 for obstructing justice by destroying documents during its investigation.

Fitch also has been criticized for unsolicited ratings. In the late 1990s, after being dropped as a paid credit rater of Simon Property Group Inc., the largest U.S. owner of regional shopping malls, Fitch did an unsolicited rating of the company. Some mall company officials were dismayed that Fitch didn't announce that its rating was done without Simon's cooperation.

Fitch said any requirement that it disclose unsolicited ratings would "inappropriately interfere in the editorial process of the rating agencies."

When asked by The Post about unsolicited ratings, S&P's Tillman said her firm is "in the process" of changing its policies so investors will be able to tell whether they are looking at a rating done with a borrower's cooperation. Moody's said the last time it issued an unsolicited rating without identifying it as such was in 2000. And in October, the company began to publicly identify unsolicited ratings.

Greg Root, a former official of the Canadian rater Dominion Bond Rating Service Ltd. who also worked at S&P and Fitch, said that making such disclosure is important because, "when a rating agency does a rating, there's the impression there's a formal due diligence and that they get non-public information. Investors assume there's a strong ongoing dialogue."

Whether an unsolicited rating is a form of coercion to earn fees is another matter, Root said: "It's always a fine line."

A Hard Sell

Moody's danced along that line when it began its push into Europe in the late 1980s, according to former company officials. It began writing letters to European companies, saying it was planning to rate them. Moody's invited the companies to participate in the ratings process; however, if they didn't, the credit rater said it felt it had adequate public information to do a rating anyway.

"That was the hook. That's where we were trying to get into the door and send them the bill," said W. Bruce Jones, now a managing director at Egan-Jones Ratings Co ., a small rival of Moody's. "The implied threat was there."

Moody's took a similar approach in mid-1998 when it approached Hannover, the big German insurance company that provides insurance for other insurance companies, helping to spread the risk in the event of a major catastrophe.

Hannover had become one of the largest reinsurers in the world, with about half of its business in the United States. Insurers must be able to demonstrate to outsiders that they have the financial strength to make good on their policies. Hannover was already paying fees for that purpose to S&P and A.M. Best Co., a leader in the insurance rating industry. They had both given Hannover high ratings.

"So we told Moody's, 'Thank you very much for the offer, we really appreciate it. However, we don't see any added value,' " said Herbert K. Haas, Hannover's chief financial officer at the time.

As Haas recalls it, a Moody's official told him that if Hannover paid for a rating, it "could have a positive impact" on the grade.

Haas, now chief financial officer at Hannover's parent company, Talanx AG, laughed at the recollection. "My first reaction was, 'This is pure blackmail.' " Then he concluded that, for Moody's, it was just business. S&P was already making headway in Germany and throughout Europe in rating the insurance business. Moody's was lagging behind. And, Haas thought, Hannover represented a fast way for the credit rater to play catch-up.

Within weeks, Moody's issued an unsolicited rating on Hannover, giving it a financial strength rating of "Aa2," one notch below that given by S&P. Haas sighed with relief. Nowhere in the press release did Moody's mention that it did the rating without Hannover's cooperation. But, Haas thought, it could have been worse.

Then it got worse. In July 2000, Moody's dropped Hannover's ratings outlook from "stable" to "negative." About six months later, Moody's downgraded Hannover a notch to "Aa3." Meanwhile, Moody's kept trying to sell Hannover its rating service. In the fall of 2001, Zeller, Hannover's chairman, said he bumped into a Moody's official at an industry conference in Monte Carlo and arranged a meeting for the next day at the Cafe de Paris. There, the Moody's official pressed his case, pointing out that the analyst who had been covering Hannover -- a man whom the insurer disliked -- had left Moody's. Zeller still declined Moody's services.

Two months later, Moody's cut the insurer's rating by two more notches to "A2." In December 2002, the rating firm put Hannover on review for another possible downgrade. Somewhere along the way, Haas appealed to his boss to yield.

"I said, 'Ultimately, you cannot win against the rating agency. Let's bite the bullet and pay,' " Haas recalled. "But for Willie [Zeller], it was a matter of principle. He said, 'I'm not going to pay these guys.' "

In March 2003, Moody's downgraded Hannover's financial strength rating by two notches and lowered its debt by three notches to junk status, sparking a 10 percent drop in the insurer's stock. S&P and A.M. Best, both of which were privy to the German insurer's confidential data, continued to give Hannover a high rating.

Industry analysts were confounded. "The scale of the Moody's downgrade was a surprise," said Damien Regent, an analyst at UBS AG, in a research report at the time. "There was no new information in the public domain to justify a three-notch downgrade."

Larry Mayewski, A.M. Best's executive vice president, said he thinks Moody's has been using unsolicited ratings to get companies like Hannover to buy its services.

Moody's declined to comment for this article about Hannover, but in its reports on the insurer, it said it was concerned that the German company had "high levels of financial and operational leverage" and a "high level of reinsurance recoverables" due to it. Since then, Moody's has softened its stance, raising Hannover's outlook from "negative" to "positive." But it still rates Hannover's debt as junk.

Zeller called the latest downgrade "ridiculous." But when his company's stock dropped sharply, he began to wonder whether he had any recourse.

As in the United States, lawmakers in Germany and elsewhere in Europe have taken a look at credit raters. But there has been no action. And Zeller isn't optimistic about the prospects of change.

"They have built up such a franchise," he said, "it's difficult, if not impossible, to do anything against it."

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GATEKEEPERS: *The Unchecked Power of Credit Raters*

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Big Misses

Critics point to what they call some of the credit raters' biggest misjudgments over the last four decades:

Penn Central Railroad car

A 1975 rally for fiscally tarnished New York.

Hong Kong shopper looks for bargains in wake of financial crisis.

Signs at headquarters of Enron and Worldcom

NEW YORK, HONG KONG AND ENRON PHOTOS BY THE ASSOCIATED PRESS; PENN CENTRAL AND WORLDCOM ARE FILE PHOTOS; GRAPHIC BY THE WASHINGTON

Credit and Blame: How Rating Firms' Calls Fueled Subprime Mess --- Benign View of Loans Helped Create Bonds, Led to More Lending

The Wall Street Journal
By Aaron Lucchetti and Serena Ng
15 August 2007
A1
English
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In 2000, Standard & Poor's made a decision about an arcane corner of the mortgage market. It said a type of mortgage that involves a "piggyback," where borrowers simultaneously take out a second loan for the down payment, was no more likely to default than a standard mortgage.

While its pronouncement went unnoticed outside the mortgage world, piggybacks soon were part of a movement that transformed America's home-loan industry: a boom in "subprime" mortgages taken out by buyers with weak credit.

Six years later, S&P reversed its view of loans with piggybacks. It said they actually were far more likely to default. By then, however, they and other newfangled loans were key parts of a massive $1.1 trillion subprime-mortgage market.

Today that market is a mess. As defaults have increased, investors who bought bonds and other securities based on the mortgages have found their securities losing value, or in some cases difficult to value at all. Some hedge funds that feasted on the securities imploded, and investors as far away as Germany and Australia have suffered. Central banks have felt obliged to jump in to calm turmoil in the credit markets.

It was lenders that made the lenient loans, it was home buyers who sought out easy mortgages, and it was Wall Street underwriters that turned them into securities. But credit-rating firms also played a role in the subprime-mortgage boom that is now troubling financial markets. S&P, Moody's Investors Service and Fitch Ratings gave top ratings to many securities built on the questionable loans, making the securities seem as safe as a Treasury bond.

Also helping spur the boom was a less-recognized role of the rating companies: their collaboration, behind the scenes, with the underwriters that were putting those securities together. 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. And that meant additional leeway for lenient lenders making these loans to offer more of them.

The credit-rating firms are used to being whipping boys when things go badly in the markets. They were criticized for being late to alert investors to problems at Enron Corp. and other companies where major accounting misdeeds took place. Yet they also sometimes get chastised when they downgrade a company's credit.

The firms say that since first asked to rate securities based on subprime loans more than a decade ago, they've done the best they could with the data they've had. "The housing market has proven to be weaker than a lot of expectations," says Warren Kornfeld, co-head of residential mortgage-backed securities at Moody's. This summer, the firms downgraded hundreds of mortgage bonds built on subprime mortgages. They say those bonds represent only a small part of the subprime-mortgage market.

The subprime market has been lucrative for the credit-rating firms. Compared with their traditional business of rating corporate bonds, the firms get fees about twice as high when they rate a security backed by a pool of home loans. The task is more complicated. Moreover, through their collaboration with underwriters, the rating companies can actually influence how many such securities get created.

Moody's Investors Service took in around $3 billion from 2002 through 2006 for rating securities built from loans and other debt pools. This "structured finance" -- which can involve student loans, credit-card debt and other types of loans in addition to mortgages -- provided 44% of revenue last year for parent Moody's Corp. That was up from 37% in 2002.

When Wall Street first began securitizing subprime loans, rating firms leaned heavily on lenders and underwriters themselves for historical data about how such loans perform. The underwriters, in turn, assiduously tailored securities to meet the concerns of the ratings agencies, say people familiar with the process. Underwriters, these people say, would sometimes take their business to another rating company if they couldn't get the rating they needed.

"It was always about shopping around" for higher ratings, says Mark Adelson, a former Moody's managing director, although he says Wall Street and mortgage firms called the process by other names, like "best execution" or "maximizing value."

Executives at both ratings firms and underwriters say the back-and-forth stopped short of bargaining over how to construct securities or over the criteria used to rate them. "We don't negotiate the criteria. We do have discussions," says Thomas Warrack, a managing director at S&P, which is a unit of McGraw-Hill Cos. He says the communication "contributes to the transparency" preferred by the market and regulators.

Some critics, such as Ohio Attorney General Marc Dann, contend the rating firms had so much to gain by issuing investment-grade ratings that they let their guard down. They had a "symbiotic relationship" with the banks and mortgage companies that create these products, says Mr. Dann, whose office is investigating practices in the mortgage markets and has been talking to rating firms.

In assembling a security such as a mortgage bond, an underwriter first pulls together thousands of loans that will serve as collateral. Before marketing the security, the underwriter slices it into perhaps 10 "tranches" with varying levels of risk and return.

The riskiest tranche has the highest potential return, but it ought to, because the buyer is taking a great risk: This tranche will absorb the first defaults that occur in the pool of mortgages. The next-lowest tranche is the second-hardest-hit by any defaults. Because of this structure, most of the higher tranches traditionally were considered well-enough insulated from defaults to merit investment-grade ratings -- in some cases, triple-A ratings.

The process, in a bad market, is like prisoners walking the plank on a pirate ship. The holders of the riskiest securities are at the front of the line and go overboard first. What's happening in the subprime-mortgage market is that investors further back than many imagined possible are going overboard as well.

Had the securities initially received the risky ratings that some of them now carry, many pension and mutual funds would have been barred by their own rules from buying them. Hedge funds and other sophisticated investors might have treated them more cautiously. And some mortgage lenders might have pulled back from making the loans in the first place, without such a ready secondary market for them.

Many money managers lacked the resources to analyze different pools of assets and relied on ratings companies to do so, says Edward Grebeck, chief executive of a debt-strategy firm called Tempus Advisors. "A lot of institutional investors bought these securities substantially based on their ratings, in part because this market has become so complex," he says.

Back in 2000, piggyback mortgages were just one among a handful of new loan varieties that credit analysts were having to evaluate. Until that point, few borrowers used piggyback loans to stretch beyond their means. But lenders began proposing these structures as a way to make homes affordable as their prices rose.

Because buyers putting less than 20% down may have less incentive or ability to avoid default, they normally had to buy private mortgage insurance to protect the lender if they fail to make the payments. But as interest rates slid and home prices rose, plenty of lenders were willing to provide a second, piggyback mortgage for all or part of the 20%, without insisting on mortgage insurance.

The big mortgage buyers Fannie Mae and Freddie Mac wouldn't purchase these piggyback deals, which didn't meet their standards. But Wall Street firms would, because they found they could turn them into high-yielding securities. And there were plenty of buyers for such securities: With interest rates low, many investors were in search of higher-yielding instruments.

Data provided by lenders showed that loans with piggybacks performed like standard mortgages. The finding was unexpected, wrote S&P credit analyst Michael Stock in a 2000 research note. He nonetheless concluded the loans weren't necessarily very risky.

S&P didn't let loans with piggybacks completely off the hook. S&P said in 2001 that it wouldn't penalize a subprime mortgage pool so long as the value of loans with piggybacks didn't exceed 20% of the overall value. Any more than that, and it would impose a rating penalty, S&P said. The firm notes that its assumptions "remained appropriate for several years."

Despite this limit, S&P's stance was good news for underwriters and lenders. For underwriters, the S&P decision made it easier to create investment-grade securities based on pools of subprime loans. And underwriters' appetite for the loans, in turn, made it easier for lenders to originate them.

Trends then converged to create explosive mortgage-market growth. Falling interest rates -- as the Federal Reserve sought to prop up the economy after the tech-bubble burst -- made home financing less expensive. New technologies let bankers construct bonds from the payments of thousands of different mortgages. The fastest-growing segment was subprime loans. Lenders brought out loans in which borrowers didn't have to document their income, or could at first pay only interest and no principal -- or could use a piggyback to, in effect, borrow the whole cost of the home.

At first, underwriters creating mortgage securities made sure the loan pools they based them on didn't have more than 20% with piggybacks. But by 2006, some were willing to accept a ratings penalty. They created securities like those structured from a pool of 14,500 loans from Washington Mutual Inc.'s mortgage arm. About 52% of the pool's value consisted of loans with piggybacks, a prospectus showed.

By 2006, S&P was making its own study of such loans' performance. It singled out 639,981 loans made in 2002 to see if its benign assumptions had held up. They hadn't. Loans with piggybacks were 43% more likely to default than other loans, S&P found.

In April 2006, S&P said it would raise by July the amount of collateral underwriters must include in many new mortgage portfolios. For instance, S&P could require that mortgage pools have extra loans in them, since it now expected a larger number to go bad.

Still, S&P didn't lower its ratings on existing securities, saying it had to further monitor the performance of loans backing them. It thus helped the market for these loans hold up through the end of 2006.

Some investors, however, grew concerned, as newer mortgage securities appeared that were based not just on piggyback loans but on loans with other risky attributes as well. One money manager, James Kragenbring, says he had five to 10 conversations with S&P and Moody's in late 2005 and 2006, discussing whether they should be tougher because of looser lending standards. "I'd think there would be more protection to guard against

defaults," Mr. Kragenbring, from Advantus Capital Management, says he said to the rating companies.

He says he was told that for much of 2005 and 2006, subprime loans were performing about the same as in previous years. Other analysts recall being told that ratings could also be revised if the market deteriorated. Said an S&P spokesman: "The market can go with its gut; we have to go with the facts."

In the second half of 2006, Mr. Kornfeld at Moody's noticed a troubling trend. In an unusually large number of subprime loans, borrowers weren't making even their first payments. The market's great strength "could not continue," Mr. Kornfeld recalls thinking at the time. He called staff meetings to discuss his concern, and in November Moody's said publicly it saw signs of deterioration.

In March 2007, S&P said it expected home prices to be stagnant this year but grow 3% to 4% in 2008. By early July, S&P had lowered this forecast. It said its chief economist projected that home prices would fall 8% from the 2006 peak to a trough expected in the first quarter of 2008.

Defaults and delinquencies rose. Hard-pressed borrowers found it harder to get a new loan to bail them out or to sell their homes and pay off the loan that way. By July, almost a third of the loans in Washington Mutual's subprime pool were delinquent or in foreclosure. This performance, much worse than what credit-rating firms had expected, forced Moody's and S&P to slash their ratings on several securities backed by those loans. On some, S&P cut an initial A-minus investment-grade rating by five notches, to a below-investment-grade BB.

The downgrading, begun late last year, became an avalanche this summer. On July 10, Moody's cut ratings on more than 400 securities that were based on subprime loans. S&P put 612 on review, and downgraded most two days later. The moves jolted financial markets and prompted some investors to criticize the ratings firms for misjudging the market.

The firms said that the soaring market of 2005-06 had reduced the relevance of their statistical models and historical data.

Money mangers unloaded on a July 12 conference call with Moody's analysts. "You had reams upon reams of data," said Steve Eisman, a managing director of hedge fund Frontpoint Partners, which had made bets against the subprime market. "Despite all that data, your original predictions of the performance of 2006 loan pools have proven to be completely and utterly wrong." He asked why the rating firms waited to take major steps.

The chief credit officer at Moody's, Nicholas Weill, replied that some of the original subprime data provided to rating firms weren't "as reliable as expected." He also said Moody's put out "early warnings" of downgrades as far back as November 2006. Instead of cutting ratings right away, he added, Moody's needed time to see whether the loans

would start to recover. "What we do is assess information available at the time," Mr. Weill said.

S&P, Moody's and Fitch Ratings have reacted by repeatedly toughening their ratings methodology for new subprime bonds, requiring significantly bigger cushions. They now assume more and quicker defaults among pools of loans, especially those with piggybacks.

The changes have had an effect. About 27% of loans made in the first quarter of this year had piggybacks attached, down from 35% a year earlier, according to S&P research. Overall, issuance of subprime-mortgage bonds is down 32.5% this year through June, according to Inside Mortgage Finance. That is resulting in lower Wall Street profits and tighter lending standards for consumers.

Committees in the U.S. House and Senate are broadly examining the mortgage market, as are various state and federal agencies. It's not clear whether ratings firms will become a focus of the inquiries.

Jim Kay

From: sovadvisers@aol.com
Sent: Tuesday, September 11, 2007 8:50 PM
To: c4cattle@bellsouth.net; rrobinson@conflictsecurities.com; Jim Kay; Taxman211@aol.com
Subject: SEC announces investigation into credit rating agencies' practices

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Ratings Firms' Practices Get Rated

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SEC Probes if Conflicts Fueled Subprime Troubles

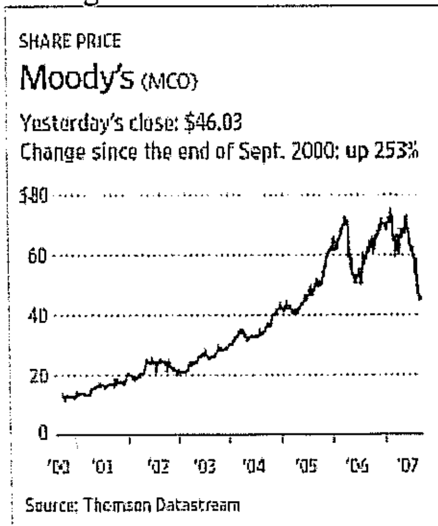
By AARON LUCCHETTI
September 7, 2007; Page C1

In the wake of mortgage-market turmoil, regulators plan to probe how the big credit-rating companies are paid and whether they are independent enough of the Wall Street firms that issue bonds.

The Securities and Exchange Commission and state attorneys general in New York and Ohio have begun to examine how the ratings firms evaluated subprime-mortgage-backed securities that grew into a trillion-dollar market.

The ratings firms include **McGraw-Hill** Cos.' Standard & Poor's; the Moody's Investors Service unit of **Moody's** Corp., whose stock has soared in recent years; and Fitch Ratings, a unit of **Fimalac** SA of Paris.

Wall Street bankers churned out profits in recent years by bundling mortgages into securities and selling them to investors. Ratings firms played an important role because they gave investment-grade ratings to many of those securities, making it easier for Wall Street firms to sell the bonds.



Hundreds of those securities have since been downgraded by the ratings companies.

Though that is a small portion of all the securities graded by the ratings firms, the reversal contributed to a rout in credit markets last month and has sparked criticism of the ratings firms.

Critics point out that ratings firms' financial fortunes are closely tied to the volume of securities deals -- and that higher ratings often spur deals on by making securities easier to sell. In recent years, mortgage-backed securities have become a major profit driver at Moody's.

From 2003 to 2006, the growth in the mortgage market helped Moody's stock price triple, while its profit climbed 27% a year on average. The firm's CEO, Raymond McDaniel, received a compensation package of $8.2 million last year, about double his pay package in 2005 and triple what his predecessor made in 2000. S&P, as a unit of a larger public company, isn't required to release compensation figures.

This type of financial information is likely to be scrutinized by the various state and federal regulators. While ratings firms generally disclose the amount they collect to rate

different kinds of bonds, the SEC wants to see whether clients that sell more deals -- and thus generate more revenue for ratings firms, tend to get better ratings. While there is no evidence so far of this kind of preferential treatment, regulators are interested in examining the question given the lucrative nature of the mortgage market, one person familiar with the matter said.

Ray McDaniel

"We're going in to look at the conflicts of interest, both in how they are paid and in their standards for rating," said Erik Sirri, director of the SEC's division of market regulation, after testifying on Capitol Hill on Wednesday.

In New York state, Attorney General Andrew Cuomo has subpoenaed documents from S&P and Fitch as part of a broader probe into the mortgage market. In Ohio, Attorney General Marc Dann is looking into the ways that rating firms interacted with Wall Street underwriters. "The more we look at it, the more we realize that these firms are important," said Mr. Dann.

Ratings firms, which say they did nothing improper, contend they remained independent evaluators of the securities even as their ratings business grew with the exploding mortgage-backed security market.

S&P and Fitch spokesmen said their firms are cooperating with the investigations and they look forward to discussions about how the ratings process works. S&P's spokesman added that the firm's ratings criteria are "publicly available, non-negotiable and consistently applied." A Moody's spokesman said: "We have received various government inquiries and we will fully assist with each of these."

The ratings firms are only one piece of the vast mortgage market. But they are an important cog at a time when the business is under scrutiny. The Senate Banking Committee and the House Financial Services Committee are planning hearings about the role of ratings firms in subprime mortgages (or those made to less-creditworthy borrowers), which have been hit by the recent decline in housing prices. Investors have lost billions of dollars and many homeowners face foreclosures, prompting ratings firms to lower ratings on hundreds of mortgage-backed bonds.

Ratings firms publish bond ratings that express an opinion about the likelihood of default. Firms like Moody's and S&P have been rating corporate bonds for generations, using ratings from safer triple-A bonds down to junk-bond levels. Recently, one of the fastest-growing segments of their business has been rating complicated pools of mortgages and other consumer-backed debt.

Their role can be tricky because the firms are paid by the companies that issue the bonds and not the buyers. Making things tougher is the desire by bond issuers to have their bonds evaluated by the firm willing to give the highest rating.

Issuers often work with the rating firms to restructure the securities that are deemed high-risk, or even attempt to get another firm to rate the bonds. Earlier this summer, Moody's said its market share dropped to 25% from 75% in rating commercial mortgage deals after it increased standards, making it harder for Wall Street firms to get high ratings on the bonds they sold.

Ratings firms employ both analysts and committees to evaluate securities in a kind of checks-and-balances system to minimize conflicts of interest. The analysts don't participate in fee negotiations and their pay doesn't depend on the fees garnered from deals they rate.

While overall compensation at Moody's rose about 17% a year from 2003 to 2006, much of that was the result of additional staff. Since 2002, Moody's spending on compensation and benefits roughly doubled, to about $650 million last year from about $330 million in 2002.

According to the Moody's data, the average compensation package at the firm, including benefits, rose about 24% from 2002 to 2006, to about $194,000 from $157,000. The Moody's spokesman said the firm's "compensation practices are in line with the industry."

Those salaries are low by the standards of Wall Street, where many analysts find jobs after working for the ratings firms. That has led some critics to question whether analysts might go easy on bond ratings so they don't alienate issuers who might be prospective employers down the road.

Sylvain Raynes, a former Moody's analyst who is now a principal at valuation advisory firm R&R Consulting, argues that such direct moves should be prohibited unless the analyst takes at least two years away from the ratings business.

Julia Whitehead, a senior adviser at boutique investment bank Miller Mathis, says it would be hard to

change the model of bond issuers paying ratings firms, but she argues ratings firms should be held more accountable when they do a poor job rating bonds.

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Credit crunch gallery of guilt

The causes of the present credit crisis are many and varied. From the Fed's policy of cheap money to the bonus-driven fee structure of the City and Wall Street, there are plenty of culprits in the debt market meltdown.Sean Farrell, Sean O'Grady and Stephen Foley identify some of the major dramatis personae

Published: 05 September 2007

Central bank

Alan Greenspan, chairman of the US Federal Reserve, 1987 to 2006

The man who underwrote the bubble. After the collapse of the dotcom boom in 2000, the attacks of 11 September 2001 and the Enron/ accounting scandals of 2002, the Fed lowered interest rates until they reached a nadir of 1 per cent in June 2003, where they stayed for a year before gently rising. Such historically low levels (negative in real terms), had the desired effect of bolstering financial markets, but also fed through to inflation and, more dangerously, a real estate and financial bubble. It also created the "Greenspan put". Homeowners borrowed and spent, often on goods made in China, hence America's vast trade deficit. The Fed is also responsible for banking regulation, but Greenspan was phlegmatic about the sub-prime phenomenon: "Where once more-marginal applicants would have been denied credit, lenders are able to quite efficiently judge the risk posed by... applicants and to price that risk appropriately." Sub-prime mortgage lending, which stood at 1 to 2 per cent of the market in the early 1990s, rose rapidly to 10 per cent of the market.

Politicians

George Bush, US President

When Bush entered the White House in 2001, the US federal government was in the black. That was before 11 September and the war on terror. A combination of radical tax cuts and higher defence spending has left America's public finances in a woeful condition. A $1.35 trillion (£670bn) tax cut put money in the pockets of the middle classes. This year, the federal budget deficit is now predicted to come in at $205bn, down from its recent peak of $413bn in 2004. Since the beginning of the Bush administration, US deficits have added $2.6 trillion to the total national debt, which now stands at more than $8.2 trillion. The Bush administration will leave a legacy of a huge budgetary crunch when members of the baby-boom generation begin retiring in large numbers.

Big UK banks

Bob Diamond, president of Barclays

It is not only the big swinging dicks on Wall Street who have taken part in the buying and selling of repackaged debt. The big UK banks have got in on the act, either by structuring and selling the stuff, investing in potentially toxic debt through obscure investment vehicles, or setting up these vehicles for clients. At the centre of the furore has been Barclays Capital, Barclays' investment bank, run by Bob Diamond. The departure of Edward Cahill, BarCap's head of collateralised debt obligations, fuelled concern about BarCap's exposure to complex debt funds. Mr Diamond has been reassuring investors there was nothing lurking in Barclays' balance sheet.

Hedge funds

Jim Simons, founder, Renaissance Technologies

The most expensive hedge-fund manager in the world, Jim Simons' first job out of college was as a mathematician working for the Defense Department cracking enemy codes during the Vietnam War. Now his hedge fund Renaissance Technologies controls $24bn in assets and charges clients 5 per cent a year to look after their cash, plus a 44 per cent of returns beyond a certain level.

What they are paying for is so-called "black box" computer programmes that harvest tiny profits from millions of automated trades. Funds such as Renaissance lost billions of dollars in the first week of August after a combination of events that their statistical models said wouldn't happen, helping spread the panic from the sub-prime mortgage sector.

Regulators

Christopher Cox, chairman, Securities & Exchange Commission

Wall Street's regulator, the Securities & Exchange Commission, has been trying to get a grip on the ballooning hedge fund industry – but it has failed. It is a difficult-to-measure industry, based largely offshore to avoid tax and disclosure rules, but it is certainly huge, with about 9,000 offshore funds holding assets estimated at around $2bn (£1bn). The SEC under Mr Cox brought in a rule requiring most hedge funds to register with the agency. Many simply ignored the rule. The SEC's approach to regulation has been in disarray ever since.

Debt investors

Herbert Suess, former CEO of Saschen LB

Someone had to buy all this stuff, and most investors only have themselves to blame for believing in the free lunch of returns without risk. At the bottom of the chain are the growing new class of wealthy individuals – from footballers and entertainers to entrepreneurs and sellers of family businesses – who were urged to invest in hedge funds. The hedge funds then bought into credit products they didn't understand, using borrowed money from investment banks. Pension funds also invested in fixed-income securities after the bursting of the dotcom bubble of the late 1990s caused fears about investing too heavily in shares. With huge demand for highly rated fixed-income assets, the investment banks had every reason to create them using ever-more complex structures.

As ever, the market attracted institutions less able to understand the investments than the hedge fund geniuses. Sleepy German institutions such as IKB and Sachsen LB stunned the market with massive losses on sub-prime securities and saw their CEOs depart as they had to be bailed out to the tune of more than €20bn (£13.5bn). Peter Hahn, a fellow at Cass Business School and a former managing director at Citigroup, said: "People said, 'I want low risk and high returns' and you had a massive buying spree by people who didn't really know what they were buying."

Credit rating agencies

Kathleen Corbet, president of Standard & Poor's

The ratings agencies apply grades to bonds and debt-related investments depending on the level of risk. Standard & Poor's and Moody's, the top two agencies, have been lambasted on both sides of the Atlantic for giving high ratings to bonds and complex credit funds linked to risky debt, particularly US sub-prime mortgages.

Critics claim agencies maintained high ratings on securities as defaults on sub-prime mortgages ballooned. S&P says it alerted the market two years ago and the fall in value of the securities is not its responsibility.

The agencies receive fees for giving ratings, meaning the more investments they grade, the more money they make. Critics say the agencies work too closely with the banks structuring debt investments, undermining the independence of their ratings.

Kathleen Corbet, the president of Standard & Poor's, resigned last week as criticism mounted, though S&P said her departure was a coincidence. The European Commission is investigating whether S&P and Moody's had conflicts of interest.

Private equity

Henry Kravis, founder of Kohlberg, Kravis, Roberts

The original barbarian at the gate, the private equity pioneer was still at the apex of the leveraged buy-out phenomenon 20 years after the battle for RJR Nabisco. But he was in danger of losing the crown to Stephen Schwarzman of Blackstone, and their battle pushed both into bigger deals. KKR's acquisitions of TXU, and First Data are amongst the biggest buy-outs of all time, at $44bn and $29bn respectively. Because LBO debt was sliced and diced and parcelled out for sale to investors across the world, no one seemed to notice as the deals got riskier, with Henry Kravis and his rivals paying higher prices that would gave them much less room to cope with any trading downturn.

Wall Street

James Cayne, chief executive, Bear Stearns

On the day that Bear Stearns was bailing out one of its hedge funds to the tune of $3.2bn, the bank's chief executive was on a New Jersey golf course. The Wall Street veteran has faced a storm of criticism for failing to understand the scale of the credit crisis, despite running a bank that is among the most heavily exposed to the mortgage-backed bond market. The Bear Stearns funds had made more than $20bn of bets on the US sub-prime mortgage market, mainly funded by debt advanced by other banks on Wall Street. When the bets went wrong in June, the funds were wiped out. Investors were forced to admit their investments in mortgage-backed debt instruments were unsellable, while lenders began to cut the amount of leverage allowed to hedge fund clients.

Mortgage lenders

Angelo Mozilo, chief executive, Countrywide Financial

As the head of the largest independent mortgage lender in the US, Angelo Mozilo was the face of the industry as it offered too-good-to-be-true mortgage deals to millions of Americans previously deemed too poor or too irresponsible to own their own home. Thanks to the innovative financing available from Wall Street, Countrywide and its smaller brethren were able to offer extraordinary "teaser" rates, which lured customers with a low introductory interest rate. With each new wave of these loans that reset to a higher, variable rate, defaults have been ratcheted higher and are now at record levels, with worse to come.

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International Representatives Demand to Oversee U.S. Markets

September 3, 2007 | From theTrumpet.com

The unfolding "made in America" worldwide subprime mortgage crisis has foreign bankers demanding international regulation of American markets, banks and rating agencies.

BY ROBERT MORLEY

In his foreign-policy speech on August 27, French President Nicolas Sarkozy called for an enhanced global rule book to avoid financial crises. Sarkozy, who has vowed to "moralize financial capitalism," said such crises could reoccur if "the leaders of major countries" did not take "concerted action to foster transparency and regulation of international markets."

International bankers and investors from China to France and Germany have lost billions of dollars because U.S. investments, sold as safe, turned out to be far riskier and worth much less than what American investment-rating agencies and banks led them to believe. They don't want to be deceived again.

The international worry is that American regulators are not properly monitoring the products or alerting investors to the risks. As the subprime crisis in America has unfolded and millions of homeowners have started to default on their mortgages, the incredibly lax lending practices of American companies and banks have come to light.

Over the past five years, high-risk subprime loans, known as "liar's loans" (where applicants simply stated their income, knowing there would be no verification) and NINJA loans (so-called because they are loans made to people with No Income, No Job or Assets) became commonplace. These loans were then packaged, marketed as high-quality securities by U.S. banks and rating agencies, and in many cases sold to international investors.

Now international investors are asking not only why American banks were allowed to originate hundreds of thousands of mortgages to home buyers whom they knew would likely be unable to repay them, but also why these risky investments were pawned off with top ratings to unsuspecting investors.

"We need an international approach, and the United States needs to be part of it," said Peter Bofinger, a member of the German government's economic advisory board.

Dick Bryan, a professor of economics at the University of Sydney, agrees. "[T]here is the need to challenge the sovereignty of national regulators—why should the rules of lending in the U.S. be left to U.S. regulators when the consequences go everywhere?" he said. In this globalized world, investors in Australia were hit particularly hard by exposure to U.S. subprime loans. "[A] problem in one location is a problem everywhere," Bryan said.

If and how long Washington will be able to resist international pressure is unclear, but America will probably fight hard to limit foreign regulation, especially since financial products and services are one of America's most dynamic and most important export industries. So far, the response from Washington is that it wants "no form of oversight."

However, while regulators in the U.S. have been unreceptive to international monitoring, Europe and Asia, unlike in years past, now have growing financial leverage up their sleeves.

"America depends on the rest of the world to finance its debt," reminded Bofinger. "If our institutions stopped buying their financial products, it would hurt."

Foreign willingness to purchase U.S. debt has kept interest rates low in America—thereby creating millions of jobs in real estate, home construction, remodeling and other associated industries. If foreigners stop lending to America because of difficulty assessing borrower credit-worthiness, the cost of borrowing could go way up.

But a potentially bigger concern is the effect the subprime disaster could have on America's reputation as a financial safe haven. As the world's largest debtor nation, America borrows hundreds of billions of dollars per year from the rest of the world. America needs foreign money, and its ability to attract it depends on its perception as a stable and trustworthy borrower.

The exposed corruption associated with America's housing bubble, which includes mortgage originators, banks and rating agencies, may be irrevocably damaging the nation's economic reputation and its ability to finance its debt.

Jim Willie, statistical analyst and financial editor of the *Hat Trick Letter*, wrote:

> The U.S. financial system is teetering. Its U.S. dollar currency is losing global support, with some outright revolts in crucial territories. The chief private sector export from the U.S . financial sector has been fraud-ridden asset-backed bonds [largely composed of risky mortgages] and their toxic credit derivatives. ... For years an institutional dishonesty within all things financial in the United States has been engrained, spreading .... The Wall Street hucksters exported fraud. The backlash might be more severe than the soft soap gurus anticipate. Look for an international boycott. The shock waves in the U.S. financial markets are preliminary symptoms of bigger events soon to come.

America's economic recklessness seems to be coming home to roost. Politicians, regulators and financial specialists outside the United States are seeking a role in oversight of American financial institutions and rating agencies in the wake of recent mortgage and banking problems. Indebtedness is eroding more than America's economic independence—it's eroding its status as a superpower. •

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Upgrade History of China's Sovereign Credit Rating by S&P, Moody's and Fitch Ratings

The Chinese government's refusal to honor repayment of its defaulted sovereign debt first became widely published in June 2001. Since that time, the three primary NRSROs have upgraded China's international sovereign credit rating (i.e., the "long-term foreign currency sovereign credit rating" assigned to China) **SIX (6) times**, as follows:

S&P: Three (3) upgrades:

From "BBB" (affirmed in 2001) to "BBB+" (February 2004)

From "BBB+" to "A-" (July 2005)

From "A-" to "A" (July 2006)

S&P has maintained an "investment grade" rating for China since 2001, which S&P defines as an issuer not having any defaulted full faith and credit sovereign debt outstanding and unpaid. S&P presently maintains a "Positive" outlook for China, indicating an imminent fourth upgrade of China's credit rating. Note that S&P affirmed China's "investment grade" credit rating the very next day (October 22, 2003) following the Congressional hearing on the ABF, in order to strengthen the sale of China's sovereign bonds and notes registered in the U.S. the same month (October 2003). Compare the published definition of China's prevailing artificial investment grade rating with the definition of the truthful rating of "Selective Default":

http://globalsecuritieswatch.org/Sovereign_Ratings_Definitions_and_Criteria

Moody's: Two (2) upgrades:

From "A3" to "A2" (October 2003)

From "A2" to "A1" (July 2007)

Fitch Ratings: One (1) upgrade:

From "A-" to "A" (September 2006)

Fitch Ratings presently maintains a "Positive" outlook for China, indicating a second upgrade of China's credit rating is imminent.

[Data range: June 2001 - August 2007].

The following information is directly pertinent to the periodic upgrades:

1. Explicit notification (i.e., constructive notice) was provided to Norman Feitz, Senior Counsel to Goldman Sachs for Regulatory Affairs and Compliance, in a letter dated January 2, 2002. This is important because Goldman Sachs served as the credit rating adviser to China in 2003 as regards the sovereign notes and bonds registered in the United States and sold by China in 2003. The 2002 letter included the following enclosure:

http://www.globalsecuritieswatch.org/Sovereign_Rating_Research_Bulletin/China.pdf

2. Explicit notification (i.e., constructive notice) was again provided to the Chief Executive Officers of all three primary NRSROs in a letter dated November 27, 2002:

http://www.globalsecuritieswatch.org/letter_to_Moodys_from_ABF

3. The prevailing artificial ratings assigned to China by the three primary NRSROs were included in the specifications describing the wrongful actions of certain parties in a letter dated April 8, 2004 sent to the Hon. Eliot Spitzer, Attorney General for the State of New York (see pages 11-17):

http://www.globalsecuritieswatch.org/Letter_to_EliotSpitzer_AG_New_York_from_Sovereign_Advisers.pdf

4. Explicit notification (i.e., constructive notice) was provided yet again in a letter dated May 18, 2006, which was sent via certified U.S. mail to the Chief Executive Officers of each of the three primary NRSROs:

http://www.globalsecuritieswatch.org/Letter_from_Sovereign_Advisors_to_Standard_and_Poor's_Corporation

5. Note that S&P upgraded China most recently during July 2006. Also note that both this upgrade, as well as the previous upgrade during July 2005, occurred subsequent to the Financial Times articles on China's defaulted sovereign debt (June 7, 2005), which articles included comments by senior representatives of the credit rating agencies:

http://www.globalsecuritieswatch.org/Financial_Times_Article.re.China's_Defaulted_Sovereign_Debt

6. EuroWeek Capital Markets magazine published two separate articles related to China's artificial sovereign credit rating (April 2005 and July 2006). The 2006 article contained denials of wrongdoing from S&P, Moody's and Fitch.

7. Moody's most recently upgraded their rating on July 26, 2007 from A2 to A1. Both Standard & Poor's and Fitch Ratings presently maintain a "positive outlook" for China, which indicates an imminent upgrade by both agencies. The higher the rating, the more issuers such as corporations and sovereign governments will pay for the rating in order to issue debt. Moody's freely admits on their website visitor agreement that they may charge issuers upwards of $1 million for a single credit rating!

8. In addition to the complaints filed with the SEC and the GAO, a comprehensive description of the wrongful actions of the primary international credit rating agencies as regards China, including an excellent analysis by the Washington Post of the conflicted and self-serving business practices of the international credit rating agencies, is accessible at:

http://www.globalsecuritieswatch.org/Wrongful_Actions_of_the_International_Credit_Ratings_Agencies

9. A narrative describing China's artificial sovereign credit rating is accessible at:

http://www.globalsecuritieswatch.org/Forbes_Article.re.China's_Artificial_Sovereign_Credit_Rating

10. 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

As demonstrated by our research into this matter, the prevailing "investment grade" sovereign credit ratings assigned to the communist Chinese government by the three primary NRSROs evidence the application of a reckless standard of care, when compared to their respective published definitions.

CNN.com

Moody's upgrades HK and China

HONG KONG, China (Reuters) --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 on Tuesday raised its foreign currency debt rating on China by one notch to A2 from A3, putting China just four notches below the agency's top AAA level.
It raised Hong Kong's foreign currency ratings, which apply to bonds and bank deposits, by two notches to A1 from A3.
The move pushed forwards contracts on the Hong Kong dollar and China's yuan higher, a sign that investors expected these currencies to strengthen in coming months despite the fact that both are pegged to the U.S. dollar.
Moody's said the rating outlook on both Hong Kong and China was stable, meaning it is not likely to shift the new ratings anytime soon.
The move follows an upgrade of China's long-term foreign currency rating outlook by Fitch Ratings on Monday and comes as China kicks off investor presentations for a global bond sale, its first since May 2001, which will also include a 500 million euro bond.

HK ahead of China

Moody's said that although Hong Kong and China were becoming more closely linked, via projects such as the planned bridge linking Hong Kong to Macau and Zhuhai, the former British colony's freer economy and stronger institutional structure justified its higher rating.
"The ratings upgrade is justified because things in Hong Kong are really improving," said Henry Tsoi, senior economist at Hang Seng Bank.
Moody's cited Beijing's policy of keeping its foreign debt, both government and private sector, at a prudent level as a major reason for China's upgrade.
China's economy is growing around eight percent a year with exports leading the charge helped by a flood of foreign investment in its factories.
The surge in foreign investment, growing export revenues and speculative funds betting that China will allow its currency to appreciate in coming months have led to a dramatic rise in the country's foreign exchange reserves.
At the end of August these reserves stood at $364.7 billion, second only to Japan's.
"These factors make even more remote the possibility that the central government would default on its foreign currency bonds," Moody's said in a statement.
"Official foreign exchange reserves that are close to twice the total amount of

external debt make for an exceptionally strong external payments position," it said.
George Leung, China economist at HSBC in Hong Kong, said Moody's move was justified and not really surprising for markets.
"They have cited accumulation of foreign reserves and the strengthening ability to meeting external payments. It is all quite visible in the past year, so it's not surprising and neither exciting for the market because everyone has been well aware of the situation," he said.

Find this article at:
http://www.cnn.com/2003/BUSINESS/10/16/moodys.hkchina/index.html