



Sovereign Advisers®

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4901 E. Sunrise Drive • Suite 711
Tucson • Arizona • 85718

Tel (USA): 520.327.2482 • Fax: 520.322.9850

Email: info@sov-advisers.com

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

United States Securities and Exchange Commission

Conference Brief: Enforcement Mandate re: Wrongful Actions of NRSROs

January 14, 2008

▶ The successor government doctrine of settled international law affirms continuity of obligations among internationally-recognized successive governments.

▶ The People's Republic of China is the internationally-recognized successor government to the internationally-recognized predecessor government of the Republic of China, which contracted full faith and credit sovereign debt of the Chinese government, and which loan agreement states that such debt is intended to be "a binding engagement upon the Republic of China and its successors."

A. Continuation of NRSRO Recognition Despite the Failure of the Three Primary NRSROs to Ensure Credible and Reliable Ratings:

1. The three primary NRSROs received recognition as such through the no-action process adopted by the Securities and Exchange Commission (the "SEC" or "Commission").¹ The Commission's decision to grant NRSRO recognition to the three primary NRSROs via the no-action process was predicated upon a set of criteria developed by Commission staff, the single most important of which is described as whether the credit rating agency is "...an issuer of credible and reliable ratings..."² Also comprising the basis of the Commission's no-action decisions pertaining to NRSRO recognition was an assessment of the credit rating agency's rating procedures.³
2. The Commission further proposed to define the term "NRSRO" as an entity that *"uses systematic procedures designed to ensure credible and reliable ratings;"*⁴
3. The Commission continues to grant NRSRO recognition to the three primary credit rating agencies despite these firms' failure to ensure credible and reliable ratings;
4. The three primary entities presently recognized by the Commission as NRSROs not only fail to maintain credible and reliable ratings, but in the instance of China's contrived sovereign credit rating, engage in a disingenuous attempt to justify the contrivance under the guise of periodic publication of contrary facts, which publication is inadequate to explain their artificial ratings and which publication lacks the force of law with which their ratings are empowered by virtue of their recognition by the Commission as NRSROs and extensive regulatory and prudential codification;
5. In the instance of China, an example of the failure of the three largest NRSROs to conform to the established criteria (i.e., publication of credible and reliable ratings) is the following:

Under international law, the November 12, 2006 letter from the PRC Ministry of Finance to the U.S. Embassy constitutes an act of repudiation of the debt (see attached Exhibit 1), and such act is an action of the post-1949 government of China (i.e., the PRC), and this action of the post-1949 government of China is not disclosed by the prevailing sovereign credit ratings published by the NRSROs, which intentionally disregard both their published criteria (see definitions) and their published metrics (i.e., willingness to pay);

¹ Securities and Exchange Commission. 17 CFR Part 240. Release Nos. 33-8570; 34-51572; IC-26834; File No. S7-04-05. RIN 3235-AH28.

² Id.

³ Id.

⁴ Id.

6. **In addition to the action of repudiation, further examples of actions by the post-1949 government of China (PRC)** which are concealed by the prevailing sovereign credit rating classifications assigned to the PRC by the three primary NRSROs include discriminatory settlement (e.g., citizens of Great Britain, 1987); exclusionary payments; and selective default;
7. An examination of the agencies' published criteria (definitions) and published metrics (willingness to pay) and comparison to the facts comprising the immediate instance evidences that the prevailing sovereign credit rating classifications assigned to the government of China are contradictory to the facts and are therefore contrived, and are thus neither credible nor reliable, and in the face of constructive notice and foreknowledge of falsity, further evidences the application of a reckless standard of care;
8. The procedures utilized to develop the prevailing international sovereign credit ratings assigned to China by the three primary NRSROs produce neither credible nor reliable ratings consistent with the standard proposed by the SEC; and
9. The Commission is empowered with both the legal authority and the legislative mandate to regulate the NRSROs including the unilateral power to rescind NRSRO recognition, and to do so in the present instance is consistent with the Commission's own proposed rule(s); therefore
10. An enforcement action by the SEC is warranted, including revocation of NRSRO recognition of the three primary NRSROs.
11. An enforcement action is further warranted by the United States Federal Trade Commission (FTC) as the NRSROs utilize the United States Postal Service and electronic wires to publish their deceitful ratings, thereby engaging in intentional mail and wire fraud.
12. A referral to the United States Department of Justice (DOJ) for investigation into possible antitrust violations is further warranted.

B. Credit Rating Agency Reform Act of 2006 (P.L. 109-291) Mandates Ratings Integrity

13. The language of Sec. 15E.(a)(1)(B)(i) states:

An application for registration as an NRSRO shall contain information regarding "credit ratings performance measurement statistics over short-term, mid-term, and long-term periods..."
14. The language of Sec. 15E.(d)(5) states (in regard to **suspension of registration**):

The Commission may revoke the recognition of any NRSRO which "fails to...consistently produce credit ratings with integrity."
15. The language of Sec. 15E.(i)(1) states:

The Commission shall take necessary action "...to prohibit any act or practice relating to the issuance of credit ratings by a nationally recognized statistical rating organization that the Commission determines to be unfair, coercive, or abusive..."
16. NRSRO recognition is thus contingent upon integrity of ratings over short-term, mid-term, and long-term durations. The Chinese government has engaged in discriminatory payments and selective default during the entire period that the three primary NRSROs have assigned and published investment grade sovereign rating classifications to the government of China, and which definitions preclude such actions. The ratings may thus be demonstrated to lack integrity.

C. Elements of Fraud: Federal Securities Anti-Fraud Statutes Prohibit Wrongful Actions by the Three Primary NRSROs

17. The 1933 and 1934 Federal Securities Acts prohibit deceit, misrepresentations and other fraud in connection with the sale of securities. Actionable elements of the offense include substantive fraud; material omissions and misrepresentations; misstatements and omissions; materiality; scienter; reliance; and willfulness. Such elements appear to be present in the instance which is the subject of this discussion brief, as the deceitful actions of three primary NRSROs may be demonstrated as the product of motivation to enhance, promote, and to profit from, the marketability of rated securities issued by the government of China, its state-owned enterprises and Chinese corporate issuers.⁵

D. Advisers Act Prohibits Fraudulent, Deceptive or Manipulative Business Practices:

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

19. 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”.⁶

20. 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”.

21. 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

⁵ It is noteworthy that Moody's recently sponsored a conference aimed at soliciting Chinese corporate issuers to exploit China's investment grade sovereign benchmark by issuing debt. It appears highly improbable that the timing of the recent upgrades by the three primary NRSROs is occurring at the same time that the Chinese government is lessening restrictions on Chinese corporations issuing debt. The deliberate assignment and publication of a contrived sovereign credit rating to the government of China represents a conflict of interest on an unprecedented and egregious scale in a transparent bid to generate windfall ratings profits.

⁶ Adopted April 27, 1997; amended April 18, 2004.

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".

22. Since the prevailing sovereign credit ratings assigned to the PRC by the three primary NRSROs are demonstrably false and so fail the test of integrity, an enforcement action is further warranted by the Commission pursuant to the Advisers Act.

E. Sovereign Disclosure Obligation: Prohibition Against Half-Truths:

► 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 the Exchange Act.⁷ Under Rule 10b-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 to the inadequate and misleading 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 (see complaint dated September 1, 2006, the amendment dated February 15, 2007, and complaint dated October 16, 2007, respectively filed with the Commission).⁸

23. The prevailing disclosure provided by Chinese state-affiliated issuers in the United States is woefully inadequate and utterly fails to meet the required threshold.⁹

⁷ 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).

⁸ 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>).

⁹ 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. Sidley Austin also recently advised Sinotruk, a PRC state-owned enterprise, regarding its \$1.16 billion IPO, including entry into the United States pursuant to Regulation S, with no disclosure of the Chinese government's refusal to honor repayment of its defaulted sovereign debt. The lack of disclosure integrity should come as no surprise in light of Sidley Austin's role in the sale of subprime mortgages. Sidley Austin was recently ranked as the top issuer's counsel for mortgage-backed securities, and even prior to its combination with Brown & Wood, Sidley had been a top adviser to issuers and underwriters of mortgage-backed securities. Interestingly, this is the same law firm that, through its predecessor firm of Brown & Wood, 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. As a result, Sidley Austin agreed to pay a \$39.4 million penalty to the IRS and also agreed, along with accounting firm KPMG, to pay \$154 million to clients that sued the firms. Criminal actions in the matter were brought by both the United States Department of Justice and the Internal Revenue Service in what was 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, the 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. 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 the defaulted sovereign debt of the government of China, and which hearing occurred prior to the date of the 2003 prospectus supplement. Sidley Austin also 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. It is revealing to 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, 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.

Schedule of Exhibits

Exhibit 1	Letter of Debt Repudiation by the Government of the People's Republic of China
Exhibit 2	Published Criteria (Definitions of Rating Classifications)
Exhibit 3	Published Metrics (Willingness to Pay)
Exhibit 4	Discriminatory Settlement by the People's Republic of China (Great Britain, 1987)
Exhibit 5	Complaint Alleging Inadequate Disclosure by the government of China Including Amendment Stating Allegation of Fraud

Exhibit 1

中 华 人 民 共 和 国 财 政 部

Ministry of Finance, People's Republic of China

Embassy of the United States of America in China:

We acknowledge the receipt of the letter dated 2 November 2006 from the Economic Section of your embassy. Upon discussion with our Treasury Department, with reference to the request by the two U.S. citizens for the Chinese Government to repay their gold certificates bought in 1913, our reply is as follows:

In accordance with the Notice of the Ministry of Finance and the Ministry of Foreign Affairs Concerning Dealing with the Public Bonds Issued by the Defunct Chinese Governments ((82) Cai Wai Zi No.021), "the People's Government will make no repayment with regard to all the public bonds issued by both the Beiyang Government and the Kuomintang Reactionary Government." All the gold certificates of 1913 that the said two U.S. citizens hold are those which were issued by the Kuomintang Government. Therefore, the Government of the People's Republic of China has no obligation to repay them.

(Seal)

International Department, Ministry of Finance
People's Republic of China
12 November 2006

San Li He St., Xichengqu, Beijing 100820, People's Republic of China
Tel: (86-10)6855-1171 Fax: (86-10)6855-1125

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中 华 人 民 共 和 国 财 政 部
Ministry of Finance, People's Republic of China

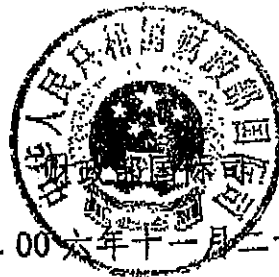
FAX IN

1-2 DEC 2006

美国驻华大使馆:

贵使馆经济处 11 月 2 日来函收悉。关于两位美国公民要求中国政府对其购买于 1913 年的金元券进行偿付一事，经商我部国库司，现作答如下：

根据《财政部 外交部关于处理我国旧政府发行的公债券问题的通知》((82) 财外字第 021 号) 的有关规定，“关于北洋政府和国民党反动政府所发行的一切公债， 人们政府不能偿还。”此次两位国民持有的全部 1913 年金元券属于国民党政府发行的公债，因此，中华人民共和国政府不能偿还。



二〇〇六年十一月二十日

San Li He St., Xichengqu, Beijing 100820, People's Republic of China
Tel: (86-10)6855-1171 Fax: (86-10)6855-1125

Exhibit 2

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	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. 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 (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.

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

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.moody.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). 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 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 2. 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.

Exhibit 3

Publication Date: 3-April-2002
Reprinted from RatingsDirect

Research

Sovereign Credit Ratings: A Primer

Analyst: David T. Beers, London (44) 20-7847-7101; Marie Cavanaugh, New York (1) 212-438-7343; Takahira Ogawa, Singapore (65) 6239-6342

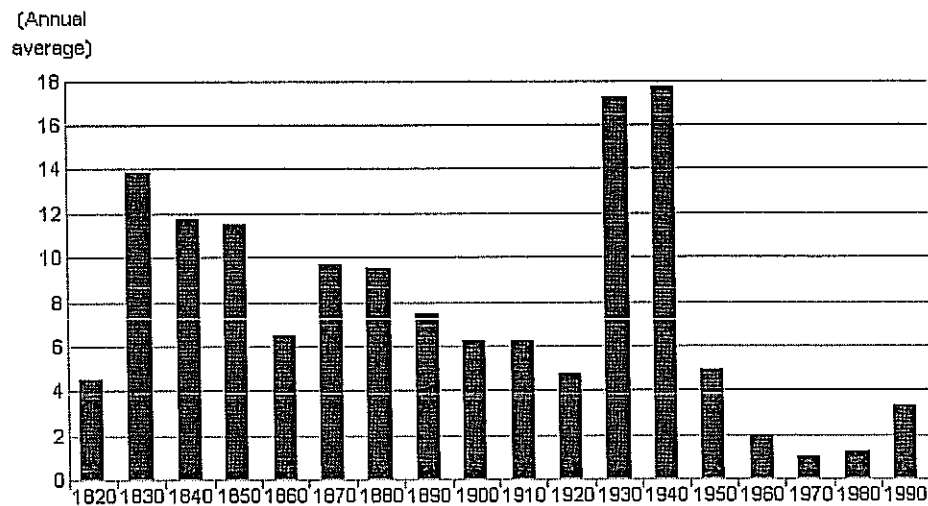
■ Sovereign Credit Ratings

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. (A full list, "Sovereign Credit Ratings," is available on Standard & Poor's Web site at standardandpoors.com, select Ratings List, then Sovereigns.) A rating is a forward-looking estimate of default probability. Sovereign ratings are not "country ratings," an important and often misunderstood distinction. Sovereign ratings address the credit risk of national governments, but not the specific default risk of other issuers. Ratings assigned to entities in each country are, most frequently, the same as the sovereign's or lower, but may be higher. Foreign currency ratings may be higher whenever the entity has stronger credit characteristics than the sovereign and the risk of the imposition of debt-service-limiting foreign exchange controls is less than the risk of sovereign default. Among the examples of this case are where there is a monetary union with a higher-rated central bank or where the issuer has a significant percentage of assets and business offshore or a very supportive offshore parent. Similarly, an issue benefiting from specific structural enhancements can be rated above the sovereign.

Defaults by rated sovereign issuers of bank and bond debt include those of the Republic of Argentina, the Dominican Republic (local currency only), the Republic of Indonesia (foreign currency only), the Islamic Republic of Pakistan (foreign currency only), the Russian Federation, and the Republic of Suriname (foreign currency only), although other rated sovereigns have defaulted in the years before they were rated. Default and transition studies (see "Sovereign Ratings 2001: The Best of Times, the Worst of Times," available on RatingsDirect, Standard & Poor's Web-based credit analysis system, and on Standard & Poor's Web site under Resource Center, Ratings Criteria, Sovereigns) indicate that, compared with corporate ratings, sovereign ratings show more stability at most rating levels. In all categories of 'A' or higher and, in most instances, in categories below 'A', the sovereign default record has been lower than the corporate default record. However, such comparisons are affected by the small sample size of sovereign defaults. Standard & Poor's expects sovereign rating stability and default probability to converge with corporate ratings over time as the number of sovereign observations increases, something one would expect given the same rating definitions.

If, as we expect, defaults occur more frequently in the sovereign sector in the future, this will not be an unprecedented development. Defaults on sovereign foreign currency bonds occurred repeatedly, and on a substantial scale, throughout the 19th century and as recently as the 1940s. Sovereign bond default rates fell to low levels only in the decades after World War II (see chart 1), when cross-border sovereign bond issuance also was minimal. Defaults on bank loans, the main vehicle for financing governments in the 1970s and 1980s, peaked in the early 1990s and have since fallen fairly steadily.

Chart 1
Sovereign Foreign Currency Bond Defaults
1820-1999



Source: Debt Cycles in the World Economy, Westview Press, 1992, and Standard & Poor's.

Past defaults reflect a variety of factors, including wars, revolutions, lax fiscal and monetary policies, and external economic shock. As we enter the new millennium, fiscal discipline, debt management, structural inefficiencies constraining productivity, and the contingent liabilities arising from weak banking systems are among the significant economic policy challenges facing many sovereigns. The associated credit risk, which may seem manageable for a time, can quickly mushroom—as events in a number of emerging market countries since 1997 have shown. Standard & Poor's believes an understanding of sovereign ratings—what they mean and the criteria behind them—is more relevant now than ever before.

■ Behind the Ratings

Standard & Poor's appraisal of each sovereign's overall creditworthiness is both quantitative and qualitative. The quantitative aspects of the analysis incorporate a number of measures of economic and financial performance and contingent liabilities, although judging the integrity of the data is a more qualitative matter. The analysis is also qualitative due to the importance of political and policy developments and because Standard & Poor's ratings indicate future debt service capacity.

Standard & Poor's divides the analytical framework for sovereigns into 10 categories (see summary below). As part of the committee process that Standard & Poor's uses to assign credit ratings, each sovereign is ranked on a scale of one (the best) to six for each of the 10 analytical categories. There is no exact formula for combining the scores to determine ratings. The analytical variables are interrelated and the weights are not fixed, either across sovereigns or over time. Most categories incorporate both economic and political risk, the key determinants of credit risk. Economic risk addresses the government's ability to repay its obligations on time and is a function of both quantitative and qualitative factors. Political risk addresses the sovereign's willingness to repay debt.

Sovereign Ratings Methodology Profile

Political Risk

- Stability and legitimacy of political institutions
- Popular participation in political processes
- Orderliness of leadership succession
- Transparency in economic policy decisions and objectives
- Public security
- Geopolitical risk

Income and Economic Structure

- Prosperity, diversity, and degree to which economy is market-oriented
- Income disparities
- Effectiveness of financial sector in intermediating funds; availability of credit
- Competitiveness and profitability of nonfinancial private sector
- Efficiency of public sector
- Protectionism and other nonmarket influences
- Labor flexibility

Economic Growth Prospects

- Size and composition of savings and investment
- Rate and pattern of economic growth

Fiscal Flexibility

- General government revenue, expenditure, and surplus/deficit trends
- Revenue-raising flexibility and efficiency
- Expenditure effectiveness and pressures
- Timeliness, coverage, and transparency in reporting
- Pension obligations

General Government Debt Burden

- General government gross and net (of assets) debt as a percent of GDP
- Share of revenue devoted to interest
- Currency composition and maturity profile
- Depth and breadth of local capital markets

Offshore and Contingent Liabilities

- Size and health of nonfinancial public-sector enterprises
- Robustness of financial sector

Monetary Stability

- Price behavior in economic cycles
- Money and credit expansion
- Compatibility of exchange-rate regime and monetary goals
- Institutional factors such as central bank independence
- Range and efficiency of monetary policy tools

External Liquidity

- Impact of fiscal and monetary policies on external accounts
- Structure of the current account
- Composition of capital flows
- Reserve adequacy

Public-Sector External Debt Burden

- Gross and net public-sector external debt, including structured debt, as a percent of current account receipts
- Maturity profile, currency composition, and sensitivity to interest rate changes
- Access to concessional funding
- Debt service burden

Private-Sector External Debt Burden

- Gross and net financial-sector external debt, including deposits and structured debt, as a percent of current account receipts
- Gross and net nonfinancial private-sector external debt, including structured debt, as a percent of current account receipts
- Maturity profile, currency composition, and sensitivity to interest-rate changes
- Access to concessional funding
- Debt service burden

Willingness to pay is a qualitative issue that distinguishes sovereigns from most other types of issuers. Partly because creditors have only limited legal redress, a government can (and sometimes does) default selectively on its obligations, even when it possesses the financial capacity for timely debt service. In practice, of course, political and economic risk are related. A government that is unwilling to repay debt is usually pursuing economic

policies that weaken its ability to do so. Willingness to pay, therefore, encompasses the range of economic and political factors influencing government policy.

As the default frequency of sovereign local currency debt differs significantly from that of sovereign foreign currency debt, both are analyzed. While the same political, social, and economic factors affect the government's ability and willingness to honor local and foreign currency debt, they do so in varying degrees. A sovereign government's ability and willingness to service local currency debt is supported by its taxation powers and its ability to control the domestic financial system, which gives it potentially unlimited access to local currency resources.

To service foreign currency debt, however, the sovereign must secure foreign exchange, usually by purchasing it in the currency markets. This can be a binding constraint, as reflected in the higher frequency of foreign than local currency debt default (see "Sovereign Defaults: Hiatus in 2000," available on RatingsDirect and on standardandpoors.com/ratings, select Resource Center, Ratings Criteria, Sovereigns). The primary focus of Standard & Poor's local currency credit analysis is on the government's economic strategy, especially its fiscal and monetary policies, as well as on its plans for privatization, other microeconomic reform, and additional factors likely to support or erode incentives for timely debt service. When assessing the default risk on foreign currency debt, Standard & Poor's places more weight on the impact of these same factors upon the balance of payments, external liquidity, and the magnitude and characteristics of the external debt burden.

■ Local and Foreign Currency Rating Factors

Key economic and political risks that Standard & Poor's considers when rating sovereign debt include:

- How political institutions and trends in the country, including public security and geopolitical concerns, affect the predictability and sustainability of government policies over time;
- Economic structure and growth prospects;
- General government revenue flexibility and expenditure pressures, general government deficits and the size of the debt burden, and contingent liabilities posed by the financial system and public-sector enterprises;
- Monetary stability; and
- External liquidity and trends in public- and private-sector liabilities to nonresidents.

The first four factors directly affect the ability and willingness of governments to ensure timely local currency debt service. Since fiscal and monetary policies ultimately influence the country's external balance sheet, they also affect the ability and willingness of governments to service foreign currency debt, which is also affected by the fifth factor above. Often, balance of payments constraints are among the most binding.

■ Sovereign Ratings Methodology Profile

Political Risk

The first of the 10 analytical categories in the sovereign ratings methodology profile (see summary above) is political risk. The stability, predictability, and transparency of a country's political institutions are important considerations in analyzing the parameters for economic policymaking, including how quickly policy errors are identified and corrected. The degrees to which politics are adversarial and changes in government are frequent are examined, as well as any public security concerns. Relations with neighboring countries are studied with an eye toward potential security risk. National security is a concern when military threats place significant burdens on fiscal policy, reduce the flow of potential investment, and put the balance of payments under stress.

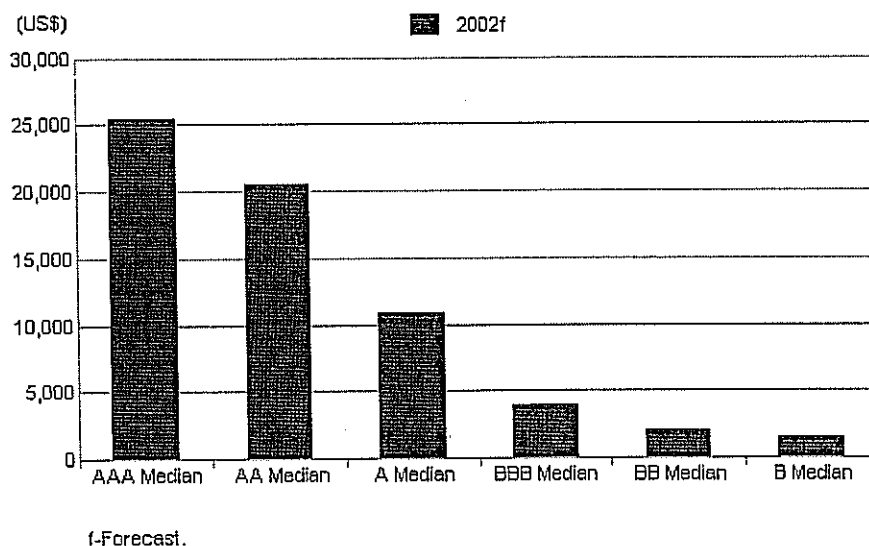
A political risk ranking of "1" for most European Union (EU) sovereigns reflects the broad public backing for their open political frameworks, in which popular participation is high, the process of succession is clear, and the conduct of government is transparent and responsive to changing situations. At the weaker end of the scale, political institutions may have a short track record and/or be considerably less open and effective. The political decisionmaking processes may be highly concentrated, or a significant portion of the population may be marginalized. There may be internal divisions along racial or economic lines, some geopolitical risks, or public security concerns. Political and external shocks are more likely to disrupt economic policy than at higher rankings. For example, Indonesia's short track record with democracy, its problems with secessionist

movements in Aceh and Irian Jaya, its strained relationship with its donor group over economic policy and military reform, and the divisions between the indigenous and Chinese populations result in a weak political risk ranking.

Income and Economic Structure

The second of the 10 sovereign criteria categories is economic structure. Due to its decentralized decisionmaking processes, a market economy, with legally enforceable property rights, is less prone to policy error and more respectful of the interests of creditors than one where the state dominates. Market reform in the transition economies of Central and Eastern Europe has brought the economic structure scores of the Republic of Slovenia, the Czech Republic, and the Republic of Hungary close to those of Western European sovereigns, whose market economies are well entrenched. Rankings in this category are highly correlated with per capita GDP (see chart 2), with a negative adjustment made for narrow economies, weak or less-developed financial systems, and wide income disparities. Weaker rankings also may reflect highly leveraged or undeveloped private sectors, structural impediments to growth, and large and somewhat inefficient public sectors.

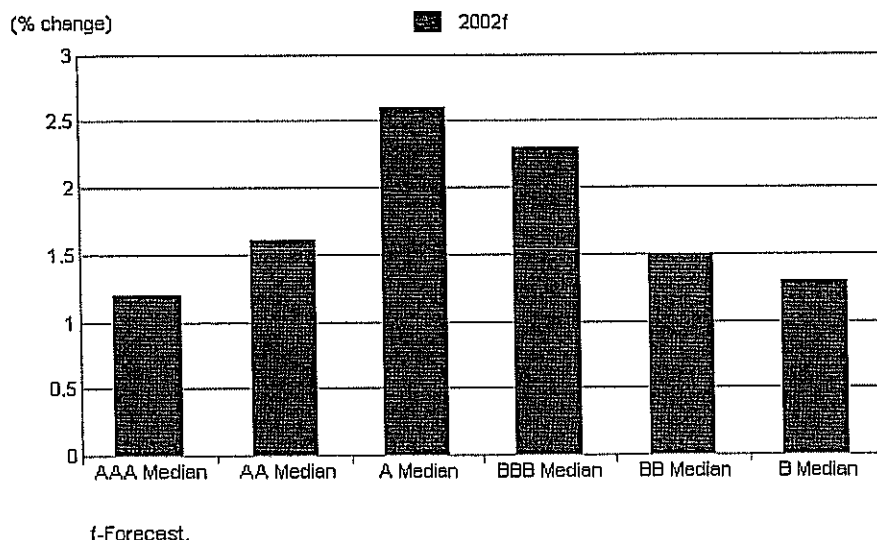
Chart 2
GDP per Capita



Economic Growth Prospects

Standard & Poor's third analytical category for sovereign ratings is economic growth prospects. A government in a country with a growing standard of living and income distribution regarded as broadly equitable can support high public-debt levels and withstand unexpected economic and political shocks more readily than a government in a country with a poor or stagnant economy. Trend growth exceeding 4.5% per annum in the Republic of Estonia and a handful of other countries provides considerably more policy flexibility and a superior economic prospects ranking than Standard & Poor's ascribes to Japan, where economic growth prospects will remain depressed until the private sector restructures more vigorously. Chart 3 illustrates how growth prospects are generally highest in the lower half of the investment-grade category. At top rating levels, the advanced level of development usually precludes high trend rates of growth. In the speculative rating categories shown ('BB' and 'B'), growth is more likely to be erratic and suffer from structural impediments. Note, too, that chart 3 shows 2002, which is an economic recovery year in most countries, but one in which rates of growth can be a bit misleading because of the sharpness of the deterioration in growth in 2001. A five- or ten-year average normally would show higher rates of growth across all categories.

Chart 3
Real GDP per Capita



Fiscal Flexibility

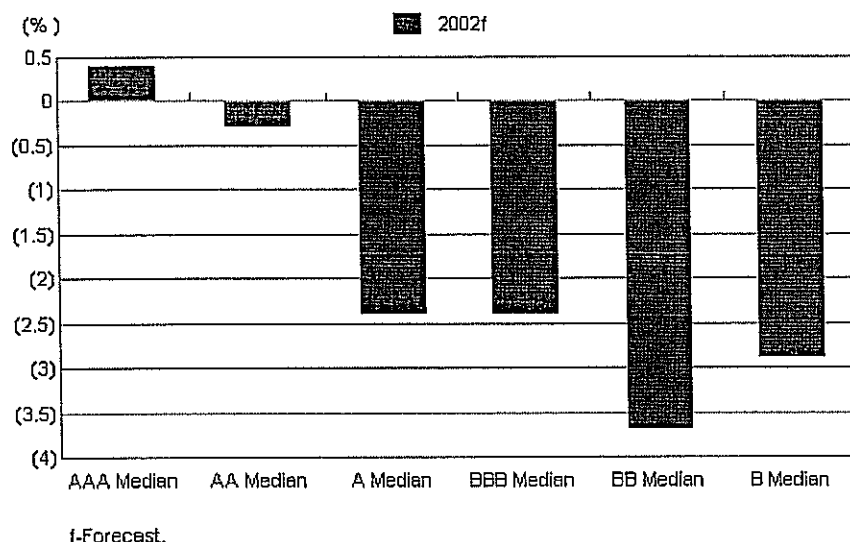
The fourth category in Standard & Poor's sovereign ratings methodology profile is fiscal flexibility, as measured by an examination of general government revenue, expenditure, and balance performance. Fiscal trends, along with methods of deficit financing and their inflationary impact, are important indicators of sovereign credit quality. Scores in this category are a function not only of surpluses and deficits, but also of revenue and expenditure flexibility and the effectiveness of expenditure programs. General government is the aggregate of the national, regional, and local government sectors, including social security and excluding intergovernmental transactions. Noncommercial off-budget and quasi-fiscal activities are included to the extent possible, with significant omissions noted.

Typically, the least-distortionary and most-growth-friendly tax system that also addresses equity concerns has a broad tax base and low tax rates. Sovereigns with strong scores in this category can fairly easily adjust tax bases and rates without serious constitutional, political, or administrative difficulties. Effective expenditure programs provide the public services demanded by the population and the infrastructure and education levels needed to underpin sustainable economic growth, all within the confines of tax and fee resources and affordable financing. Procurement and tendering procedures are transparent. Arrears are quantified and deficits can be reconciled to trends in debt.

The Republic of Singapore receives a top score of "1" in the fiscal flexibility category, despite significant financing needs in its history, because astute investment in public infrastructure and an educated workforce have, over the past 40 years, transformed the country into a prosperous manufacturing- and service-based center. Lower scores are given where government money is not spent as effectively because of constitutional rigidities, political pressures, or corruption, and where revenue flexibility is constrained by already-high taxes or tax-collection difficulties. The environment is less conducive to sustainable economic growth and more suggestive of debt-servicing difficulties. The Republic of Turkey's sizable, albeit declining, deficits and limited revenue and expenditure flexibility give it a weak score in this category. As chart 4 illustrates, deficits tend to be highest in the speculative grade categories. At the lowest rating levels ('B' and below), the deficit may be somewhat lower, with the fiscal flexibility score affected more by quasi-fiscal activities, lack of transparency, and limited revenue and expenditure flexibility.

Looking forward, pension obligations are a fiscal pressure of growing significance for countries in which the population is aging rapidly. Standard & Poor's believes that the sovereign credit ratings of some highly rated EU members could begin to come under downward pressure by the end of this decade if there is no further fiscal consolidation and structural reform to counter the financial problems of ageing societies (see "Western Europe Past Its Prime—Sovereign Rating Perspectives in the Context of Ageing Populations," available on RatingsDirect and on standardandpoors.com, select Resource Center, Ratings Criteria, Sovereigns).

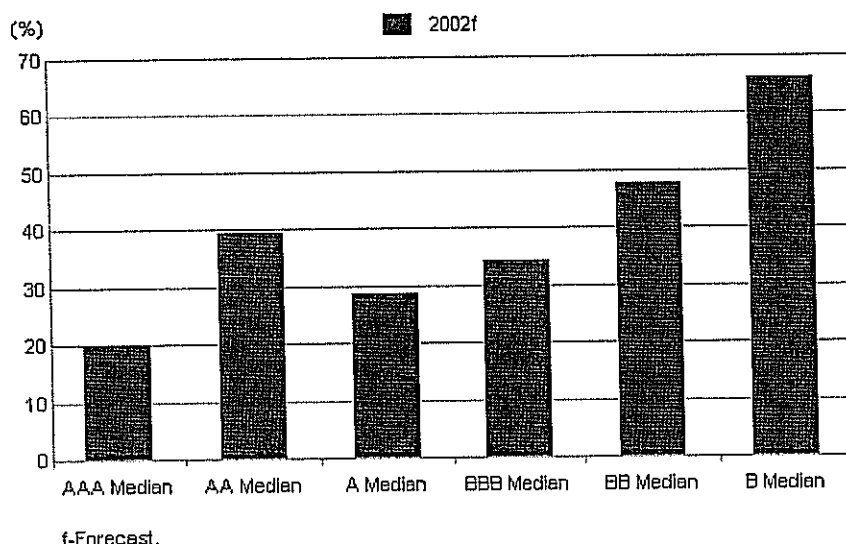
Chart 4
General Government Balance/GDP



General Government Debt Burden

The fifth sovereign criteria category is the general government debt burden. Typically, governments borrow to finance combinations of consumption and investment that increase general government debt. Analysis of public finance is complicated by the fact that the taxation and monetary powers unique to sovereigns can permit them to manage widely varying debt levels over time. A sovereign such as Canada (with a substantial debt burden but an unblemished track record of honoring debt obligations and a strong domestic capital market providing fairly low-cost financing) receives a better score in this category than some sovereigns in Latin America, which may have lower debt to GDP ratios but have higher and more variable debt-servicing burdens. The Government of Japan, the Kingdom of Belgium, and the Republic of Italy, all rated 'AA' and among the most indebted of the rated sovereigns, bring the 'AA' median for general government debt above what one might expect, as shown in chart 5; however, these countries have the wealth, level of development, and revenue-raising ability that allow their governments to support such high debt levels.

Chart 5
Net General Government Debt/GDP



Off-Budget and Contingent Liabilities

Off-budget and contingent liabilities, the sixth sovereign criteria category, can be important rating considerations, with attention focused on the size and health of nonfinancial public sector enterprises (NFPEs) and the robustness of the financial sector. NFPEs pose a risk to the sovereign because they generally have been formed to further public policies and often suffer from weak profitability and low (or virtually nonexistent) equity bases, which leave them highly vulnerable to adverse economic circumstances. To varying degrees, NFPEs may collect revenue and make expenditures that further public policies outside of the budgetary process. If such quasi-fiscal activities are sizeable, the usefulness of general government statistics as an indicator of fiscal performance and position and the role of the government in the economy is diminished. Quasi-fiscal activities generate implicit contingent liabilities. The indebtedness of nonself-supporting NFPEs is a useful measure of the contingent liability, but account is also taken of profitable enterprises that price their products to further budgetary objectives, provide noncommercial services, and/or pay higher-than-commercial prices to suppliers.

The financial sector is a contingent liability because problems can impair a sovereign's credit standing when they lead to official rescues of failing banks. The impetus to assist banks is strong when there is a systemic crisis, since banking system soundness is essential to macroeconomic stability, effective demand management, and sustained economic growth. The sovereign foreign and local currency ratings of the Republic of Korea were sharply downgraded in 1997-1998, in part because of the escalating costs of supporting their banking sectors. Standard & Poor's financial sector analysts regularly examine global financial-sector risk (see "Global Financial System Stress," available on RatingsDirect and on standardandpoors.com, select Resource Center, Criteria, Sovereigns), and their assessments of the potential for a systemic crisis are a crucial input in this category of sovereign analysis. Public-sector banks may weigh heavily in this category when they engage in various quasi-fiscal activities such as subsidized lending, bank rescue operations, or exchange-rate guarantees that are not provided for in the government's budget.

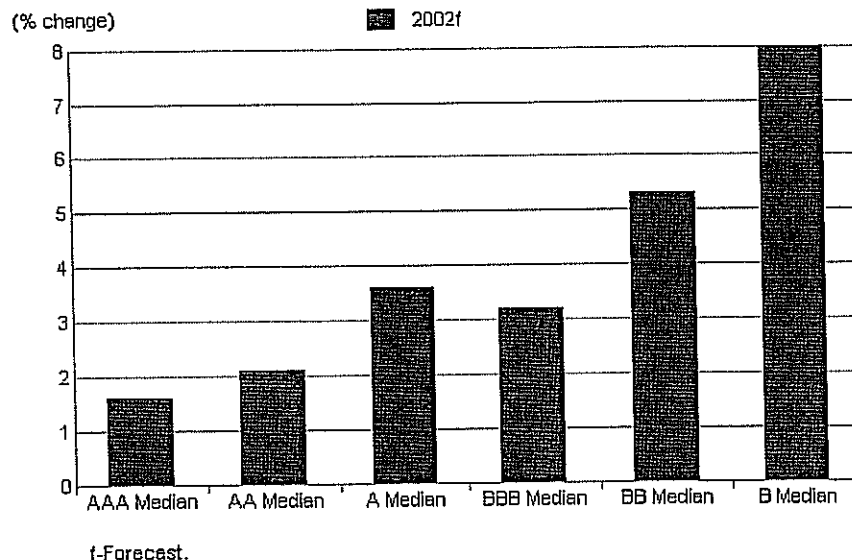
Modest off-budget and contingent liabilities provide New Zealand with a "1" ranking in this category. Asset quality is generally sound, and creditworthy foreign banks own the financial system's largest institutions. In contrast, the government of the People's Republic of China's heavy involvement in troubled state-owned enterprises and poor lending standards in its banking sector justify a low ranking in this category.

Monetary Stability

Monetary stability, the seventh risk category in the sovereign ratings methodology profile, is an important leading indicator of sovereign credit trends. Significant monetization of budget deficits often fuels price

inflation, which can undermine popular support for a government; as a result, policymakers usually respond with containment measures. If they do not, and price increases accelerate, serious economic damage and an erosion of public trust in political institutions can result. These conditions are fertile ground for a sovereign default. Chart 6 shows higher levels of inflation at lower rating categories, although the discrepancies are much smaller than in the past because world inflation has dissipated. Nonetheless, in the 'B' and lower categories, inflation rates for some countries reach well into double digits.

Chart 6
CPI



In evaluating monetary stability, Standard & Poor's considers:

- Price behavior in past economic cycles;
- The level, currency, and maturity structure of the public-sector debt burden, together with the likely extent of future borrowing;
- Money and credit expansion;
- Institutional factors, such as the independence of the central bank;
- The compatibility of the exchange-rate regime with monetary policy goals;
- The range and efficiency of monetary policy tools.

The top ranking of "1" is assigned to the European Central Bank and the U.S., among others. Low inflation is supported by independent central banks pursuing sustainable monetary and exchange-rate policies, and monetary flexibility is bolstered by transparent and well-developed capital markets. On the other hand, Turkey's central bank has not traditionally been independent, and, while this situation is changing, Turkey continues to be plagued by high inflation, resulting in a much weaker monetary stability score.

In conjunction with enhancing monetary flexibility and the effectiveness of monetary tools, the depth and breadth of a country's capital markets can also act as an important discipline. The sovereign has fewer incentives to default on local currency obligations when they are held by a broad cross-section of domestic investors, rather than concentrated in the hands of local banks. For this reason, the establishment of mandatory, privately funded pension funds in a number of countries (such as the Republic of Chile) helps bolster the sovereign's credit standing by creating an influential new class of bondholders. The experience of many Organization for Economic Cooperation and Development (OECD) countries suggests that, even when public debt is high, creditworthiness can be sustained over long periods when policymakers are responsive to constituencies with vested interests in safeguarding the internal value of money and financial contracts.

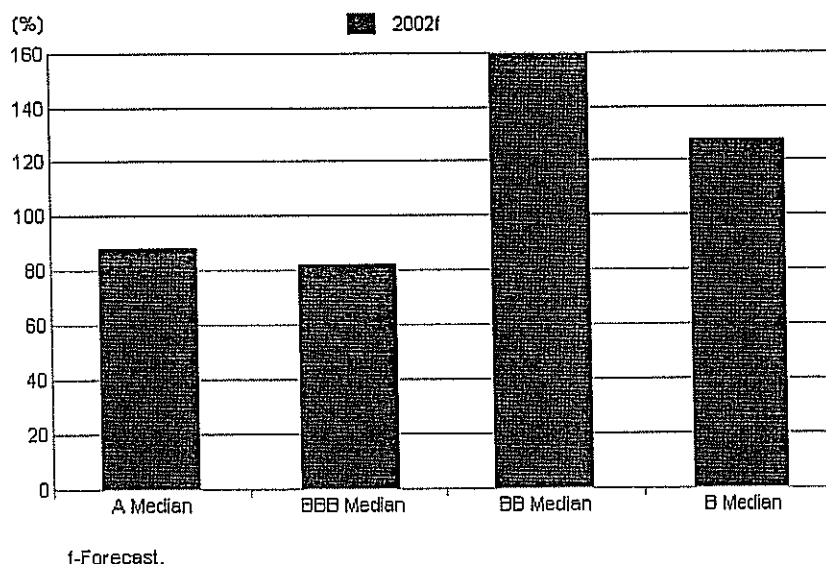
External Liquidity

The eighth risk category in the sovereign ratings methodology profile is external liquidity. Standard & Poor's balance of payments analysis focuses on the impact of economic policy upon the external sector, as well as the external sector's structural characteristics. In the short run, the ability of policymakers to manage financial pressures from abroad depends partly upon the structure of merchandise trade, services, income, and transfers. Yet, balance-of-payments pressures neither appear spontaneously nor reach large magnitudes for structural reasons alone. In most cases, they can be traced back to flawed economic policies. Standard & Poor's approach reflects the premise that the macroeconomic and microeconomic policies discussed earlier affect balance-of-payments behavior.

For this reason, the size of a country's current account deficit, which reflects the excess of investment over savings, may not by itself be an important rating consideration. The tendency for some countries to run current account surpluses and others to run current account deficits is well documented. It is the product of many factors, not all of them negative, and not all related to government policies. Singapore ran very large current account deficits in the 1970s and 1980s, but they were readily financed because they were not the byproduct of fiscal mismanagement. However, Thailand's foreign exchange crisis in 1997 is a sharp reminder that large current account deficits can also be a symptom of serious underlying weaknesses—in this case, a financial sector whose asset quality had weakened dramatically after years of rapid domestic credit growth. And, as the United Mexican States' debt servicing crisis in 1995 illustrated, current account deficits are a concern when government policies result in a public-sector external debt structure that is vulnerable to sudden changes in investor sentiment.

The primary quantitative measure in this criteria category is the gross external financing gap (the current account deficit plus principal due on medium- and long-term public- and private-sector debt plus the stock of debt with an original maturity of less than a year) as a percentage of official foreign exchange reserves, as shown in chart 7. The ratio tends to be below 100% for investment-grade sovereigns and above for speculative grade sovereigns. At the lowest rating levels, the ratio may be below that of high speculative-grade sovereigns because of lack of access to affordable commercial financing or because of the high percentage of concessional financing from official creditors. The degree to which 1) foreign direct investment, particularly greenfield, "finances" a portion of the gap, and 2) strong export growth may mitigate balance-of-payments pressures going forward, are also taken into consideration.

Chart 7
Gross Financing Requirement/Reserves



Official foreign exchange reserves usually act as a financial buffer for the government during periods of balance-of-payments stress. Whether a given level of reserves is adequate or not is judged in relation not only to the gross financing gap, but also to the government's financial and exchange-rate policies and, consequently, the

vulnerability of reserves to changes in trade and capital flows. Reserve management is also reviewed, with adjustment made for any reserves deposited with national banks, placed in questionable special-purpose vehicles, or sold forward in the exchange markets.

The U.S. maintains very low reserves. It can do so because the U.S. dollar generally has floated against other currencies since 1971. The dollar's unique status as the key currency financing global trade and investment also reduces the need for gold and foreign exchange. Most other high investment-grade sovereigns with floating currencies and little foreign currency debt also require relatively modest reserves. (This is the reason the top two rating categories are excluded from chart 7.)

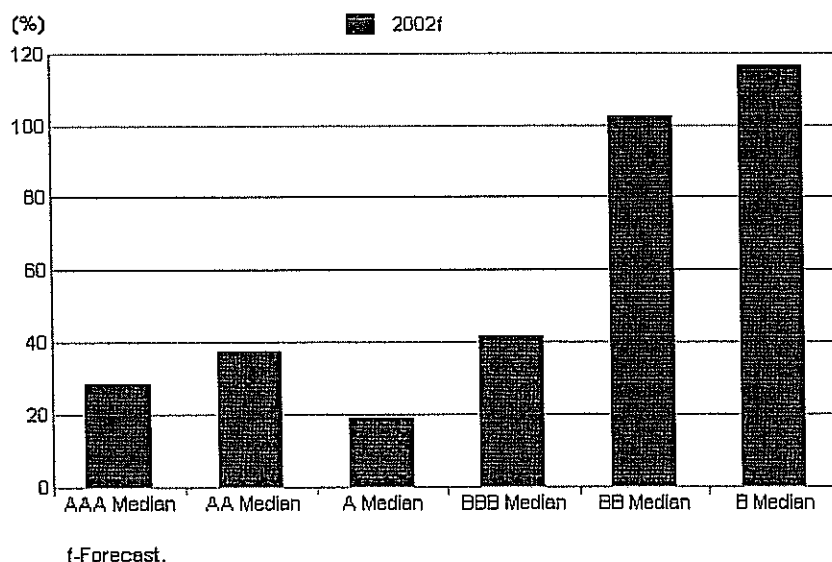
However, at lower rating levels international liquidity is more critical when, as is often the case, government debt is denominated in foreign currencies or significant amounts of local currency debt are held by cross-border investors. Public finance setbacks and other economic or political shocks, consequently, can impair financial market access. Most Latin American sovereigns fall into this category and generally maintain above-average reserves as a result.

Public- and Private-Sector External Debt Burdens

The ninth and tenth sovereign criteria categories are the external debt burdens of the public and private sectors, respectively. Standard & Poor's examines each sovereign's external balance sheet, which shows residents' assets and liabilities vis-à-vis the rest of the world, alongside its analysis of balance-of-payments flows. The main focus is on trends in the public-sector external debt position, the magnitude of contingent liabilities of the government, and the adequacy of foreign exchange reserves to service both public- and (especially in a crisis) private-sector foreign currency debt. To complete the picture, Standard & Poor's calculates an international investment position. This is the broadest measure of a country's external financial position. It adds the value of private-sector debt and equity liabilities to public-sector external indebtedness denominated in local and foreign currencies.

Public-sector external debt includes the direct and guaranteed debt of the central government, obligations of regional and local governments, and the nonguaranteed debt of other public-sector entities. Net public-sector external debt equals total public-sector external debt minus public-sector external financial assets, including official reserves. To measure the magnitude of the public-sector external debt burden, Standard & Poor's compares it to current account receipts (proceeds from exports of goods and services along with investment income and transfers received from nonresidents), as shown in chart 8. The presence in the 'A' category of a few sovereigns with public sectors in strong net external creditor positions (namely, the Republic of Botswana, Republic of Chile, the Czech Republic, the Government of Hong Kong, and the State of Kuwait) keep the 'A' debt burden below what one might otherwise expect. However, the ratings of these sovereigns are constrained by a combination of geopolitical risk, economic concentration, and other factors.

Chart B
Total Public-Sector External Debt/Current Account Receipts



Private-sector external debt burdens are measured as follows. Financial institutions' net external debt equals their borrowings from nonresidents (including nonresident deposits in resident banks) minus financial institutions' deposits with and lending to nonresidents. Net external debt of the nonfinancial private sector equals their borrowings from nonresidents minus nonfinancial private-sector deposits with and lending to nonresidents. Private-sector debt is examined because it can pressure reserves and, in some cases, ultimately become a liability of the state.

External debt also is evaluated in terms of its maturity profile, currency composition, and sensitivity to changing interest rates. Along with new borrowings, these factors influence the size of future interest and amortization payments. Debt service, including interest and principal payments on both short- and long-term debt, is compared with projected current account receipts. Debt contracted on concessional bilateral terms, to some extent, can offset a high public-sector external debt burden. Senegal, for instance, has high public-sector external debt, around 195% of exports in 2002, but favorable terms on restructured foreign currency debt mean that debt service (excluding short-term debt) is moderate at 13% of current account receipts.

Funding from the International Monetary Fund (IMF) and other multilateral official sources is a related factor to consider. However, the availability of official resources is limited in relation to the funds deployed by banks and cross-border investors. Reserve levels and the strength of current account receipts, consequently, deserve particular scrutiny during periods of global financial volatility.

Local and Foreign Currency Rating Distinctions

Any divergence between a sovereign's local and foreign currency ratings reflects the distinctive credit risks of each type of debt. For example, stable, predictable political institutions, fiscal and monetary policies resulting in relatively low inflation, and prosperous and diverse economies are characteristics of sovereign issuers of 'AAA' rated local currency debt. The manageable public-sector external debt burdens of these issuers, in turn, result in foreign currency debt ratings at the upper end of the investment-grade spectrum. Canada ('AAA' local currency and 'AA+' foreign currency) is a good example of a government shouldering a moderate public-sector external debt burden of 47% of current account receipts in 2002, but where fiscal flexibility is substantial and the political commitment to low or moderate rates of inflation is well entrenched. Differences between local and foreign currency debt ratings may widen to some degree with sovereigns that are further down the ratings scale. These sovereigns, typically, fall into one of two categories:

- 1) Those with long records of timely service on both local and foreign currency debt. Inflationary pressures are moderate and public finances are relatively sound, but foreign currency indebtedness may

- be relatively high or is likely to become so over time.
- 2) Those that also have unblemished local currency debt servicing track records, but histories of foreign currency default. The local and foreign currency debt ratings assigned to them balance often substantial improvements in inflation and public finances with the risks inherent to still-heavy foreign currency debt burdens.

At the lower end of the rating scale, such rating differences sometimes narrow. A number of sovereigns in this category have emerged from local or foreign currency debt default within the last decade, and still carry the risk of policy reversals that can result in renewed default. Other sovereigns in this category may not have defaulted, but face high inflation and other forms of social and political stress that carry a material risk of local currency default after payment of foreign currency debt can no longer be assured.

Ratings of EU states in the European Monetary Union (EMU) present a special case. Sovereigns in EMU have ceded monetary and exchange-rate responsibilities to the European Central Bank. As a result, Standard & Poor's rates each government's euro-denominated and foreign-currency debt the same. Economic and fiscal factors are the dominant criteria for differentiating credit quality of sovereigns inside EMU (see "Local and Foreign Currency Ratings Converge for EMU Issuers," on RatingsDirect). Local currency ratings for the Principality of Liechtenstein, the Cook Islands, and the Republics of Panama, El Salvador, and Ecuador are the same as their respective foreign currency ratings because these countries use the currencies of the EMU, New Zealand, and the U.S. (for the latter three).

A number of factors must be examined when considering whether distinctions between local and foreign currency ratings are appropriate. Governments less frequently default on local currency debt because the ability to tax and control over the domestic banking system give them access to some finance, even when foreign currency debt is in default. Sovereigns must also have the political will and influence to use these powers. Russia defaulted on its ruble debt in August 1998, in part, because a substantial portion was held by nonresidents seeking to reduce their holdings of both government debt and rubles. In such cases, the flexibility needed to meet local currency obligations is more limited, and Standard & Poor's usually rates local currency debt the same as, or only slightly higher than, foreign currency debt. The same considerations constrain the rating of dollar-indexed local currency debt, which usually is (at most) one notch higher than the foreign currency rating. The cost of servicing such debt is similar to the cost of servicing foreign currency debt.

In cases in which the primary rating constraint is geopolitical risk, there also may be little or no distinction between foreign and local currency ratings because the special powers of a sovereign in its ability to tax and control over the monetary and financial systems may count for little in the event of geopolitical stress. Hong Kong's foreign and local currency ratings are both constrained by China risk and are only one notch apart.

Sovereign Rating Changes

Until the 1990s, rated sovereigns formed an exclusive club of the world's most creditworthy governments. In 1980, Standard & Poor's rated just a dozen sovereign issuers—all at the 'AAA' level. Rating downgrades were relatively rare over the remainder of that decade and, when they occurred, usually were of modest dimensions. Today, the sovereign sector is far more heterogeneous. The 90 plus sovereigns Standard & Poor's monitors carry ratings between 'AAA' and 'SD' (selective default). Given this range of credit quality, rating changes occur more frequently.

Because sovereign ratings measure future debt service capacity, rating committees consider reasonable "worst-case" scenarios over a five-year time horizon to gain a better understanding of future downside risks. The government's medium-term financial program, when available, is scrutinized alongside independent forecasts. Standard & Poor's then examines the interaction between public-sector finances, external debt, and other variables, such as real export growth, asset quality trends affecting the local banking system, and changes in overseas interest rates. Standard & Poor's attempts to incorporate in its ratings risks arising over economic, political, commodity, and interest rate cycles. Rating changes occur whenever new information significantly alters Standard & Poor's view of likely future developments. This usually results from the policy response or the degree of latitude in a given area being different from what was expected.

For sovereigns, one of the lessons of recent years is that a strong policy response that identifies and addresses sources of instability is key. Whether the problem is a weak banking sector, excessively leveraged corporates, inflexible exchange-rate regimes, or high fiscal imbalances, a strong policy response is crucial for strengthening the economic environment and sovereign creditworthiness.

■ Sovereign Ratings and Corporate Credit Risk

Sovereign credit risk is a consideration in assessing the credit standings of private-sector entities, but sovereign ratings do not cap private-sector ratings. Sovereign risk comes into play in analyzing private-sector creditworthiness because the unique, wide-ranging powers and resources of each national government affect the financial and operating environments of entities under its jurisdiction. Past experience has shown that defaults by otherwise-creditworthy borrowers can stem directly from the imposition of exchange controls that impede debt service, often, though not always, linked to a sovereign default. This has occurred most recently in Argentina.

In the case of foreign currency debt, the sovereign has first claim on available foreign exchange and controls the ability of residents to obtain funds to repay creditors. As a result, absent a monetary union with a higher-rated central bank or special considerations insulating the issuer or issue (such as a supportive foreign parent, substantial offshore business, or structural features), the credit rating of an international borrower most often is at, or below, the rating of the sovereign in the country of domicile. In some cases, Standard & Poor's may decide that the risk of sovereign interference is less than the risk of sovereign default and rate a private-sector entity higher than the sovereign even without the special features noted above, but such instances have been rare. Moreover, as the international community considers various sovereign bankruptcy plans that may include the imposition of foreign exchange controls, the scope for assigning higher sovereign interference ratings (lower sovereign interference risk) is likely to remain limited.

In contrast, sovereigns are not very likely to interfere directly in the service of private-sector debt when access to foreign exchange is not involved. As a result, the potential for rating a private-sector entity higher than a sovereign on a local currency basis is much greater. Private-sector local currency ratings speak to the willingness and ability of the entity to service its debt (both foreign- and local-currency denominated) in full and on time, absent foreign exchange controls. However, indirect sovereign risk continues to be an important consideration because when a sovereign is in distress or default, economic and business conditions are apt to be quite hostile for all entities. The economy likely will be contracting, the currency depreciating, taxes increasing, public services deteriorating, inflation escalating, and interest rates soaring. In the most difficult situations, bank deposits will be frozen. Thus, only corporations with exceptional operational and financial flexibility that diminish these risks are likely to be rated higher than the sovereign.

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Research:

Sovereign Credit Characteristics by Rating Category

Publication date: 19-Nov-2003
 Primary Credit Analyst(s): Marie Cavanaugh, New York (1) 212-438-7343;
 marie_cavanaugh@standardandpoors.com

Sovereign profiles by rating category illustrate how the various components of Standard & Poor's Ratings Services' sovereign ratings criteria (see "Sovereign Credit Ratings: A Primer," published on RatingsDirect, Standard & Poor's Web-based credit analysis system, March 15, 2004) are combined to produce ratings. A sovereign rating reflects Standard & Poor's opinion on a central government's willingness and ability to service commercial financial obligations on a timely basis. The listed characteristics are a summary, not any sort of checklist, and sovereigns in any given rating category may have some traits more commonly found in higher or lower rated sovereigns. An individual sovereign's variations from the described profile are also a function of the forward-looking nature of the rating process. In its sovereign analysis, Standard & Poor's looks at trends and vulnerabilities to potential shocks in a wide variety of political and economic factors, analyzing developments with both quantitative and qualitative measures. (Standard & Poor's has public ratings on more than 100 sovereign governments. See "Sovereign Ratings History Since 1975," updated monthly on RatingsDirect, for a full list of all sovereign ratings.)

■ 'AAA' Rated Sovereigns

Sovereigns assigned Standard & Poor's highest rating, 'AAA', typically have strong political institutions (including well-established property rights and an effective judicial framework) and adaptable political systems. Sovereigns rated 'AAA' are open to trade and finance, which facilitates competition and specialization and permits the efficient use of resources. The macroeconomic stability of these sovereigns precludes the development of destabilizing imbalances and provides an environment conducive to investment.

Most of the world's largest industrialized countries have 'AAA' rated sovereigns (the U.S., U.K., Federal Republic of Germany, and Republic of France), as do a handful of smaller countries with specific attributes underlying their strength (e.g., the Grand Duchy of Luxembourg, the State of The Netherlands, the Kingdom of Norway, the Republic of Singapore, and the Swiss Confederation).

Characteristics of 'AAA' rated sovereigns include:

- Stable, transparent, and accountable political institutions.
- The flexibility to respond to changing economic and political circumstances relatively quickly and without major disruption.
- Openness to trade and integration into the global financial system.
- A prosperous, diverse, and resilient economy, with high per capita income.
- An efficient public sector with countercyclical fiscal policies, low deficits, and largely local currency government debt.
- An independent central bank pursuing sustainable monetary and exchange rate policies; an international currency; low inflation.
- Strong, diversified, well-regulated financial sector and capital markets.
- Ample external liquidity and low external debt.

■ 'AA' Rated Sovereigns

'AA' rated sovereigns have a very strong capacity to service debt on a timely basis, and their characteristics are similar to those of 'AAA' rated sovereigns, differing only in degree. Thus, their economies are a little more vulnerable to adverse external influences, fiscal deficits tend to be more

variable, and government and external debt burdens are generally higher. Among the most challenging issues are pension reform and labor market flexibility.

Characteristics of 'AA' rated sovereigns include:

- Stable, transparent, and accountable political institutions.
- The flexibility to respond to changing economic and political circumstances quickly and without major disruption.
- Openness to trade and integration into the global financial systems.
- A prosperous economy, but slightly more vulnerable than 'AAA' sovereigns to adverse external influences.
- An efficient public sector with countercyclical fiscal policies, variable deficits, and largely local currency government debt.
- An independent central bank pursuing sustainable monetary and exchange rate policies; low inflation.
- Diversified, well-regulated financial sector and capital markets.
- A low public and private sector external financing requirement relative to usable reserves; modest external debt.

≡ 'A' Rated Sovereigns

For 'A' rated sovereigns, ratings tend to be constrained by vulnerabilities associated with a sovereign's stage of development, narrowly based economy, need to restructure, and/or political situation. This diverse group of countries has, for the most part, enjoyed fairly rapid economic development and diversification in recent years; a result of their success in economic liberalization. For many of these sovereigns, some macroeconomic, fiscal, and external indicators may be as strong as or even stronger than those of 'AA' rated sovereigns. However, their vulnerabilities keep the ratings below what a solely quantitative approach would suggest.

Characteristics of 'A' rated sovereigns include:

- Political institutions evolving toward greater accountability and more stable, transparent forms of governance; possibly some geopolitical risk.
- Openness to trade and integration into the global financial system.
- A less diversified economy than for 'AA' rated sovereigns, but economic policies are generally cautious, flexible, and market oriented.
- Rapid trend growth in output and GDP per capita, reflecting progress in economic restructuring.
- A fairly efficient public sector with moderate fiscal deficits; a less developed local debt market may necessitate offshore borrowing.
- A fairly independent central bank pursuing sustainable monetary and exchange rate policies, but flexibility is more limited than at higher rated sovereigns; moderate inflation.
- A well-regulated financial sector, possibly with some ongoing challenges, and developing capital markets.
- A public and private sector external financing requirement that is modest relative to usable reserves; moderate external debt.

≡ 'BBB' Rated Sovereigns

The 'BBB' range is the lowest within what the investment community commonly refers to as the investment-grade category. In Standard & Poor's opinion, the cushion supporting timely debt service is not as large as at higher rating levels. Political factors play a larger role here than at higher levels, but orthodox market-oriented economic programs are generally well established. 'BBB' rated sovereigns tend to be the most heavily immersed in economic reform and liberalization (as are many lower rated sovereigns), and are at an earlier stage in the reform process than their more highly rated peers. Median per capita GDP is about US\$5,000, far below the 'A' median's US\$11,000. Debt may be high, and there is likely to be greater reliance upon short-term debt and debt indexed to, or denominated in, a foreign currency than at higher rating levels. Capital markets are less developed, and the financial sector may be small and/or encumbered by weak economic performance and supervisory

shortcomings.

Characteristics of 'BBB' rated sovereigns include:

- Less transparent political institutions; system may be in transition or succession process may be divisive; some geopolitical risk and social stress possible.
- Openness to trade and growing integration in global financial system.
- A less prosperous economy than in higher rated sovereigns, with more vulnerability to political and external shocks.
- A record of satisfactory economic performance under adverse external conditions and well-established support for market-oriented economic programs; reform to enhance competitiveness, transparency, and flexibility is under way.
- Government revenue and expenditure flexibility limited by already-high taxes/fees, collection difficulties, and spending pressures; greater need to borrow externally than in a higher rated sovereign.
- A fairly independent central bank pursuing sustainable monetary and exchange rate policies, but market orientation of tools is limited by less developed financial markets.
- An evolving financial sector, with possible problems creating a significant contingent liability for the government.
- Public and private sector external financing requirement significant relative to usable reserves; moderate to high external debt.

≡ **'BB' Rated Sovereigns**

The 'BB' range, the highest in what is commonly referred to as the speculative-grade category, reflects significantly more political risk, with political factors possibly disrupting economic policy. Income is low to moderate, and lack of diversity and structural impediments may restrain economic growth. As at higher levels, the central bank pursues sustainable monetary and exchange rate policies, but market-oriented tools are not well developed. The financial sector is likely to come under stress when economic growth slows, and capital markets have a short track record. Debt and debt service are usually high and variable.

Characteristics of 'BB' rated sovereigns include:

- Political factors are a source of some uncertainty, with less transparent institutions and less open process than at higher ratings; possibly some geopolitical risk and social stress.
- Openness to trade and a growing integration into the global financial system, though possibly with more restrictions than at higher rating levels.
- A low- to moderate-income economy, with variable economic performance and vulnerability to adverse political and external influences.
- An economy that is not well diversified or suffers from structural impediments to growth; wide income disparities.
- Government revenue and expenditure flexibility limited by already-high taxes/fees, collection difficulties, and spending pressures; absent capital controls, nonofficial debt tends to be short term and denominated in, or linked to, a foreign currency.
- A central bank pursuing sustainable monetary and exchange rate policies, but relying more heavily upon direct means than at higher rating levels; variable inflation.
- The financial sector comes under stress when economic growth slows, with possible problems creating a significant contingent liability for the government
- A large public and private sector external financing requirement relative to usable reserves; moderate to high external debt.

≡ **'B' Rated Sovereigns**

In the 'B' range, political factors tend to be a source of uncertainty when the economic environment deteriorates. Orthodox economic policies are usually not well established. Much of the private sector may be dependent upon government protection. Financial sectors tend to be weak. Absent capital controls, nonofficial debt tends to be short term and denominated in or linked to a foreign currency. The

narrowness of the economic base, fiscal imbalances, and/or shallow debt markets constrain central bank flexibility. Timely debt service is vulnerable to adverse external influences while income is low to moderate, and fiscal deficits, inflation, and external debt tend to be high.

Characteristics of 'B' rated sovereigns include:

- Political factors are a source of uncertainty, with change in government sometimes leading to economic policy disarray; institutions are less open and effective than at higher rating levels; possibly some geopolitical risk and social stress.
- Openness to trade, but integration into the global financial system is weak and subject to changing circumstances
- A low- to moderate-income economy, with a variable economic performance and vulnerability to adverse political and external influences.
- The economy is either not well diversified or suffers from structural impediments to growth; the private sector is less developed and sometimes dependent upon government protection/support; wide income disparities.
- Macroeconomic stabilization efforts may be untested; government revenue and expenditure flexibility limited by already-high taxes/fees, collection difficulties, and spending pressures; absent capital controls, nonofficial debt tends to be short term and denominated in, or linked to, a foreign currency.
- A central bank constrained by structural problems or fiscal imbalances and debt markets that are shallow; variable and sometimes high inflation.
- The financial sector is undeveloped, possibly creating a significant contingent liability for the government.
- A very large public and private sector external financing requirement relative to usable reserves; moderate to high external debt.

☰ **'CCC' and Lower Rated Sovereigns**

Below the 'B' category, at 'CCC' or 'CC', there is a clear and present danger of default. Governments may have already missed payments to official bilateral creditors, with Paris Club rescheduling under way. There is considerable economic, and perhaps political, turmoil. The currency is weakening, inflation is rising, and the short-term debt service burden is a huge challenge. At the selective default ('SD') level, there have already been some missed payments or a coercive exchange offer on debt to commercial banks and/or bondholders.

Characteristics of 'CCC' or lower rated sovereign include:

- A clear and present danger of default.
- May be in default on bilateral debt (and other classes of debt, in the case of 'SD').
- Relatively weak political institutions and an uncertain political environment, with potentially difficult internal divisions and geopolitical risk.
- Sharp currency depreciation and high inflation, possibly hyperinflation.
- High fiscal and external debt, with a significant near-term debt-servicing burden.
- A weak financial sector and an acute shortage of credit.

☰ **Surveillance and Rating Changes**

Standard & Poor's has an ongoing surveillance policy, which normally includes a formal review of each rated sovereign at least annually, and often more frequently. The primary analyst communicates with the sovereign issuers for which he or she is responsible on a regular basis by telephone and e-mail. In most countries, the ministry of finance and the central bank post a great deal of information to the Internet, as do outside observers. This facilitates the process by which the analytical team monitors economic and political developments. Meetings in the country usually are held once a year, supplemented by meetings with government officials when they visit Standard & Poor's offices or various development bank gatherings. Information collected from any of these sources may be the basis for a committee at any time it is deemed necessary.

In its sovereign ratings, Standard & Poor's seeks to look through economic, commodity, and political cycles. Rating changes occur whenever new information significantly alters Standard & Poor's view of likely future developments. This usually results from the policy response or degree of latitude in a given area being different from what was expected. For sovereigns, one of the lessons of recent years is that a strong policy response that identifies and addresses sources of instability is key. Whether the problem is a weak banking sector, excessively leveraged corporates, inflexible exchange regimes, or high fiscal imbalances, a strong policy response is crucial for strengthening the economic environment and sovereign creditworthiness.

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Exhibit 4

EXPLANATORY NOTE

(This note is not part of the Order)

This Order provides:

1) for the determination by the Foreign Compensation Commission of claims to participate in a sum received by Her Majesty's Government from the Government of the People's Republic of China under the Agreement between the two Governments signed in Beijing on 5th June 1987 concerning the Settlement of Mutual Historical Property Claims; and

(2) for the distribution by the Commission of that part of the aforesaid sum that is paid to them to applicants who have established claims under the Order.

STATUTORY INSTRUMENTS

1987 No. 2201 FOREIGN COMPENSATION

The Foreign Compensation (People's Republic of China) Order 1987

Made	18th December 1987
Laid before Parliament	8th January 1988
Coming into force	1st March 1988

At the Court at Buckingham Palace, the 18th day of December 1987

Present,

The Queen's Most Excellent Majesty in Council

Whereas Her Majesty is authorised to make provision by Order in Council under section 3 of the Foreign Compensation Act 1950 for the determination by the Foreign Compensation Commission (hereinafter referred to as "the Commission") of claims to participate in compensation received under an agreement with the government of any other country, for the making of reports by the Commission with respect to such claims and for the distribution by the Commission of such compensation:

And Whereas an Agreement (hereinafter referred to as "the Agreement") entered into between Her Majesty's Government and the Government of the People's Republic of China on 5th June 1987 provides that the Chinese Government shall pay to the Government of the United Kingdom the sum of £23,468,008 and that the Government of the United Kingdom shall be responsible for the settlement of claims and for any distribution from that sum:

And Whereas Her Majesty's Government in the United Kingdom intends to pay part of the said sum to the Commission for distribution:

Now, therefore, Her Majesty, by virtue and in exercise of the powers in that behalf by the Act of 1950 or otherwise in Her Majesty vested, is pleased, by and with the advice of Her Privy Council, to order, and it is hereby ordered, as follows:

PART I

COMMENCEMENT, CITATION AND INTERPRETATION

1. This Order shall come into operation on 1st March 1988, and may be cited as the Foreign Compensation (People's Republic of China) Order 1987.

2. In this Order:—

"Bond" means a bond or other document of title in respect of a loan or obligation issued or guaranteed before 1st October 1949 by a former government of the territory or any part thereof or by any other public authority in the territory.

"British national" means:—

- (a) any individual who was at the material time a citizen of the United Kingdom and Colonies, a British subject by virtue of sections 2, 13 or 16 of the British Nationality Act 1948 or the British Nationality Act 1965, or a British protected person within the meaning of the said Act of 1948; except that any individual who was a British subject at any time before the date of the commencement of the said Act of 1948 only by virtue of the provisions of the Act of 1705, intituled "An Act for the Naturalization of the Most Excellent Princess Sophia Electress and Duchess Dowager of Hanover and the Issue of Her Body", shall be deemed not to be a British national;
- (b) any corporation, firm or association incorporated or constituted under the laws in force in the United Kingdom or in any territory for whose international relations Her Majesty's Government in the United Kingdom were, at the material time, responsible;
- (c) any individual who as regards any material time after 31st December 1949 was a citizen of Southern Rhodesia or a citizen of Rhodesia and Nyasaland, and any individual who as regards any material time after 31st October 1957 and prior to 17th September 1963 was a citizen of Singapore.

"Debt" means a sum due or owing, or a claim for unliquidated damages, but shall not include a balance in a bank, or any such sum or claim in respect of which a bond or share has been issued, or a pension or contributions towards a pension.

"Material time" means any time before 1st January 1980 at which it is material for the purposes of this Order whether or not a person is a British national.

"Person" includes, except where the context otherwise requires, an individual, corporation, firm, or association.

"Predecessor in title" means any person through whom, whether directly or indirectly, a person making application under this Order (including a trustee) has succeeded, whether by assignment or otherwise, to the property or claim to which the application relates.

"Property" includes all rights or interests of any kind in property.

"Relevant date" means 1st October 1949 or such later date before 1st January 1980 on which the applicant, or his predecessor in title, was deprived of title to or enjoyment of property, or of the right to recover a debt, or suffered loss in respect of a share, or became unable to recover a bank balance, or upon which a debt first became due for repayment.

"Rules of the Commission" means rules made by the Commission with the approval of the Lord Chancellor under section 4(2) of the Foreign Compensation Act 1950 regulating the procedure of the Commission in determining applications made under this Order.

"Share" includes stock, a debenture, debenture stock and any funded obligation of a corporation.

"Secretary of State" means Her Majesty's Principal Secretary of State for Foreign and Commonwealth Affairs.

"The territory" means the territory which is on the date on which this Order comes into operation controlled by the authorities of the People's Republic of China.

"Trustee" includes a personal representative of a deceased person or a nominee; and "beneficiary" shall have a corresponding meaning.

PART II

THE FUND

3. The Commission shall pay into a fund to be called the People's Republic of China Fund (hereinafter referred to as "the Fund") all such sums as may be paid to them by Her Majesty's Government, being sums received under the Agreement and any income arising therefrom.

4.—(1) Any sums standing to the credit of the Fund may be temporarily invested by the Commission in such manner as the Treasury may authorise.

(2) All interest, dividends and other sums received by the Commission as a result of any investment made by them of any sum standing to the credit of the Fund shall be paid into the Fund.

5. When it appears to the Secretary of State that all payments to be made into the Fund have been made and that all payments which it is practicable to make out of the Fund have been made, he may direct that the Fund shall be wound up and that any sum remaining therein shall be paid into the Consolidated Fund.

PART III

GENERAL PROVISIONS CONCERNING THE ESTABLISHMENT OF CLAIMS.

6. An application shall not be entertained by the Commission under Part IV, V or VI of this Order unless:

(a) being an application under Part IV, it has reached the Commission on or before 30th June 1988, or, being an application under Part V or VI, it has reached the Commission on or before 31st August 1988; and

(b) it is made in accordance with the Rules of the Commission.

Provided that no such application shall be entertained by the Commission if it is made by the Crown, the Duchy of Lancaster or the Duke of Cornwall or by any person acting in their name or on their behalf.

7.—(1) Each application made under this Order shall be determined by a single member of the Commission, who may proceed directly to a final determination of the application solely on the written evidence and submissions, provided that, notwithstanding the foregoing:

(a) no claim shall be dismissed except upon determination by not less than two members of the Commission;

(b) where the aggregate of all amounts claimed by an applicant under this Order exceeds £100,000, the application shall in any event be determined by not less than two members of the Commission;

(c) the Commission:—

- (i) may if they think fit direct that an application be the subject of an oral hearing and
- (ii) shall not refuse a request for an oral hearing in respect of any application except by decision of not less than two members of the Commission.

(2) Nothing in paragraph (1) of this Article shall be taken as limiting or restricting the power of the Commission to review any determination in accordance with the Rules of the Commission.

8. Subject to the provisions of this Order, the Commission shall assess the amount of loss with respect to each claim established under this Order as may seem just and equitable to them having regard to all the circumstances.

9. If, for the purposes of this Order, it is necessary for the Commission to determine the rate of exchange between foreign currency and sterling on any date, that rate shall be deemed to be the middle rate for telegraphic transfers ruling in the London market on that date or, if the Commission consider that middle rate to be inappropriate, such rate as the Treasury may determine.

10. In assessing the amount of loss with respect to any claim established under this Order the Commission shall take into account the principal value only of the claim and shall not include any element in respect of interest thereon; and for this purpose the principal value of a claim shall be deemed to be the principal amount outstanding on the relevant date irrespective of whether any contract provided for the payment of interest.

11. In assessing the amount of loss with respect to any claim established under this Order, the Commission shall have regard to any compensation, recoupment or payment received in respect of that loss from any source by the person making the application or his predecessor in title or any trustee for such person or predecessor in title or, if the person making the application is a trustee, any beneficiary or any predecessor in title of any beneficiary.

12.—(1) An application under Part IV or V of this Order may be made by a trustee qualified under Articles 14 or 16 or by a beneficiary so qualified. An application by a trustee shall, however, be entertained by the Commission only in so far as the beneficial interest in the property or in the claim to which the application relates was, at the material times, owned by a British national.

(2) If an application under this Order is made by a trustee and by a beneficiary in relation to the same claim, and both the trustee and the beneficiary are qualified to make the application under this Order, the Commission may entertain the application made by the trustee in preference to that made by the beneficiary, or entertain the application made by the beneficiary in preference to that made by the trustee. The Commission shall dismiss the application by the trustee or by the beneficiary, as the case may be, which it has decided not to entertain.

13. The Commission shall report, in such manner as the Secretary of State may direct, upon any applications made under this Order, upon any claims established and upon the amount of loss assessed with respect to the claims so established.

PART IV

CLAIMS IN RESPECT OF BONDS

14.—(1) To establish a claim in respect of a bond under this Part of the Order, any person making application to the Commission shall be required to establish to the satisfaction of

the Commission that he:

- (a) was on 4th June 1987 (or, if he is a trustee, is a trustee for a person who was on 4th June 1987) either:
 - (i) a British citizen, a British Dependent Territories citizen, a British Overseas citizen, a British subject or a British Protected Person, or
 - (ii) a corporation, firm or association incorporated or constituted under the laws in force in the United Kingdom or in any country or territory for whose international relations Her Majesty's Government in the United Kingdom were on 4th June 1987 responsible, and
- (b) is and was on 4th June 1987 the beneficial owner of the bond to which the application relates, or is a trustee for a person who was the beneficial owner of the bond on 4th June 1987 and who has since died.

(2) Any person making application to the Commission in accordance with paragraph (1) shall be required to deliver to the Commission the bond to which the application relates and to make a statutory declaration in such form as may be prescribed by the Commission in relation to the matters specified in paragraph (1)(b).

15. For the purposes of this Part of the Order:—

- (a) the value to be assigned to a bond denominated in sterling shall be the amount specified as the nominal capital value on the bond;
- (b) the value to be assigned to a bond denominated in a currency other than sterling but bearing on its face the sterling equivalent of its nominal capital value shall be taken to be the amount so specified in sterling;
- (c) the value to be assigned to any other bond denominated in a currency other than sterling shall be the amount of that currency specified as the nominal capital value on the bond converted at the rate of exchange ruling between that currency and sterling on the date of issue of the bond.

PART V

CLAIMS IN RESPECT OF DEBTS, BANK BALANCES, SHARES AND OTHER PROPERTY

Qualifications to make Application

16. An application to the Commission for the purpose of establishing a claim under this Part of the Order may be made by any person who was on 5th June 1987 (or, if he is a trustee, is a trustee for a person who was on 5th June 1987) either:—

- (a) a British citizen, a British Dependent Territories citizen, a British Overseas citizen, a British subject or a British Protected Person, or
- (b) a corporation, firm or association incorporated or constituted under the laws in force in the United Kingdom or in any country or territory for whose international relations Her Majesty's Government in the United Kingdom were on 5th June 1987 responsible.

Property

17.—(1) To establish a claim under this Part of the Order in respect of property (other than a debt, a balance in a bank, a share or a pension or contributions towards a pension), any person making application to the Commission shall be required to establish to the satisfaction of the Commission:—

- (a) that he is a person qualified under Article 16 of this Order to make such application;
- (b) that immediately before the relevant date the property to which the application relates was situated in the territory and was British property (as provided in paragraph (2) of this Article); and
- (c) that he or his predecessor in title (or, if he is a trustee, the person for whom he is a trustee or the predecessor in title of such person) was deprived on a relevant date of ownership or enjoyment of such property by any act of confiscation, nationalisation, expropriation, destruction, or dispossession whether direct or indirect or through the application of measures effectively causing dispossession.

(2) Property shall be deemed to be British property for the purposes of this Article to the extent that it was beneficially owned by a British national.

Debts and Bank Balances

18. To establish a claim under this Part of this Order in respect of a debt or a balance in a bank, any person making application to the Commission shall be required to establish to the satisfaction of the Commission:—

- (a) that he is a person qualified under Article 16 of this Order to make such application;
- (b) that his application relates, either
 - (i) to a debt which at the relevant date was owing to a British national from a public authority or other person (other than a British national) resident or carrying on business in the territory and which is still unpaid; or
 - (ii) to a balance which was held by a British national on the relevant date in a bank in the territory and which is still outstanding; and
 - (iii) to a balance in a bank in the territory which, as a result of any provision of the Agreement, he (or if he is a trustee, the person for whom he is a trustee) has become unable to recover and which is still outstanding; and
- (c) that he (or, if he is a trustee, the person for whom he is a trustee) is the person to whom the debt or the outstanding bank balance is owing.

Shares

19. To establish a claim under this Part of the Order in respect of a share, any person making application to the Commission shall be required to establish to the satisfaction of the Commission:

- (a) that he is a person qualified under Article 16 of the Order to make such application;
- (b) that the share was beneficially owned at the relevant date by a British national;
- (c) that the company to which the share related was incorporated or constituted under the laws in force in the territory; and
- (d) that he or his predecessor in title (or, if he is a trustee, the person for whom he is trustee or the predecessor in title of such person) has suffered loss in respect of the share as a result of any act of confiscation, nationalisation, expropriation or other act of dispossession applied in the territory on a relevant date to the share or to the company or to any of its assets.

20. For the purposes of this Part of this Order, the Commission may, if they think fit, assume, without proof of any specific act of dispossession, that any person has been deprived of title to or enjoyment of any property, or that such a person has suffered loss in respect of a share, and that such deprivation or loss was the result of an action or course of action or omission of the authorities of the area in which the property or share was situated.

PART VI

CLAIMS IN RESPECT OF PENSIONS

21. To establish a claim under this Part of this Order, any person making application to the Commission shall be required to establish to the satisfaction of the Commission:

- (a) that he was on 5th June 1987 a British citizen, a British Dependent Territories citizen, a British Overseas citizen, a British subject or a British Protected Person;
- (b) that his application relates to a pension, or to the contributions made towards a pension, which is or would in due course have become payable to him by any public authority in the territory or by a person (other than a British national) resident in the territory;
- (c) that at a time when he was a British national the payment to him of the pension was stopped, or his future rights to receive payment of the pension were taken away or ceased.

PART VII

PAYMENTS OUT OF THE FUND

22.—(1) The Commission shall make payments out of the Fund to every person who has established a claim under this Order and who applies to the Commission for payment.

(2) If any person who has so established a claim shall have died before the amounts payable to him under Articles 23 and 24 of this Order have been paid to him, such payments or the balance thereof shall be made to his personal representatives if they apply to the Commission for payment: provided that, if the Commission are satisfied that no grant of administration of his estate has been made in the United Kingdom and that the assets of his estate (including the amount payable under this Order) do not exceed £1,500 in value, the Commission may, at their discretion and subject to such conditions as the Commission think proper, make such payment either to any person who has taken out administration in any other part of the Commonwealth, or to the person who shall appear to the Commission to be the person who, being a widower, widow, child, father, mother, brother or sister of the deceased person, would, under the law of England, have the prior right to a grant of administration of the estate of the deceased person if such deceased person had died intestate domiciled in England.

(3) If any person whose claim has been so established is a minor at the date when the amounts payable to him under Articles 23 and 24 of this Order are due to be paid, the Commission may make payment thereof into the Supreme Court, or, if the amount thereof does not exceed £5,000, into the County Court for the district in which the minor resides, under the provisions of the Trustee Act 1925, or, if the amount does not exceed £50, may place the same on deposit in the name of the Commission in any bank for such time as the person remains a minor.

(4) The reference in paragraph (1) of this Article to a person who has established a claim under this Order includes a reference to any person who has become entitled to the amounts payable or any part of them, in consequence of any assignment or transfer of the benefit thereof and who produces such evidence of his title as may be reasonably required by the Commission.

23.—(1) The payment in respect of each claim established under this Order shall be a fraction of the distributable amount of the Fund equal to the proportion which the amount assessed in respect of the claim bears to the total of the amounts assessed with respect to all claims established under this Order: provided that no such payment in respect of any claim shall exceed the amount of the loss with respect to that claim as assessed by the Commission under this Order.

(2) The distributable amount shall be the total of all sums paid into the Fund, after the deduction of any payments made therefrom into the Consolidated Fund in accordance with any Order in Council made under section 7(2) of the Foreign Compensation Act 1950 as originally enacted and as applied by section 3(3) of the Foreign Compensation Act 1962.

24.—(1) Whether or not all claims under this Order have been finally determined by the Commission, the Commission shall make from the Fund interim payments in accordance with paragraph (3) of this Article and may make from the Fund interim payments under paragraph (4) of this Article.

(2) Interim payments made under the provisions of this Article shall be made on account of payments to be made in accordance with Article 23 of this Order.

(3) At such time or times after 31st August 1988 as the Secretary of State shall specify the Commission shall make to all persons whose claim in respect of a bond has been established under Part IV of this Order an interim payment representing such percentage

of the amount assessed in respect of the claim as the Secretary of State may direct. For this purpose the Commission shall, when so requested by the Secretary of State, estimate the total liability likely to fall upon the Fund, and report thereon to the Secretary of State.

(4) Subject to the prior approval of the Secretary of State, the Commission may, at such time or times as they may decide, make interim payments to any of the persons who have established claims under Parts V and VI of this Order.

(5) Interim payments made under the provisions of paragraph (4) of this Article shall be made at a uniform rate upon the assessed amount of the claim. The uniform rate of payment shall be determined by the Commission having regard to the total liability likely to fall upon the Fund.

(6) For the purposes of this Article a claim shall be deemed to be established under this Order even though the determination thereof may be subject to review and the phrase "assessed amount of the claim" shall be construed accordingly.

25.—(1) Subject to the provisions of paragraph (2) of this Article, the Commission shall, as a condition of the making of any payment to any person under this Order, require him to surrender to the Commission all available documents of title, if any, relating exclusively to the claim to which the payment relates and shall require him to sign and deliver to the Commission a document in such form as the Commission may determine declaring that he renounces all those claims to which the payment relates.

(2) If the person for whose benefit a payment is to be made is a minor, the Commission shall, as a condition of the making of any payment into Court or placing the same on deposit under paragraph (3) of Article 22 of this Order, require the person who, in accordance with the Rules of the Commission, has made an application for payment on the minor's behalf to surrender to the Commission the documents of title, if any, under his control relating exclusively to the claim and to sign and deliver to the Commission a document in such form as the Commission may determine declaring that the minor renounces all claims to which the payment relates; and the document so signed shall operate as a valid surrender by the minor of all such claims.

(3) All documents which are delivered to the Commission under paragraphs (1) and (2) of this Article shall remain in their custody until the Fund is wound up and the Commission shall then deliver them to the Secretary of State.

G. I. de Deney

Clerk of the Privy Council

Exhibit 5



American Bondholders Foundation LLC

2840 Glasscock Road Lewisburg, Tennessee 37091 USA (931) 359-8781/(931) 359-9689 Fax

Via Facsimile, Electronic Mail and Certified Mail

October 16, 2007

Hon. Christopher Cox, Chairman
Office of the Chairman

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: **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:**

COMPLAINT

Failure of Chinese companies, that are Government State-Owned Enterprises Listed on the NYSE, Euronext and NASDAQ Exchanges to Disclose Defaulted Full Faith and Credit Defaulted Sovereign Debt; and

Failure of the Nationally Recognized Statistical Rating Organizations (NRSRO's), primarily Standard & Poor's, Moody's and Fitch Ratings Agencies to properly and accurately assign the sovereign credit rating status of the People's Republic of China (PRC) to the appropriate and truthful credit rating status of a "Selective Default" classification consistent with their own published rating metrics and criteria.

Dear Chairman Cox, Mr. Cartwright, Ms. Thomsen and Mr. White:

We respectfully write to your attention on behalf of the many defaulted bondholders represented by the American Bondholders Foundation, LLC¹ in reference to the disclosure obligation of the state-owned enterprises of the Government of China which presently have shares listed and actively traded on the NYSE, Euronext and NASDAQ securities exchanges (please refer to Exhibit 1 for a schedule of such companies).

¹ The American Bondholders Foundation, LLC is an organization comprised of U.S. individual owners of Chinese Government full faith and credit bonds issued prior to 1949 and due to mature in 1960, that seek to require China to abide by settled international law and honor its contractual sovereign 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 refused to make any payments to American bondholders of similar Chinese Government bonds.

Access to the United States capital markets conveys significant economic benefits to the listed issuers and, in turn, entails certain obligations including the responsibility to make full and complete disclosure in connection with such listings. At present, no disclosure appears as regards the companies appearing in Exhibit 1 referencing the refusal of the Chinese Government to honor repayment of China's defaulted sovereign debt held by American citizens. Under the successor Government doctrine of settled international law, the repayment obligation for this debt is the responsibility of the Government of the People's Republic of China, which continues to attempt to evade repayment to American citizens. We further note that the United States Foreign Claims Settlement Commission, an agency of the U.S. Department of Justice, has determined that the defaulted bonds represent a valid unpaid general obligation of the Chinese Government.

Accordingly, we request that the Securities and Exchange Commission carefully examine whether the state-owned enterprises of the Government of China and other foreign issuers based in China are adequately disclosing investment risks to current and prospective American owners of Chinese securities including corporate or Government equities 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 do not meet the financial reporting standards required of issuers in U.S. public markets including the absence of a market determined exchange rate as represented by the U.S. Treasury, and the consequent implication on asset valuations; (2) the adverse consequences of increasing and predicted political instability of the Chinese Government; (3) the human rights and freedom of expression violations ordinarily exhibited by the PRC towards its own people and the constrained individual rights already leading to rural demonstrations and riots, portending opposition that will invite instability, or political repression by the government with increased human rights violations; (4) the official PRC's selective repudiation and non-recognition of remaining Chinese sovereign debts (after having settled such claims from British bondholders) issued by established predecessor Chinese Governments.

We believe that current and future American investors merit 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,² 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" during that period.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 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. Any misrepresentation of financial reports are inconsistent with SEC filing obligations. American investors risk otherwise, 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. Furthermore, the major Chinese corporations listed on the NYSE are reported to have poor quality earnings, according to a recent article published in the Financial News⁷, citing a report by an independent research firm which is highly critical of the NYSE for allowing the listings.

In this regard, we further note the following revealing comments by experienced Chinese industry observers:

"If you have any credibility, you would probably be rating everything junk in China."

"China doesn't adhere to international accounting standards. To make matters worse, the Government issues misleading statistics."

- *Indiana University's Dr. Scott Kennedy, who specializes in China's political economy.*

"Sometimes you have a column of figures that don't add up to the total at the bottom. It's that bad."

- *Brian Colton, an analyst who rates China's sovereign bonds for Fitch Ratings (Hong Kong).*

(Above statements reported by the *Wall Street Journal*, January 5, 2004).

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.

⁷ See, "Study Slams NYSE Over Chinese Listings" (Financial News), September 17, 2007.

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.

We urge the Commission to conduct a special study of the reliability of the statistics and the financial reporting of State Owned Enterprises in the PRC where the transition to a market economy is far from complete and the exchange rate is managed. Conferring with U.S. intelligence analysts, Treasury officials and others 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”⁸. 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 markets in recent years, including the U.S. capital markets.⁹ Accordingly, the American Bondholders Foundation, LLC urges the Securities and Exchange Commission to (1) carefully review each registration statement and periodic report filed by a Chinese Government or

⁸ 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”

⁹ 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.

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”¹⁰

The increasing risks to investors posed by the political instability of the Chinese Government are further evidenced by the following socio-economic trends occurring in China¹¹:

Increasing wealth disparity;

Perceived deprivation by diverse segments of the populace;

Pervasive employment dislocation;

Escalating inflation;¹²

Rampant pollution and toxic environmental poisoning (which was suppressed at the Chinese Government's request in a 2007 World Bank report);

Economic dependence on mercantilist trade policies; and

Vast quantities of uncollectible debt held by the Chinese Government's state-owned banks (estimated by Ernst & Young to exceed \$1 trillion at just one bank).

¹⁰ “China's Governance Crisis”, September/October 2002 Foreign Affairs, Minxin Pei

¹¹ See, for example, Economist Magazine (October 13, 2007).

¹² See, for example, “China Freezes Prices in Move to Contain Inflation” (Associated Press), September 19, 2007).

The American Bondholders Foundation, LLC 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 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 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.

Full and adequate disclosure requires filings to include the experience and risk of default and unwillingness to pay debt (including debt repudiation) by sovereign and sovereign owned enterprises, filed with the Commission for debt securities issued by a Chinese issuer, including sovereign debt of the People's Republic of China, to contain a clear statement that the People's Republic 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 does not feel 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 and before.¹³ Such disclosure will alert American investors to the low regard the PRC gives to accepted international practices, legal precedent and established international law. Selective debt repudiation, using regime change as an excuse not to recognize obligations of prior governments is directly contrary to the norms of international commerce and globalization. Recent court rulings are current evidence of this reality. 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 Government of the People's Republic 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)¹⁴ In fact, in 1987 China entered into a treaty with Great Britain that recognized the obligation of the current PRC Chinese Government

¹³ 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."

¹⁴ 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.

for bonds issued prior to the 1949 change of Governments.¹⁵ This treaty provided compensation to British holders of Chinese Government bonds issued prior to 1949.¹⁶ 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 an essential component of full disclosure, 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. The issue of the PRC accepting the obligations of most favored nations trade arrangements and the World Trade Organization membership is directly related to accepting the commercial and financial practices of the world trading and investing community. This is a point our Treasury repeatedly makes in Beijing. Clearly, as the possibility of political volatility in China becomes increasingly noted by credible analysts,¹⁷ 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.

The specifications articulated in Exhibit 2 and Exhibit 3 appended hereto are reiterated in their entirety and are incorporated by reference, and made a part of, this complaint. We allege the disclosure violations described herein as against each of the companies appearing in Exhibit 1, individually, and further allege disclosure violations against all state-owned enterprises of the Government of China which are presently registered, or may become registered with the Commission.

We further note that the Commission has previously received explicit notification of the failure of the Chinese Government to disclose its defaulted sovereign debt on numerous occasions, including:

Letter from Stites & Harbison PLLC addressed to Mr. Harvey L. Pitt, Chairman and Mr. Allen L. Beller, Director, Corporate Finance Division (January 8, 2003);

Letter from Sovereign Advisers addressed to Mr. Michael Macchiaroli, Associate Director, Division of Market Regulation (March 31, 2005);

Letter from the Chairman of the Joint Economic Committee of the United States Congress addressed to the Hon. William H. Donaldson, Chairman, U.S. Securities and Exchange Commission (May 24, 2005);

Letter from Sovereign Advisers to the Hon. Christopher Cox, Chairman, U.S. Securities and Exchange Commission (August 4, 2005);

¹⁵ 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.

¹⁶ 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.

¹⁷ See Parts 1 and 2 of this Letter.

Letter from Sovereign Advisers addressed to Mr. Brian G. Cartwright, General Counsel, Office of the General Counsel, Ms. Linda Thomson, Director, Division of Enforcement and Mr. John W. White, Director, Division of Corporation Finance (September 1, 2006); and

Letter from Sovereign Advisers addressed to Mr. Brian G. Cartwright, General Counsel, Office of the General Counsel, Ms. Linda Thomson, Director, Division of Enforcement and Mr. John W. White, Director, Division of Corporation Finance (February 15, 2007).

4. Failure of the Nationally Recognized Statistical Rating Organizations (NRSRO's) to Conform to Published Metrics (e.g., Willingness to Pay): "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"; and Failure to Conform to Published Criteria (e.g., Definitions) as Referenced Below.

Published Definitions: International Sovereign Credit Rating Classifications

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

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

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

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.

In summary, the American Bondholders Foundation, LLC urges the Commission to hold the People's Republic of China, their State-Owned Enterprises, businesses and corporations to the very same policies and procedures, rules and regulations, laws of proper disclosure and reporting that U.S. businesses and corporations are required to adhere to. Stop the "double set of standards" and require 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.

Sincerely,

Jonna Z. Bianco, President
American Bondholders Foundation, LLC

Exhibits Appended Hereto:

- Exhibit 1:** Schedule of state-owned enterprises of the Government of China presently listed on the NYSE Euronext and NASDAQ securities exchanges.
- Exhibit 2:** Complaint describing violations of 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 including violations of Rule 10b-5 and Section 10(b) of the Exchange Act.
- Exhibit 3:** Complaint alleging fraud in connection with offerings of securities by the Government of China within the United States.

cc: Mr. John A. Thain, Chief Executive Officer
NYSE Group, Inc.

Mr. Robert Greifeld, President and Chief Executive Officer
NASDAQ Stock Market

Ms. Patricia Rado, President and Chief Operating Officer
American Stock Exchange

Ms. Mary L. Schapiro, Chief Executive Officer
Financial Industry Regulatory Authority

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

Hon. Lawrence G. Wasden, President
National Association of Attorneys General

Hon. Andrew M. Cuomo, Attorney General for the State of New York
Office of the New York State Attorney General

Mr. John Petty, President
United States Foreign Bondholders Protective Council

Mr. Kevin O'Brien, President
Sovereign Advisers

Exhibit 1

Exhibit 1.1: PRC SOEs listed on the NYSE Euronext Securities Exchange:

Aluminum Corp. of China Ltd. (ACH)

China Eastern Airlines Corporation Limited (CEA)

China Life Insurance Company Limited (LFC)

China Mobile (Hong Kong) Ltd. (CHL)

China Netcom Group Corporation (Hong Kong) Limited (CN)

China Petroleum & Chemical Corporation (SNP)

China Southern Airlines Company Limited (ZNH)

China Telecom Corporation Limited (CHA)

China Unicom (CHU)

Guangshen Railway Co. Ltd. (GSH)

Huaneng Power International Inc. (HNP)

Jilin Chemical Industrial Company, Ltd. (JCC)

PetroChina Company Ltd. (PTR)

Semiconductor Manufacturing International Corporation (SMI)

Sinopec Shanghai Petrochemical Company Limited (SHI)

Suntech Power Holdings Co., Ltd. (STP)

Yanzhou Coal Mining Co. Ltd. (YZC)

Exhibit 1.2: PRC SOEs listed on the NASDAQ Securities Exchange:

Aluminum Corp. of China
American Dairy
ASAT Holdings
Asia Payment Systems
AsiaInfo Holdings
Alpha Spacecom
Baidu.Com, Inc.
Beijing Med-Pharm Corp
Brilliance China
China Automotive Systems
China Eastern Airlines
China Energy Ventures Corp
China Cable & Comm.
China National Offshore Oil
China Energy Savings Tec
China Techfaith Wireless
China Telecom
Chinadotcom
China Unicom
China Netcom
Chindex
Comtech Group
Ctrip.com
China Yuchai International
Deswell Industries
Guangshen Railway
HuaNeng Power
International DisplayWorks,
INTAC International
Jilin Chemical Industrial J

51 Job, Inc.
China Finance Online
KongZhong Corporation
China Life Insurance
eLong
Linktone
The9 Limited
Ninetowns Digital World
Nam Tai Electronics
Netease.com
Pacifinet Inc.
PetroChina
Radica Games
Sinopec Shanghai
Sina Corp.
Semiconductor Manufac.
Shanda Interactive
Sina.com Corp
Sinopec
Sohu.com
Sinovac Biotech
Target Media
Tiens Biotech
Tom Online
UTStarcom
Watchdata System
Webzen
Qiao Xing Telephone
Yanzhou Coal Mining
China Southern Airlines

Exhibit 2



Sovereign Advisers®
Specialists in Risk Metrics Analytics

4901 E. Sunrise Drive • Suite 711
Tucson • Arizona • 85718

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

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.¹⁸

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

¹⁸ 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.¹⁹ Under Rule 10b-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.²⁰

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.

¹⁹ 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).

²⁰ 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.²¹ 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

²¹ 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.”

this 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.²² The generic risk disclosure language offered in 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.

²² 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.²³

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.²⁴ 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

²³ 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.

²⁴ 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.²⁵

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.²⁶ 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.²⁷

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.

²⁵ 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://www.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).

²⁶ 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).

²⁷ 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;²⁸
3. Injunction(s) enjoining and prohibiting the Government of China from making discriminatory payments to other creditors in circumvention of payments to defaulted creditors;²⁹
4. Injunction(s) enjoining and suspending publication of the sovereign credit rating assigned to the Government of China;³⁰
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.

²⁸ 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.

²⁹ 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.

³⁰ 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

Exhibit 3



Sovereign Advisers®
Specialists in Risk Metrics Analytics

4901 E. Sunrise Drive • Suite 711
Tucson • Arizona • 85718

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

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.³¹ 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.

³¹ 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 China³², 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.³³

³² 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>

³³ 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 ³⁴	1983
2. The practice of selective default ³⁵	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 ³⁶	Continues in effect at present
4. Rejection of the successor government doctrine of settled international law ³⁷	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 ³⁸	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, Issue 16 (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

³⁴ 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.

³⁵ Ibid.

³⁶ 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.

³⁷ 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.³⁹ Certain instances involving such claims have been brought before the United States Foreign Claims Settlement Commission (the "Commission").⁴⁰ 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.⁴¹ 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.⁴² As

³⁸ See the 1987 treaty between the governments of China and Great Britain which settled the claims of British citizens holding the Defaulted Debt.

³⁹ 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).

⁴⁰ 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).

⁴¹ 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.

⁴² 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.

Summary and Conclusion of Allegation Asserting Specification of Fraud:

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.⁴³ 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.⁴⁴ 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."

⁴³ 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.

⁴⁴ 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 notice⁴⁵ 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.⁴⁶

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

⁴⁵ 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.

⁴⁶ 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.