

July 26, 2007

Electronic version

<http://www.globalsecuritieswatch.org/SenatePolicyBrief.pdf>

Background Information

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

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

Purpose:

1. To protect the American public including U.S. pension funds from the misleading and fraudulent disclosure statements filed by the communist Chinese government (PRC) in connection with the offer and sale within the United States of Chinese securities, which continue to be offered and sold in reliance upon a false and artificial sovereign credit rating which conceals China's defaulted sovereign debt for which the government of the PRC is legally obligated under international law to repay, and refuses to do so;
2. To provide relief to American citizens holding defaulted sovereign debt of the PRC (see for example, the 1960 bond, which remains unpaid and in a state of default) upon which the PRC government continues to evade repayment while engaging in discriminatory and preferential payments to selected creditors; and
3. To establish a policy which will prove effective in encouraging China to restrain and reform its abusive international trade practices and transition into an international, rules-based economy by fostering compliance with established conventions of international trade and commerce.

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

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

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

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

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

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

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

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

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

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

Research: [http://www.globalsecuritieswatch.org/Letter from Stites & Harbison to Sidley Austin Brown & Wood](http://www.globalsecuritieswatch.org/Letter_from_Stites_&_Harbison_to_Sidley_Austin_Brown_&_Wood)
http://www.globalsecuritieswatch.org/Sovereign_Disclosure_Obligation.pdf
<http://www.foreignaffairs.house.gov/archives/108/90360.pdf>

- Intentional falsehood regarding the “equal ranking” of China’s sovereign debt obligations.

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

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

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

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

Example: China Life Investor Fraud: <http://www.globalsecuritieswatch.org/Spitzer.pdf> [see footnote #42 (page 22)]

China Aviation Oil Investor Fraud: <http://www.energyrisk.com/public/showPage.html?page=200016>
<http://www.deloitte.com/dtt/article/0,1002,cid%253D113280,00.html>

Research: [http://www.globalsecuritieswatch.org/Letter from Stites & Harbison to SEC](http://www.globalsecuritieswatch.org/Letter_from_Stites_&_Harbison_to_SEC)

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

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

Research: http://www.globalsecuritieswatch.org/Wrongful_Actions_of_the_International_Credit_Ratings_Agencies
[See Exhibit 4 (page 8) entitled, "Washington Post Special Feature"]
http://www.globalsecuritieswatch.org/Chairman_Saxton_Demand_for_Investigation.pdf
http://www.globalsecuritieswatch.org/GAO_LETTER.pdf
http://www.globalsecuritieswatch.org/SEC_Memorandum_Disclaiming%20Regulatory%20Jurisdiction

An international sovereign credit rating is absolutely essential for any government seeking to borrow internationally, or more significantly, to establish an international sovereign benchmark against which its corporations may raise capital in the world financial markets in order to compete internationally. The international sovereign credit rating assigned to a specific government acts to set a "sovereign ceiling" which constrains the ratings of the corporate issuers located within that nation. If the ceiling is artificially high, then the creditworthiness of the corporations within that nation enjoy a higher rating and a commensurately lower cost of capital, which translates into a major competitive advantage globally. In the instance of China, the three primary rating agencies have intentionally and wrongfully assigned false and artificial sovereign credit ratings to the communist Chinese government which conceal the existence of the Chinese government's defaulted sovereign debt and which do not conform to the published definitions, and have knowingly done so in order to maximize the profits of the rating agencies.

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

Standard & Poor's presently maintains an "A" rating for China. Note the definition of this rating classification as published by S&P: "An obligor rated 'A' has STRONG capacity to meet its financial commitments but is somewhat more susceptible to the adverse effects of changes in circumstances and economic conditions than obligors in higher-rated categories." Compare this definition to S&P's published definition of the "Selective Default" rating classification, which is the classification S&P claims to assign to a nation with defaulted sovereign debt: "An obligor rated "SD" (Selective Default) has failed to pay one or more of its financial obligations (rated or unrated) when it came due. An "SD" rating is assigned when Standard & Poor's believes that the obligor has selectively defaulted on a specific issue or class of obligations but it will continue to meet its payment obligations on other issues or classes of obligations in a timely manner." A nation rated "Selective Default" is unable to issue international sovereign bonds until it repays its defaulted sovereign debt.

Research: http://globalsecuritieswatch.org/Sovereign_Ratings_Definitions_and_Criteria
<http://www.globalsecuritieswatch.org/SEC>
http://www.globalsecuritieswatch.org/Summary_of_Complaint
http://www.globalsecuritieswatch.org/Letter_from_Sovereign_Advisors_to_SEC_Chairman_and_Associate_Director

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

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

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

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

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

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

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

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

Since the communist Chinese sovereign benchmark can be shown to be artificial, then by extension, the rating of all Chinese corporate issuers is phony as well. Furthermore, since corporations cannot generally penetrate the sovereign ceiling, creation of a false and artificial benchmark opens the door to global issuance by Chinese corporations, resulting in the dislocation of entire industries. Such an effect would not have occurred to the effect which is manifest at present if the rating agencies had followed their published methodologies and assigned the truthful rating classification of “Selective Default” to China, reflecting the existence of the Chinese government's attempts to evade repayment of its defaulted sovereign debt.

Conclusion:

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

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

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

EXHIBIT

Published Definitions International Sovereign Credit Rating Classifications ¹

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

Agency	Rating	Definition
Standard & Poor's	A	An obligor rated 'A' has STRONG capacity to meet its financial commitments but is somewhat more susceptible to the adverse effects of changes in circumstances and economic conditions than obligors in higher-rated categories.
Moody's	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

Endnotes:

¹ The definition for each specific rating classification was obtained as published by the respective credit rating agencies on the respective agency's website, accessed via the following URLs:

Standard and Poor's: <http://www2.standardandpoors.com>

Moody's Investors Service: <http://www.moodys.com>

Fitch Ratings: <http://www.fitchratings.com>

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

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

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

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

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

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

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

⁹ In this regard, we note the following statement, “*NRSROs should be legally accountable for their ratings.*” Source: Investment Company Institute, Statement Before the SEC Hearings on Issues Relating to Credit Rating Agencies (November 21, 2002). See also the statement, “*Reliance by credit rating agencies on issuer fees could lead to a conflict of interest and the potential for rating inflation.*” United States Securities and Exchange Commission, Rating Agencies and the Use of Credit Ratings Under the Federal Securities Laws (2003). See also the statement, “*Given the steps the SEC has taken to improve levels of independence for accounting firms and equity analysts, similar action should be required to restore the credibility of and confidence in the rating system.*” Source: “*Is the SEC Going Soft on Credit Rating Agencies?*” Danvers, Krag and Billings, B. Anthony, The CPA Journal (May 2004). We observe that the Chinese government’s defaulted sovereign debt, existing unpaid and in a state of default, has come to rest principally in the hands of individual investors as opposed to institutions, and that the agencies and the advisers to the Communist Chinese government therefore anticipated a very minimal risk of objection via a unified voice as respects the assignment of a long-term foreign currency sovereign credit rating to the Chinese Government which has the action of concealing the existence of the Chinese Government’s defaulted sovereign debt. When Standard & Poor’s first assigned the rating in 1992, it did not reflect the existence of the Chinese Government’s defaulted sovereign debt and established a new, and artificial, foundation upon which the Chinese Government could resume international financing without repaying its defaulted sovereign debt, and also constitute the basis upon which to inflate the rating over the future term.