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Briefing note March 2014

New rules facilitate cash flow in the Shanghai Free Trade Zone

In order to further realise financial deregulation in the Shanghai (China) Pilot Free Trade Zone (Shanghai FTZ), the People's Bank of China Shanghai Head Office (Shanghai PBOC) and the State Administration of Foreign Exchange (SAFE) Shanghai Office (Shanghai SAFE) both issued rules in February 2014 respectively to facilitate cross-border investment activities and relax foreign exchange administration. Set out below are the key measures arising from these rules that aim to streamline regulatory requirements and administrative procedures within the Shanghai FTZ.

Expedited payment procedures for trade and direct investment

Much simpler procedures are now in place to facilitate cross-border trade of goods and services and foreign direct investment in the Shanghai FTZ. With a view to streamlining administrative procedures in support of genuine cross-border trading and investment activities, cross-border payments and receipts (whether in Renminbi (RMB) or foreign currencies) could now be processed via bank accounts simply by way of instructions given to the bank. The prior requirements of having to submit supporting transaction documents and/or approval, filing and registration documents have been removed. The bank however is responsible for exercising due care in ensuring the authenticity of the relevant payments and receipts. The discretion now lies with the bank to determine whether additional documents or information should be requested.

Simplified administration for direct investment

Foreign investment enterprises (FIEs) in the Shanghai FTZ may now generally approach banks for foreign exchange registration. However, where the registration involves complicated transactions, round-trip investment or capital contribution in kind, it must still be processed by Shanghai SAFE directly. To help banks perform such duties, Shanghai SAFE has issued a set of clear operational guidelines to list the legal basis, required verification documents, key issues and timing requirement for each kind of registration.

One major break-through in the direct investment area is that an FIE in the Shanghai FTZ can now settle all or a certain percentage (as imposed and adjusted by SAFE based on the macro economy) of its foreign currency capital funds into a special RMB deposit account it opens in China. This is referred to as "discretionary capital funds settlement" which will allow FIEs to manage their treasury and currency risk more efficiently. However, an FIE may not use such funds (i) beyond its approved business scope, or (ii) for securities investments, extending entrustment loans, or repaying loans from other corporate or bank loans that have been on-lent to others, or (iii) for buying real estate unless it is either for self-use or that the FIE has been filed with the relevant authorities as an FIE engaged in real estate business.

A company in the Shanghai FTZ can now lend more funds to its offshore subsidiaries. Compared to a Chinese company outside the Shanghai FTZ which, without seeking SAFE approval, may only lend up to 30% of its equity interest to its offshore subsidiaries, a company within the Shanghai FTZ may lend up to 50%.

Easier to provide foreign security and obtain offshore borrowing

Companies in the Shanghai FTZ are no longer required to obtain prior approval for providing foreign security (which mainly refers to security provided by a PRC entity in favour of a foreign entity) or paying guarantee fees from China to an offshore account. Likewise, such companies as obligors need not satisfy any asset or profitability requirement or have any shareholding relationship with the guarantor. The security provider in the Shanghai FTZ can proceed to register the foreign security with Shanghai SAFE directly.

Shanghai PBOC has launched a new regime to regulate borrowing from offshore lenders. Banks in the Shanghai FTZ can borrow RMB from offshore lenders (i.e. foreign debt denominated in RMB) without any limit on the amount, but the borrowed funds must be "utilised" within the Shanghai FTZ. Corporates and non-bank financial institutions within the Shanghai FTZ are subject to a borrowing quota (BQ) determined by their paid-in capital (PC) and the macro prudence policy factor (F), which is published and adjusted by Shanghai PBOC from time to time. BQ is calculated as follows:

- *BQ (for corporates) = PC × 1 × F*
- *BQ (for non-bank financial institutions) = PC × 1.5× F*

Corporates and non-bank financial institutions may only borrow long-term RMB foreign debt with a tenor of no less than one year. The borrowed funds may be "utilised" either within the Shanghai FTZ or outside China. The term "utilised" is rather ambiguous and a more flexible interpretation may be acceptable considering that China aims to grant increasing administrative convenience to investors in the Shanghai FTZ. One is however advised to investigate thoroughly what is permissible when structuring a borrowing. When determining the BQ, an existing FIE in the Shanghai FTZ may elect to follow the "borrowing gap" approach which has long been in force, or otherwise compute according to the formula above as set out in the recent Shanghai PBOC notice. Once elected, the decision is final and the FIE may not subsequently change the way of computing their BQ.

Extended application of the multinational FX cash pooling pilot scheme

In respect of multinational FX cash pooling, the Shanghai FTZ only requires an applicant to attend to prior filing with Shanghai SAFE, rather than having to obtain SAFE approval as previously required. In addition to other documents, the applicant must, however, obtain a further endorsement from the Shanghai FTZ Administrative Committee. In order to benefit from the pilot scheme, an applicant must engage a bank located in Shanghai (not necessarily within the Shanghai FTZ) and prepare a detailed business plan as part of the filing package to be lodged with Shanghai SAFE.

The applicant may open two accounts with the bank: a domestic foreign exchange master account (Domestic Master Account) and an international foreign exchange master account (International Master Account). The Domestic Master Account can be used to pool foreign currency cash from participating group members generated from or purchased for current account transactions, direct investment, foreign debt and lending to offshore subsidiaries, and is capable of conducting discretionary capital funds settlement for pooled capital funds as discussed above. The Domestic Master Account may also be used for daylight and overnight overdraft.

It is worth noting that the restriction on moving funds between the International Master Account and other offshore accounts has been lifted. An applicant can apply for an aggregate foreign debt quota (Aggregate Quota) that applies to the movement of funds from the International Master Account to the Domestic Master Account. Once Shanghai SAFE has approved the Aggregate Quota, the relevant participating companies may not further borrow foreign debt individually. The Aggregate Quota is the total amount of foreign debt quotas of *all the domestic group member companies* net of incurred mid and long-term foreign debt and *all* outstanding short-term foreign debt of each *domestic group member* company, i.e.:

- *Aggregate Quota = Aggregate Foreign Debt Quotas of All Domestic Group Member Companies – Aggregate Incurred Mid and Long-term Foreign Debt of All Domestic Group Member Companies – Aggregate Outstanding Short-term Foreign Debt of All Domestic Group Member Companies*

The net amount that may be remitted from the International Master Account into the Domestic Master Account (Net Inward Remittance Quota) is subject to the Aggregate Quota, the amount of borrowed and outstanding foreign debt through cash pooling arrangement (Outstanding Foreign Debt) and the amount of outstanding shareholder loan granted to offshore subsidiaries through cash pooling arrangements (Outstanding Outbound Loan) as per the formula below:

- *Net Inward Remittance Quota = Aggregate Quota - Outstanding Foreign Debt + Outstanding Outbound Loan*

The amount of Outstanding Foreign Debt must not exceed the Aggregate Quota, while the amount of Outstanding Outbound Loan must be less than 50% of the value of equity interest which participating companies hold in the offshore borrowers.

Apart from the trade of goods, multinational cash pooling also benefits trade of services by processing payments and receipts on a netting basis. This means that a company does not need to settle each payment/receipt individually, but that the entire group can net off payments and receipts within the group and only make the monthly (which is the minimal frequency required) physical payment. Nonetheless, the relevant companies must maintain clear internal records to ensure that the information of each individual transaction is reported for statistics and taxation purposes.

The recent Shanghai PBOC notice allows group companies to operate RMB cash pooling through an onshore RMB account opened with a bank in Shanghai, which could be used to process current account payments and receipts of participating group members. However, borrowed RMB funds cannot be pooled.

Both the recent Shanghai SAFE rules and Shanghai PBOC notice require a lead company to be registered within the Shanghai FTZ, but do not restrict the location of participating companies.

Other than group companies, a single corporate may also explore the possibility with its bank as to how to avail certain features of the Shanghai FTZ pilot programme, such as making payments and receipts on a netting basis.

A more relaxed regime for finance leasing

Finance leasing companies in the Shanghai FTZ can now lease ships and aircraft etc. to offshore lessees by registering with Shanghai SAFE within 15 working days of the lease taking effect, without having to seek prior approval from Shanghai SAFE. They may also collect rentals in foreign currency from the onshore lessees to minimise currency risk arising from mismatch between the rental currency and the currency in which the leased object was paid.

Framework for commodity derivatives clarified for the first time

Certain banks with derivatives licences that are located within the Shanghai FTZ or in Shanghai may provide commodity hedging services to their clients within the Shanghai FTZ. These banks can enter into back-to-back transactions in the international market, and the relevant foreign currency income/loss can be settled in China's inter-bank market. While such banks must satisfy certain eligibility requirements in order to conduct these activities, there is no need for them to seek prior SAFE approval as mere prior filing with Shanghai SAFE would suffice.

Sea of change in the pipeline

As at the date of writing, neither the Shanghai PBOC nor Shanghai SAFE has published any rules on the operation of free trade accounts for non-bank entities and the corresponding settlement mechanisms of banks to further implement the Shanghai FTZ pilot programme. These rules, when available, are expected to provide much clearer guidance on how the Shanghai FTZ pilot programme will be implemented, such as what on-lending restrictions apply to banks within the Shanghai FTZ that seek to on-lend their offshore borrowed funds to onshore borrowers.

While existing deregulating measures of the Shanghai FTZ mainly facilitate the operation of trading activities, regulators are still silent on how they might practically and effectively open up the financial market within the Shanghai FTZ. To date, only general principles have been announced, such as the opening up of the onshore inter-bank foreign exchange market and gold market. Since relaxations on the financial market should provide strong support for the development of trading activities, it is expected that China will reform the financial regulations as the Shanghai FTZ pilot programme progresses in time. We will monitor the developments closely and prepare follow-up briefings to capture new business opportunities and changes that may affect your business.

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