

China's new rules on cross-border security affect offshore bond issuance and cross-border financing

With a view to liberalising control over capital account transactions, the State Administration of Foreign Exchange (SAFE) issued the *Provisions for Foreign Exchange Control over Cross-border Security* and a set of corresponding operation guidelines (jointly the Provisions) on 12 May 2014. The Provisions became effective as from 1 June 2014, and aim to reform and deregulate China's regulatory regime for cross-border guarantees and security (referred to as Cross-border Security).

The Provisions now present new opportunities for greater accessibility to Cross-border Security. This briefing navigates through the main changes introduced by the Provisions, and specifically addresses their implications on offshore bond issuance and cross-border financing structures.

What are the main changes?

Clearer definition of Cross-border Security

The new term Cross-border Security will replace the much disputed term of foreign security. Cross-border Security is now defined as a written binding commitment to pay under a security agreement, which may result in cross-border payments and receipts, transfer of property titles, and other transactions affecting China's balance of payments.

Registration less vital

The Provisions introduce two important changes on the significance of SAFE registration. First, SAFE approval is no longer required and only specific kinds of Cross-border Security attract SAFE registration and reporting requirements. In other words, if the Cross-border Security in issue does not attract SAFE registration or reporting requirement, there will be no need to attend to any SAFE procedures.

Second, SAFE registration is no longer a precondition for Cross-border Security to take effect. This means that if a security provider fails to register with SAFE, it will not necessarily render the relevant Cross-border Security invalid or unenforceable. The security provider may, however, be subject to SAFE's administrative penalties for failing to register, which may delay enforcement in certain circumstances.

Cross-border Security classified

Depending on the locations of the relevant parties, Cross-border Security is now classified under the Provisions into (i) onshore security for offshore credit (*Nei Bao Wai Dai*), (ii) offshore security for onshore credit (*Wai Bao Nei Dai*), and (iii)

Cross-border Security in other forms. *Nei Bao Wai Dai* refers to security provided by an onshore Chinese entity or individual in favour of an offshore entity for the debts owed by another offshore entity. *Wai Bao Nei Dai* refers to security provided by an offshore entity or individual in favour of an onshore financial institution for the debts owed by an onshore non-financial institution.

Post-event regulation

While SAFE may no longer be involved in all Cross-border security transactions after the Provisions take effect, it is keen to monitor the situation following the enforcement of security. Providers of Cross-border Security are required to ensure that the debtor is creditworthy and that it complies with the laws of the PRC and other relevant jurisdictions. Domestic account banks must also check that the enforcement of Cross-border Security complies with all relevant laws. Non-compliance may trigger penalties imposed by SAFE.

How do the Provisions affect *Nei Bao Wai Dai*?

No quota restriction applies nor prior SAFE approval required: Onshore banks are no longer subject to any annual quota on the *Nei Bao Wai Dai* that they grant. This means that a bank can provide *Nei Bao Wai Dai* without quota restriction from an exchange control perspective.

Likewise, non-bank financial institutions and corporates are no longer subject to any quota restriction nor are they required to obtain SAFE approval before providing Cross-border Security. Previously, approval was required on a case-by-case basis. These relaxations also apply to individuals, who in the past were only allowed to provide Cross-border Security together with other PRC institutions. The Provisions have also removed previous requirements on the financial status of the guarantor or security provider and its shareholding relationship with the debtor.

Business scope must include provision of security: SAFE requires that for a financial institution to provide *Nei Bao Wai Dai*, it must have been approved to provide security.

SAFE registration should be completed: The provision of *Nei Bao Wai Dai* must be registered with SAFE. While banks can complete this registration through the data interface provided by an online SAFE system, non-bank financial institutions that have not established access to the online SAFE system, corporates and individuals must register with SAFE within 15 working days after the execution of the relevant security documents. If a key term of the relevant security document is amended, the registration with SAFE must be updated accordingly.

Restriction on the application of proceeds: The restriction on repatriating proceeds from financing activities supported by *Nei Bao Wai Dai* remains unchanged. Under the Provisions, an offshore debtor (e.g. an offshore bond issuer) must apply these proceeds towards settling expenses and costs incurred within its ordinary business scope. The application of these proceeds in any business activity outside its ordinary business scope, arbitrage transactions without trade background and other speculative transactions is prohibited. Without SAFE approval, the offshore debtor is prohibited from repatriating such proceeds directly or indirectly into China, whether for: (i) equity and debt investments in Chinese entities; (ii) acquisition of shares in "PRC-assets-rich" offshore entities (those which have more than 50% assets within China); (iii) refinancing any financial indebtedness the proceeds of which have been repatriated into China as equity or debt investments; or (iv) prepayment under current account items that exceed prescribed threshold in terms of amount and timing. In practice this will limit the benefit of the new rules for offshore acquisition financings (or refinancing) of predominantly PRC businesses and assets.

The guarantor or security provider is further required to monitor how the offshore debtor applies the proceeds and the transaction background of the offshore financing activities. It must also conduct due diligence to ensure compliance with the laws of the PRC and other relevant jurisdictions.

Special rules for bond issuance: If a bond issue is the underlying debt secured by *Nei Bao Wai Dai*, the Provisions specifically provide that an onshore entity in China must directly or indirectly hold shares in the offshore bond issuer. Such an onshore entity does not necessarily have to be the guarantor or security provider. The bond issuance proceeds must be applied towards "offshore investment projects" that are invested by an onshore entity. The relevant regulatory procedures in China must have been completed to establish such an offshore debtor or offshore investment project.

Hence, for a bond issuance to take place, the bond issuer must be affiliated to a Chinese entity. SAFE limits the application of proceeds to offshore projects sponsored by Chinese entities. It also requires that all relevant approvals, registrations, filings and other regulatory formalities must have been duly completed.

Special rules for offshore acquisition: If the underlying debt secured by *Nei Bao Wai Dai* is for the direct or indirect acquisition of equity or debts of offshore entities, outbound investment rules should be complied with.

Special rules for derivatives: If the underlying debt secured by *Nei Bao Wai Dai* is the payment obligation under derivatives transactions, the debtor must trade these derivatives for stop-loss and/or hedging purpose, comply with its scope of main business and obtain the proper authorisation from its shareholder(s).

No SAFE verification required for enforcement: Verification by SAFE is no longer required to enforce *Nei Bao Wai Dai*. When *Nei Bao Wai Dai* is enforced, the PRC guarantor or security provider which is a bank can make the relevant payment directly, or where it is not a bank, apply to its account bank by presenting the SAFE registration document to process payment.

Restrictions after enforcement: After enforcement, an onshore non-bank institution must refrain from granting new *Nei Bao Wai Dai* until it is fully repaid, or until SAFE grants a waiver on repayment requirement.

How do the Provisions affect *Wai Bao Nei Dai*?

Equal treatment for Chinese-funded enterprises and foreign-invested enterprises: Previously only foreign-invested enterprises and approved Chinese-funded enterprises were allowed to borrow money from financial institutions by leveraging *Wai Bao Nei Dai*. Now all Chinese entities (assuming they are non-financial institutions) may take advantage of this scheme to obtain offshore guarantee to support their Renminbi, foreign currency loans or facilities extended by onshore financial institutions.

Restrictions after enforcement: Where an onshore debtor fails to fulfill its payment obligation to the creditor and triggers an enforcement event under *Wai Bao Nei Dai*, this debtor may not enter into new *Wai Bao Nei Dai* deals or draw new loans under any existing facility supported by *Wai Bao Nei Dai*, until it has repaid the guarantor or security provider in full or unless SAFE approves otherwise.

Changes in the maximum enforcement amount: Previously in the case of a foreign-invested enterprise debtor, when *Wai Bao Nei Dai* is triggered, the debtor could only reimburse the guarantor or security provider up to its available borrowing gap. Where the debtor is a Chinese-funded enterprise, reimbursement was limited to its foreign debt quota as approved by SAFE. The Provisions now change the limits such that for both types of debtors, it will be their respective net asset amount (audited) as at the end of the preceding year.

If the required reimbursement exceeds such net asset amount, a foreign-invested enterprise debtor may apply its available borrowing gap while a Chinese-funded enterprise debtor may apply its approved foreign debt quota to make up for any required reimbursement. Any further reimbursement that is not covered may only be paid to the guarantor or security provider outside China upon the completion of investigation and possibly the imposition of penalties by SAFE.

How do the Provisions affect security over property?

Posting collateral regulated the same way as guarantee: In addition to guarantee, Cross-border Security may also be provided by way of security over property (e.g. share charge, mortgage or pledge over property) under *Nei Bao Wai Dai* or *Wai Bao Nei Dai*, which is regulated the same way as providing guarantee as mentioned above.

SAFE review not required in the creation of Cross-border Security over property: SAFE will not interfere with the creation of Cross-border Security over property. Hence, the relevant parties must conduct their own due diligence as to whether security over property is consistent with mandatory requirements under the relevant governing law. They should also ascertain whether any prior regulatory procedures for creating the security interest exist, and whether there is any restriction on the liquidation or transfer of the relevant property.

Where Cross-border Security over property is enforced, the security provider or creditor may have to apply to a domestic bank to remit the liquidation proceeds outside China. The bank is then required to conduct due diligence on the authenticity and compliance of the enforcement. Enforcement results in cross-border payments and receipts and/or capital-item transactions such as title transfer. At this juncture, if there are any foreign exchange restrictions, those restrictions shall be complied with.

How do the Provisions affect other forms of cross-border security?

Regulatory approach of "negative list": Except for *Nei Bao Wai Dai* and *Wai Bao Nei Dai*, and unless otherwise stated, SAFE does not require the registration or filing of security documents. This will substantially enhance legal certainty in cross-border financing transactions that involve security that cannot be categorised as either *Nei Bao Wai Dai* or *Wai Bao Nei Dai*. It represents a big step forward from the past where guarantors and security providers had great difficulty in obtaining the approval or registration from local SAFE offices while not knowing if it was in fact legally required.

Commitments that are excluded from regulation: The Provisions have specified other commitments that are excluded from Cross-border Security regulation. They include non-contractual or non-binding commitments, and commitments that do not involve payment of funds or trade-in of collateral upon enforcement. They also comprise commitments that will not give rise to subrogation rights against debtors (whether these rights are subordinated or deferred), and those that have been expressly excluded by SAFE from the Cross-border Security regulatory regime, such as L/C, and security deposit or counter guarantee that is provided to a bank for it to issue a bank guarantee or L/C.

Implications for offshore bond issuance

In light of the tight onshore credit market, Chinese enterprises have been keen to explore the offshore markets if conditions make it favourable for funding. In order to obtain a higher credit rating for bond issuance so as to lower the corresponding financing costs, Cross-border Security and other types of support from onshore parent companies or sister companies have always been sought after.

The changes introduced by the Provisions now provide more flexibility in structuring bond issuance by a bond issuer established by a Chinese entity. The issuer may be able to achieve credit enhancement, such as obtaining a guarantee from the head office and group members under more favourable terms in China, or creating security over onshore assets in China.

It is, however, important to note that the Provisions have not liberalised the existing restrictions on repatriation. In fact, the Provisions have imposed further requirements such as those on ownership of the issuer, the types of project and the pre-

approval of competent regulatory authorities. Due to these pre-conditions, it may not be easy for PRC corporate to provide cross-border security for a bond issuance as compared to loan financings. If an issuer wants to use the proceeds in China, credit support through guarantee or security provided by entities in China may not be a good choice. In addition, given the broad definition of Cross-border Security, it is advisable to have a carefully drafted "keepwell" deed in place to avoid it being deemed as Cross-border Security.

These requirements will also need to be taken into account when structuring bridge to bond financings. While the bridge (bank loan) financing may be able to take the benefit of the new rules, the bond issuance may not, unless the additional requirements applicable to bond financings are satisfied.

Implications for cross-border financing structures

The Provisions also extend greater flexibility to structuring a cross-border financing deal. Set out below are five recent and very common cross-border financing structures in their simplified forms. Each is compared on the ground of how it would be regulated before and after the Provisions became effective on 1 June 2014. These structures could be more complex in practice, but the key considerations would be similar.

For the purposes of the structures, the abbreviations used below have the following meanings:

- FIE means a foreign-invested enterprise set up in China;
- MOFCOM means the Ministry of Commerce;
- Offshore Bank means a lender or a syndicate of lenders operating outside China;
- Onshore Bank means a lender or a syndicate of lenders operating in China;
- Onshore Entity means an entity incorporated by Chinese shareholders in China;
- SAIC means the State Administration for Industry and Commerce;
- SPV means a special purpose vehicle / holding company established outside China; and
- X→ Y means X granting a loan facility to Y.

Structure 1: Offshore lender / offshore borrower (security in the form of assets in China)

An Offshore Bank grants a loan facility directly to an SPV, which is secured by assets that are registered in China (e.g. aircraft) and held by the SPV in China.

Key considerations:

The SPV grants security over its assets in China in favour of the Offshore Bank. The proceeds are not deemed to be repatriated to the PRC because of this security. Our experience suggests that there may be practical difficulties in registering security interest for certain types of assets. Accordingly, this structure may not always be feasible due to the legal restriction on foreign entities directly holding assets in China.

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| <p>The diagram illustrates the structure across two jurisdictions: Offshore and China. In the Offshore jurisdiction, an 'Offshore Bank' is shown with an arrow pointing to an 'SPV'. The SPV is also shown with an arrow pointing to 'Assets' located in the China jurisdiction. A horizontal dotted line separates the Offshore and China jurisdictions.</p> | <p>Before 1 June 2014</p> <p>Rules are not clear. However, it is generally understood that security provided by an SPV is beyond the administration of SAFE.</p> | <p>After 1 June 2014</p> <p>This would be within the definition of Cross-border Security. There is no registration requirement under the Provisions. However, SAFE registration relating to the assets needs to be satisfied.</p> |
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Structure 2: Onshore lender / onshore borrower

An Onshore Bank grants a loan facility to an FIE, which is secured by assets held by the FIE in China and equity interest held by the SPV in the FIE.

Key considerations:

The SPV may grant security over its equity interests in the FIE in favour of the Onshore Bank, subject to the approval of the relevant local branch of MOFCOM and the registration with the local branch of SAIC. The SPV may also provide guarantee or other forms of security.

The FIE may grant security over its assets in China in favour of the Onshore Bank. Such security does not constitute "Cross-border Security" but must be registered with the relevant government authorities, depending on the type of assets involved.

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| | <p>Before 1 June 2014</p> | <p>After 1 June 2014</p> |
| | <p>The Security provided by the SPV is regulated by <i>Wai Bao Nei Dai</i>.</p> <p>The enforcement amount is limited to the FIE's available borrowing gap.</p> | <p>The security provided by the SPV is regulated as <i>Wai Bao Nei Dai</i>.</p> <p>After the guarantee or security provided by the SPV is enforced, the maximum amount that the FIE is allowed to reimburse the SPV is limited to the FIE's net assets plus its available borrowing gap.</p> |

Structure 3: Offshore lender / onshore borrower

An Offshore Bank grants a loan facility to an FIE, which is secured by assets held by the FIE in China and equity interest held by the SPV in the FIE.

Key considerations:

The SPV may grant security over its equity interests in the FIE in favour of the Offshore Bank subject to the approval of the relevant local branch of MOFCOM and the registration with the local branch of SAIC. The SPV may also provide guarantee or other forms of security.

The FIE may grant security over its assets in China in favour of the Offshore Bank. While such security constitutes Cross-border Security, but it constitutes neither *Nei Bo Wei Dai* nor *Wai Bao Nei Dai*, which means it does not need to be registered with SAFE. In addition, such security must be approved by, and registered with, the other relevant government authorities, depending on the type of FIE and assets involved.

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| | <p>Before 1 June 2014</p> <p>Again, the security provided by the SPV is beyond SAFE's administration. The security granted by the FIE should be registered with SAFE.</p> | <p>After 1 June 2014</p> <p>Both types of security are regulated as Cross-border Security, but neither is required to be registered with SAFE.</p> |
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Structure 4: Offshore lender / offshore borrower (security in the form of equity interest in an FIE)

An Offshore Bank grants a loan facility to a SPV, which is secured by equity interest held by the SPV in an FIE.

Key considerations:

The facility may be used for an offshore acquisition.

The SPV may grant security over its equity interests in the FIE in favour of the Offshore Bank, subject to the approval of the relevant local branch of the MOFCOM and the registration with the local branch of SAIC. The proceeds are not deemed to be repatriated to the PRC because of this security. The SPV may also provide guarantee or other forms of security.

| | Before 1 June 2014 | After 1 June 2014 |
|---|---|--|
| <p>The diagram illustrates the structure across two jurisdictions: Offshore and China. In the Offshore region, an Offshore Bank provides a loan facility to an SPV. The SPV holds equity interest in an FIE/Onshore Entity located in China. This FIE/Onshore Entity holds Assets. A horizontal dashed line separates the Offshore region (top) from the China region (bottom).</p> | <p>Again, the security provided by the SPV is beyond SAFE's administration.</p> <p>The FIE is not allowed to provide security over its assets due to the prohibition on upstream foreign guarantee / security. However, if the SPV is invested by the Onshore Entity, the security provided by the Onshore Entity over its assets is allowed as it is downstream.</p> | <p>Both the FIE and the Onshore Entity are allowed to provide guarantee or security, which constitute Cross-border Security. It is required to be registered with SAFE as a <i>Nei Bao Wai Dai</i>.</p> <p>However, the facility supported by the security may not be repatriated into China the same as before 1 June 2013 (including for the purpose of acquiring an entity which has more than 50% assets in China) and the underlying acquisition project of the SPV must comply with PRC outbound investment rules.</p> |

Structure 5 - Offshore lender / offshore borrower, and onshore lender / onshore borrower

An Offshore Bank lends to a SPV while an Onshore Bank lends to a FIE.

Key considerations:

The facility may be used for an offshore acquisition.

The SPV may grant security over its equity interests in the FIE in favour of the Onshore Bank and the Offshore Bank, subject to the approval of the relevant local branch of MOFCOM and the registration of the local branch of SAIC. The proceeds are not deemed to be repatriated to the PRC because of this security. The SPV may also provide guarantee or other forms of security.

The FIE may grant security over its assets in China in favour of the Onshore Bank. As this is a purely onshore security if provided to the Onshore Bank, it is not subject to any SAFE regulation.

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| <p>The diagram illustrates the structure across two jurisdictions: Offshore and China. In the Offshore jurisdiction, an Offshore Bank provides a loan to an SPV. In the China jurisdiction, an Onshore Bank provides a loan to an FIE. The SPV and FIE are connected by a vertical line, indicating a relationship between them. The FIE is further connected to a box labeled 'Assets'.</p> | <p>Before 1 June 2014</p> | <p>After 1 June 2014</p> |
| | <p>Again, the security provided by the SPV is beyond SAFE's administration.</p> <p>The FIE cannot provide security over its assets in favour of the Offshore Bank due to prohibitions on upstream foreign guarantee / security. Therefore, the Offshore Bank is structurally subordinated to the Onshore Bank.</p> <p>The Offshore Bank and the Onshore Bank may agree to enter into intercreditor arrangements in respect of their respective financings, but such arrangements cannot override the mandatory prohibition on upstream foreign guarantee/security under PRC law. Hence, the effect of the intercreditor agreement may be limited.</p> | <p>The FIE can provide security over its assets in favour of the Offshore Bank. Such security constitutes Cross-border Security and is required to be registered with SAFE as a <i>Nei Bao Wai Dai</i>.</p> <p>Again, the facility provided by the Offshore Bank supported by the security provided by FIE may not be repatriated into China, including for the purpose of acquiring an entity which has more than 50% assets in China.</p> |

Conclusion

The Provisions demonstrate great effort made by the PRC government to transform its function from an approval-based system to a registration-based system. This move endeavours to lead the PRC economy into one that is more market-oriented, and provides more flexibility for market players in structuring deals.

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