Latham & Watkins Capital Markets and Financing Practice | July 2014 | Number 1710

China: New SAFE Regulations Improve Access to Onshore Credit Support

New SAFE cross-border security rules will ease restrictions on offshore bond offerings and other offshore financings by Chinese companies.

Introduction

On May 19, 2014, China's State Administration of Foreign Exchange (the SAFE) released the Provisions on the Administration of Foreign Exchange for Cross-Border Security (跨境担保外汇管理规定) (the New Cross-Border Security Provisions) and the Administration of Foreign Exchange for Cross-Border Security Implementation Guidelines (跨境担保外汇管理操作指引) (the Implementation Guidelines, together with the New Cross-Border Security Provisions, the New SAFE Rules). The New SAFE Rules came into force on June 1, 2014, and replaced the then existing set of rules governing the provision of cross-border security, including the Notice on Issues Relating to the Administration of Offshore Security Provided by Domestic Entities issued by the SAFE on July 30, 2010 (Circular 39).

The Peoples' Republic of China (PRC) regulatory restrictions on the granting of guarantees and other types of security by onshore companies had been limiting Chinese companies' ability to access offshore financing. Among other changes, the New SAFE Rules allow PRC onshore banks and companies to guarantee, or provide other types of security in connection with, offshore bond offerings and other offshore financings without being subject to an annual quota or the need for approval by the SAFE, provided the banks meet certain conditions. This move represents a positive regulatory development for Chinese companies looking to raise financing offshore and is expected to facilitate offshore bond offerings and other offshore financings by Chinese companies. This Client Alert focuses on the key provisions of the New SAFE Rules relating to onshore credit support for offshore bond offerings and other offshore financings (内保外贷) by Chinese companies.[1]

Key Provisions

The key provisions affecting offshore bond offerings and other offshore financings by Chinese companies include:

- ***Definition of Cross-Border Security.*** Under the New SAFE Rules, "cross-border security" (跨境担保) is broadly defined as a binding obligation (made in writing) to provide security that may result in cross-border payments and receipts, transfer of assets and other transactions affecting China's balance of payments.[2] This includes "security" in the form of guarantees and other forms of security interests recognized under PRC laws provided by PRC companies in respect of offshore financings.

- ***No SAFE Approval Required.*** The New SAFE Rules allow a PRC onshore security provider to register the security with local SAFE, within 15 working days from the date of the execution of a security agreement.[3] This new rule replaces the previous requirement for prior approval from the SAFE for providing cross-border security.[4]

Latham & Watkins operates worldwide as a limited liability partnership organized under the laws of the State of Delaware (USA) with affiliated limited liability partnerships conducting the practice in the United Kingdom, France, Italy and Singapore and as affiliated partnerships conducting the practice in Hong Kong and Japan. The Law Office of Salman M. Al-Sudairi is Latham & Watkins associated office in the Kingdom of Saudi Arabia. In Qatar, Latham & Watkins LLP is licensed by the Qatar Financial Centre Authority. Under New York's Code of Professional Responsibility, portions of this communication contain attorney advertising. Prior results do not guarantee a similar outcome. Results depend upon a variety of factors unique to each representation. Please direct all inquiries regarding our conduct under New York's Disciplinary Rules to Latham & Watkins LLP, 885 Third Avenue, New York, NY 10022-4834, Phone: +1.212.906.1200. © Copyright 2014 Latham & Watkins. All Rights Reserved.

- ***Restriction on Use of Proceeds.*** Unless specific SAFE approval has been obtained, the proceeds from the offshore financing secured by cross-border security may not be remitted back into China, directly or indirectly, in the form of loans, equity investment or securities investment.[5] This restriction on "round-tripping" remains unchanged from the old rules.[6] In addition, the proceeds from such financing may only be used in the ordinary course of the borrower's business, and must not be used in connection with any fictitious trade or speculative transactions. Onshore banks providing cross-border security are required to carry out due diligence on the underlying transactions to ensure that it is in compliance with PRC laws and the New SAFE Rules.

- ***SAFE Registration not a Precondition*.** SAFE registration is not a precondition for the cross-border security agreement to take effect.[7] In other words, if a security provider fails to register with the SAFE, the non-registration (on its own) would not necessarily render the security invalid or unenforceable. However, registration should be made promptly in any case because, in order to remit the proceeds from the enforcement of the security offshore, the relevant SAFE registration documents must be presented to purchase foreign exchange.[8]

- ***SAFE Registration of Material Changes.*** Material changes to key terms of the security agreement or the principal contract must be registered with the local SAFE within 15 working days.[9] Any discharge of such security should also be registered.

- ***Ownership Required.*** In relation to any **offshore bond issuance**, the onshore security provider must, directly or indirectly, hold shares in the offshore bond issuer (although the New SAFE Rules do not specify the minimum shareholding requirement); the proceeds from the bond issuance should be used in overseas investment projects in which the onshore company has an equity interest; and the incorporation of the offshore issuer and the overseas investment must comply with relevant PRC regulations on outbound investments.[10]

Impact on Offshore Bond Offerings by Chinese Companies

The promulgation of the New SAFE Rules is a significant step forward; giving Chinese businesses greater access to the international debt financing, which market participants will welcome. PRC onshore parent companies, especially state-owned enterprises, will likely take advantage of the rules to facilitate offshore bond issuances by their offshore subsidiaries for purposes of funding their offshore operations and investments. The ability to provide cross-border security for offshore bond offerings without the need to seek SAFE approval will likely allow PRC companies to tap offshore bond markets at a lower cost by providing onshore credit support.

The benefit of the New SAFE Rules, however, is likely to be limited for offshore bond issuance under the following two circumstances:

- ***No upstream guarantees permitted*.** Under the New SAFE Rules, onshore operating subsidiaries cannot provide upstream guarantees (to mitigate the structural subordination issue) because of the ownership requirement as discussed above, *i.e.*, the onshore security provider must, directly or indirectly, hold shares in the offshore bond issuer.

  Historically, most PRC-based companies accessing the offshore capital markets have done so via offshore holding companies (offshore holdcos) that own equity interest in PRC onshore operating subsidiaries. These offshore holdcos are typically incorporated in tax-efficient jurisdictions, such as Hong Kong, the Cayman Islands and the British Virgin Islands (and some are often listed on offshore stock exchanges). When the offshore holdcos issue bonds in the offshore bond markets, the bondholders do not have any direct claims against the onshore operating subsidiaries, and are often structurally subordinate to creditors of the onshore operating subsidiaries, i.e. the offshore bondholders will not have claims against the assets of the onshore operating subsidiaries and therefore will not be able to make any recovery until after all the onshore subsidiaries'

creditors have been paid. This structural subordination of the offshore creditors may be overcome only if the bonds could be guaranteed by the onshore subsidiaries (which would still require SAFE approval under the New SAFE Rules.

- ***Restriction on Use of Proceeds.*** The Implementation Guidelines specifically restrict using the proceeds from the offshore bond issuance if such issuance was secured by the security provided by the issuer's onshore parent. Issuers who wish to use the proceeds to fund PRC onshore operations, such as PRC real estate developers, will not be able to benefit from the New SAFE Rules, and instead will need to continue to rely on other "soft" credit enhancement techniques, such as the keep well deed and equity interest purchase undertaking, to support its offshore bond issuance.

  Under a keepwell deed, typically the onshore parent company undertakes to ensure that its offshore subsidiary issuer remains solvent and has sufficient liquidity to service the interest and principal of the bonds. Under an equity interest purchase undertaking (EIPU), the onshore parent company typically undertakes to purchase the equity interest in the onshore subsidiaries of the offshore issuer; and the purchase price will be used by the offshore issuer to service the interest and principal payment under the bonds. However, neither a keepwell deed nor an EIPU is as good as a guarantee, and their validity and enforcement have not been tested in PRC courts. Due to the uncertainty over the effectiveness of enforcement, the credit quality of bonds supported by such credit enhancement structures is typically weaker than that of bonds with a guarantee provided by the onshore parent company, which is likely to result in higher funding costs. In addition, whether or not a keepwell deed or an EIPU would be characterized as cross-border security given the broad definition in the New SAFE Rules remains uncertain. If not carefully drafted, such documents may be interpreted to provide a cross-border security, and the issuer would then not be able to use the proceeds onshore without prior SAFE approval.

Impact on Other Offshore Financings by Chinese Companies

- ***Upstream guarantee possible***. Besides offshore bond offerings, other forms offshore financing by Chinese companies are also expected to benefit from the New SAFE Rules. Other types of offshore financings, such as loans, are not subject to the same ownership requirement which applies to offshore bond issuance (as discussed above). In other words, upstream guarantees/security provided by onshore subsidiaries for offshore "holdco" financings are now possible under the New SAFE Rules, which will help mitigate the structural subordination issue in offshore "holdco" financing structures mentioned above.

- ***Financing of overseas acquisitions.*** The same restriction on "round-tripping" financing proceeds back into China apply. Of particular relevance to acquisition financing, the New SAFE Rules do not permit cross-border guarantees/security to be provided in connection with offshore financing for the acquisition of a target with over 50 percent of its assets in the PRC. Whilst this may limit the use of cross border security to finance the acquisition of PRC business, the New SAFE Rules will benefit PRC companies using onshore credit support to finance overseas acquisitions and business operations.

Conclusion

We believe that the New SAFE Rules will facilitate offshore bond offerings and other offshore financings by Chinese companies. The removal of the SAFE approval requirement for cross-border security will likely encourage PRC onshore parent companies, particularly state-owned enterprises, to utilize such a mechanism to tap offshore bond markets. The New SAFE Rules will also help improve the credit quality of such offshore bonds, and therefore, enable an offshore subsidiary to obtain funding at a lower cost. It should be noted that, given the fact that no upstream guarantees for offshore bond issuance are permissible under the New SAFE Rules and the restriction on repatriating

the proceeds onshore continues to apply, not all financing structures for Chinese companies would benefit from such rules. Overall, the New SAFE Rules represent a milestone in the evolution of the financial markets in China and will give Chinese companies improved access to offshore financing going forward.

If you have questions about this *Client Alert*, please contact one of the authors listed below or the Latham lawyer with whom you normally consult:

Howard K. H. Lam
howard.lam@lw.com
+852.2912.2570
+852.9103.9902
Hong Kong

Guiping Lu
guiping.lu@lw.com
+852.2912.2511
Hong Kong

You Might Also Be Interested In

How exposed are holders of Chinese debt?

Client Alert is published by Latham & Watkins as a news reporting service to clients and other friends. The information contained in this publication should not be construed as legal advice. Should further analysis or explanation of the subject matter be required, please contact the lawyer with whom you normally consult. The invitation to contact is not a solicitation for legal work under the laws of any jurisdiction in which Latham lawyers are not authorized to practice. A complete list of Latham's *Client Alerts* can be found at www.lw.com. If you wish to update your contact details or customize the information you receive from Latham & Watkins, visit http://events.lw.com/reaction/subscriptionpage.html to subscribe to the firm's global client mailings program.

Endnotes

1 The New SAFE Rules apply to cross-border security provided by PRC banks, non-banking financial institutions and enterprises. The New SAFE Rules also apply to cross-border security provided by individuals in China and contain provisions relating to offshore security for onshore financings (外保内贷), which are not covered in this Client Alert.

2 Article 2 of the New Cross-Border Security Provisions.

3 Article 9 of the New Cross-Border Security Provisions.

4 See Article 2 of Circular 39. In addition, Article 13 of Circular 39 provided that the onshore parent's net assets could not be less than 15 percent of its total assets, and that the secured amount could not exceed 50 percent of its net assets. Also, Article 14 of Circular 39 provided that the offshore subsidiary issuer had to be profitable in at least one of the most recent three years (or one of the most recent five years if it is a resource development company), but that no profitability was required if the offshore subsidiary issuer was incorporated less than three years (or less than five years if it is a resource development company).

5 Article 11 of the New Cross-Border Security Provisions and Article 4 of the Implementation Guidelines.

6 Article 17 of Circular 39.

7 Article 29 of the New Cross-Border Security Provisions.

8 Article 14 of the New Cross-Border Security Provisions.

9 Article 9 of the New Cross-Border Security Provisions and Article 2 of the Implementation Guidelines.

10 Article 4 of the Implementation Guidelines.