



SAFE SIGNIFICANTLY EASES RESTRICTIONS ON CROSS-BORDER SECURITY AND GUARANTEES

China's foreign exchange authority has significantly eased restrictions on cross-border security and guarantees, a much-anticipated and game-changing development that opens the door to many previously prohibited or otherwise impractical financing structures.

Overview

On 19 May 2014, the State Administration of Foreign Exchange of the PRC ("SAFE") formally issued the *Foreign Exchange Administration Rules on Cross-border Security* and its corresponding implementation guidelines (Hui Fa [2014] No. 29) (collectively, the "**New Regulations**"). Among the most exciting changes is that the New Regulations, which come into effect on 1 June 2014, will allow domestic onshore entities and individuals in China to grant security and provide guarantees to offshore creditors ("**Outbound Security**") without the need for SAFE approval.¹ Prior to the New Regulations, the provision of Outbound Security was subject to SAFE's review of whether a set of onerous requirements had been satisfied, including those relating to the principal debtor's profitability and the security provider's net assets position, total foreign currency revenues, and affiliation with the principal debtor. In many cases, these requirements effectively rendered Outbound Security arrangements prohibited or at least impractical.

As a whole, the New Regulations have fundamentally changed SAFE's approach to regulating the provision (and acceptance) of cross-border security and guarantees by PRC entities or involving assets in the PRC, not just in the case of Outbound Security but also where the security provider or guarantor is an offshore entity. Whereas in the past, SAFE's cross-border security regime revolved around substantive review and approval requirements, the New Regulations take on a procedural,

¹ In this article, "onshore" refers to mainland China and "offshore" refers to outside mainland China (including Hong Kong and Macau).

registration-based approach. Furthermore, registration with SAFE is itself not a condition to the validity of the guarantee or security interest.

The New Regulations classify cross-border security and guarantees into three types:

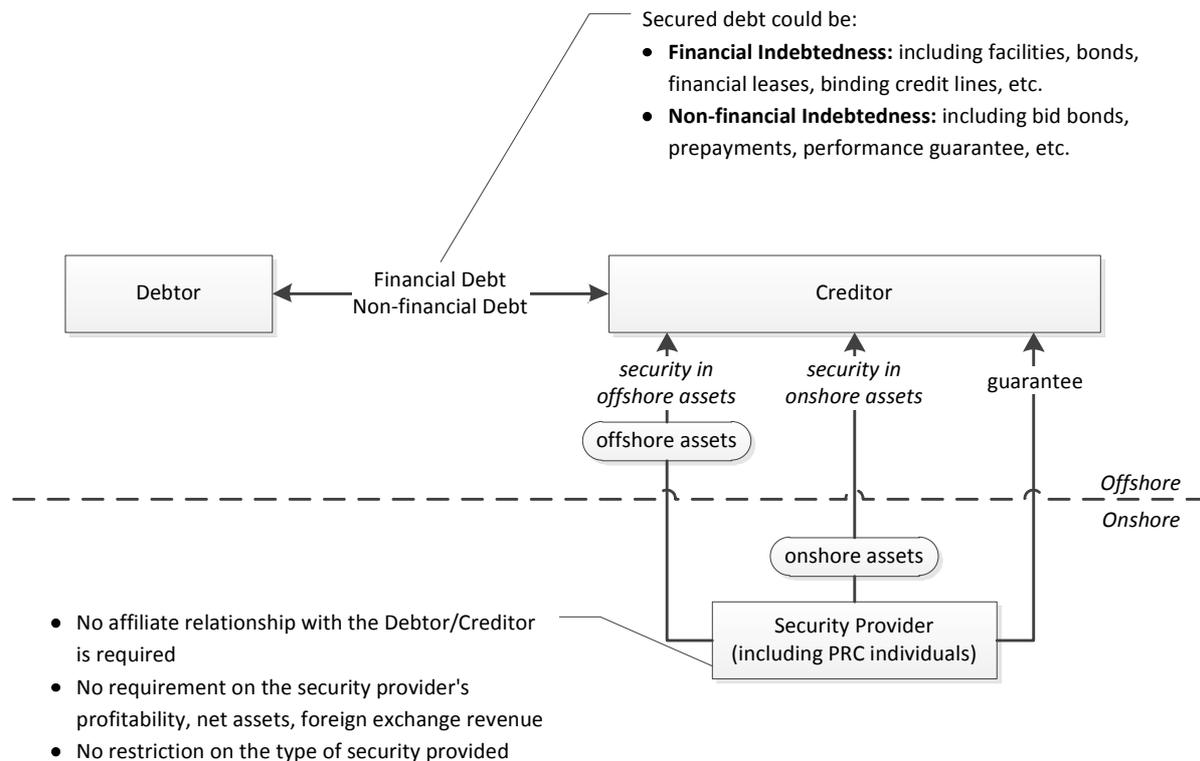
- An onshore entity or individual providing security or guarantees to an offshore creditor to secure the obligations of an offshore principal debtor ("**Onshore Security Offshore Debt**" or "**Nei Bao Wai Dai (内保外贷)**");²
- An offshore entity or individual providing security or guarantees to an onshore financial institution to secure the obligations of an onshore borrower (the "**Offshore Security Onshore Debt**" or "**Wai Bao Nei Dai (外保内贷)**");³ and
- Other types of cross-border security and guarantees not included above.

Security or guarantees provided in Onshore Security Offshore Debt or Offshore Security Onshore Debt structures must be registered with SAFE (though, as mentioned above, registration is merely a procedural matter that is not a condition to the validity of the security interest or guarantee itself). All other types of cross-border security and guarantees, unless SAFE specifically requires otherwise, generally do not need to be registered or filed with SAFE.

² Note that the Onshore Security Offshore Debt structure is a specific form of Outbound Security where the secured obligations are those of an offshore principal debtor. All other forms of Outbound Security are generally not required to be registered with SAFE.

³ The text of the New Regulations suggests that the Offshore Security Onshore Debt provisions apply only to financial indebtedness (i.e. where the creditor is a financial institution). This is a narrower scope than the Onshore Security Offshore Debt provisions, which seem to apply to indebtedness generally.

Onshore Security Offshore Debt (or "Nei Bao Wai Dai (内保外贷)")



Restrictions on Purpose of Debt

While the New Regulations abolished requirements relating to the security/guarantee provider and principal debtor, the purpose of the debt being secured in an Onshore Security Offshore Debt transaction is subject to certain restrictions. This means SAFE will likely closely examine the purpose clauses of offshore facility documents where there is an onshore security/guarantee provider.

Generally, the debt incurred should be in relation to expenditures in the debtor's ordinary course of business and not be for the purpose of carrying out speculative transactions. Furthermore, debts incurred for the following purposes are not permitted under this structure (unless otherwise approved by SAFE):

1. Making direct or indirect **equity investments in onshore entities** or **intercompany lending to onshore entities**;
2. Financing the **acquisition** of an offshore company that has **more than 50% of its assets onshore**;

3. **Refinancing debt** that has been used to make an **equity investment** in or a **loan** to an onshore entity; or
4. **Initial payments** to an onshore entity for goods or services, if the payment is made **more than a year** before taking delivery on such goods or services, the amount of prepayment is **more than US\$1 million**, and such amount of prepayment **exceeds 30% of the total price**.

Requirements for Certain Secured Obligations

The New Regulations also contain the following requirements:

1. If the security or guarantee secures repayment obligations under bonds issued by an offshore entity, the onshore security provider must (directly or indirectly) own an equity interest in such offshore issuer and the proceeds of the bond issuance must be used in an offshore transaction that has been (or is to be) invested in by the onshore security provider having obtained all necessary PRC governmental approvals for such investment;
2. If the security or guarantee secures loan proceeds used to fund capital contributions or on-lending to an offshore entity, all necessary PRC governmental approvals shall have been obtained in relation to the underlying transaction; and
3. If the security or guarantee secures payment obligations under an offshore derivative transaction, such transaction shall only be for hedging purposes within the principal debtor's main business scope and shall have been duly authorized by its shareholders.

Registration

If the onshore security provider (under the Onshore Security Offshore Debt structure) is a bank, it must be properly qualified to engage in the security provision business and must register any security or guarantee provided by it electronically with SAFE.

If the domestic security provider is a financial institution other than a bank or is an enterprise or individual, it must register the security or guarantee with SAFE by submitting the following application documents:

1. Application form (which contains basic information about the security provider, the total outstanding amount of the security or guarantee provided, key terms of the transaction

and obligations being secured, anticipated source of repayment and any other important information, such as if there is any joint security provider);

2. The transaction agreement containing the obligations being secured (accompanied by a certified Chinese translation where applicable and, if the agreement is lengthy, a brief summary of its terms); and
3. Any other documents SAFE considers necessary (such as outbound investment approval documents from the National Development and Reform Commission and the Ministry of Commerce, amendments to the agreements in the event of a change of registration).

To provide the Onshore Security Offshore Debt, a financial institution must be qualified in security provision business.

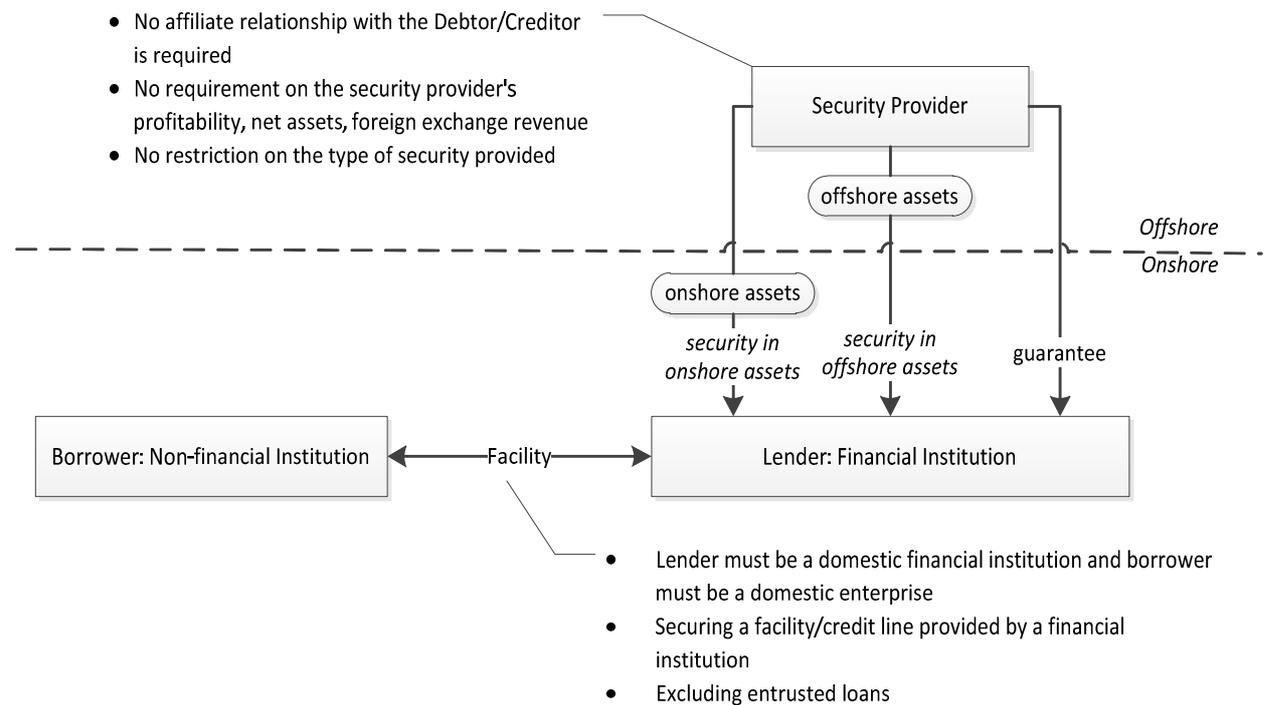
Enforcement

There is no additional administrative procedure required to enforce upon a security interest or guarantee provided under the Onshore Security Offshore Debt structure. If the onshore security provider, upon enforcement of its security or guarantee, wishes to exercise its right to claim against the offshore principal debtor whose obligations were being secured, such rights must first be registered with SAFE.

Procedures for Registration Amendments and Releasing Security

A change of registration is required if key terms of the registered security agreement and/or the principal debt agreement changes. After the secured obligation has been discharged or the term of the security or guarantee has expired, the onshore security provider can apply to deregister the security of guarantee with SAFE.

Offshore Security Onshore Debt (or "Wai Bao Nei Dai (外保内贷)")



Restrictions on Purpose of Debt

Security and/or guarantees provided under the Offshore Security Onshore Debt structure are only permitted to secure repayment obligations of an onshore borrower (which itself is not a financial institution) to an onshore financial institution under a loan transaction. Any other types of underlying obligations being secured will require specific SAFE approval. Furthermore, the type of loan transactions includes RMB and foreign currency loan and credit line facilities but does not include entrusted loans⁴. This means that onshore entities (other than financial institutions) and PRC nationals are unlikely to be the secured creditors under the Offshore Security Onshore Debt structure. Note also that any counter indemnity provided by an offshore entity for an onshore security provider will also be subject to specific SAFE approval.

⁴ PRC regulations prohibit direct loan transactions between onshore entities that are not qualified financial institutions. Thus, if an onshore company seeks to borrow funds from another onshore company, such loan must be carried out through a bank. Such a transaction is commonly referred to as an "entrusted loan".

Registration

Unless otherwise approved by SAFE, only onshore financial institutions can be secured creditors in relation to security or guarantees provided under the Offshore Security Onshore Debt structure. Such onshore financial institutions must register their security interests electronically with SAFE.

Enforcement

Onshore financial institutions which receive security or guarantees from offshore security providers may directly receive proceeds from the enforcement of such security or guarantees without providing further notice to SAFE.

If the offshore security provider, upon enforcement of its security or guarantee, wishes to exercise its right to claim against the onshore principal debtor whose obligations were being secured, such rights must first be registered with SAFE. Furthermore, the total amount of such a claim must not exceed the borrower's unaudited net assets at the end of its last financial year.

Other Types of Cross Border Security

Under the New Regulations, registration or filing with SAFE is generally not required for security interests or guarantees that are not provided under either an Onshore Security Offshore Debt or an Offshore Security Onshore Debt structure. However, parties should ensure that such arrangements are in compliance with other PRC laws and applicable foreign laws. For instance, an onshore guarantor providing a guarantee to an offshore lender to secure the obligations of an onshore borrower shall comply with regulations regarding foreign debt registration with SAFE (even though the guarantee itself does not need to be registered). If all parties are offshore entities but a security interest is being created in onshore assets (or vice versa, if all parties are onshore but a security interest is created in offshore assets), relevant foreign direct investment (or outbound investment, as applicable) approval requirements should be satisfied.

Practical Implications

While it remains to be seen how the new SAFE regime will reshape conventional financing structures going forward (and to what extent SAFE will permit transactions that push the boundaries of the new restrictions on use of debt proceeds), we've set out below a few possibilities under the New Regulations:

- **Onshore companies can now grant security or provide guarantees to support offshore parent companies in offshore financings** - Prior to the New Regulations, it was only feasible

for onshore *parent* companies to grant security or provide guarantees to support offshore *subsidiaries* (for instance, in order to fund an outbound acquisition). This has been a common structure for onshore state owned enterprises conducting outbound investments, particularly in the energy sector. The New Regulations allows for an entirely new profile of offshore borrower (i.e. that of the offshore listed company with substantially most or all of its assets onshore) to be able to bolster its security package with security and guarantees from onshore.

- **Onshore credit support for leveraged acquisition financing** - More conventional leveraged buyout (LBO) structures may be possible with onshore entities providing "downstream" credit support for the acquisition of their offshore parent companies. Although Onshore Security Offshore Debt structures under the New Regulations are restricted from being used to directly fund acquisitions of onshore entities and assets, alternative structures may nonetheless create new possibilities in the PRC private equity space.
- **Secured financing from offshore, particularly for FIEs and other entities with foreign debt quotas** - Foreign invested enterprises (FIEs) such as WFOEs and Sino-foreign joint ventures, together with many large scale companies in China (often state-owned enterprises) can borrow funds from offshore with only the requirement to conduct a foreign debt registration with SAFE. Previously, it has been impractical for such offshore cross-border financings to be secured, requiring SAFE pre-approval before any security interest or guarantee may be provided by the onshore Borrower. However, the New Regulations have now abolished such approval requirements, making it easier for onshore Borrowers to provide attractive security packages for potential offshore lenders.
- **Offshore security securing onshore financing to foreign-invested real estate enterprises (FIREs)** - PRC laws have certain requirements on FIREs before they can borrow foreign debts, such as registered capital of the FIRE borrower being fully paid up by its equity holders, land use rights having already been obtained by the FIRE and the equity capital must be at least 35% of the total investment of the project to be developed. The New Regulations may provide an alternative choice for FIREs seeking financing by borrowing facilities from onshore financial institutions by offering offshore security provided by the FIRE's parent company and/or offshore affiliates.

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