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Client**Alert**

China Bank Finance

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SAFE Released Ground Breaking Draft Rules Regarding Cross-Border Security

The State Administration of Foreign Exchange of the PRC ("**SAFE**") released the consultation draft of the *Foreign Exchange Administration Rules on Cross-border Security* (《跨境担保外汇管理规定（征求意见稿）》) together with the draft operation guidelines (the "**Draft Rules**") on 13 February 2014 for public comments. In the Draft Rules, SAFE has proposed to reform and liberate the regulatory regime for outbound and inbound security substantially. This paper focuses on the outbound security rules where most of the exciting changes are proposed.

Under the existing rules, most PRC companies must first apply to SAFE for its approval if they wish to provide guarantee/security in favour of an offshore entity (the "**Outbound Security**"). SAFE will grant the approval on a case-by-case review basis, subject to various shareholding and net asset restrictions. Those PRC companies can formally provide the Outbound Security only after receiving the SAFE approval and must register the same with SAFE within 15 days of its execution. Registration is a condition precedent for the Outbound Security to be valid. On the other hand, PRC banks and a few large PRC companies may provide Outbound Secruity within the quota pre-approved by SAFE.

The Draft Rules have removed both the approval and the quota requirements. The Outbound Security is still subject to the requirement that it must be registered with SAFE within 15 days of its execution. However, the registration is no longer a condition precedent to the validity of the Outbound Security.

We set out below our understanding on how the basic cross-border China financing structures may evolve if the Draft Rules are formally issued.

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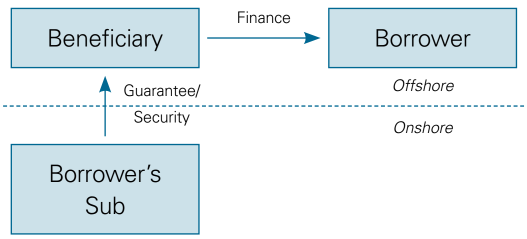
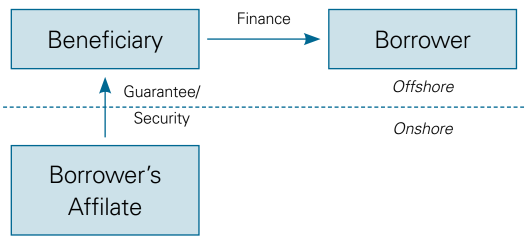
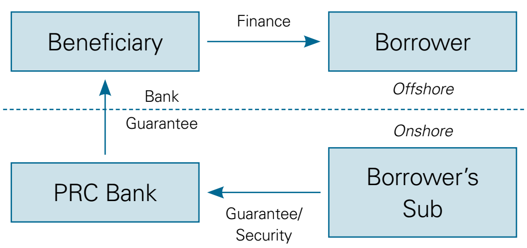
I. Glossary

No Flow-Back of Loan Proceeds refers to the restrictions that if an offshore finance is supported by Outbound Security, its proceeds must not flow directly or indirectly back into China[1]

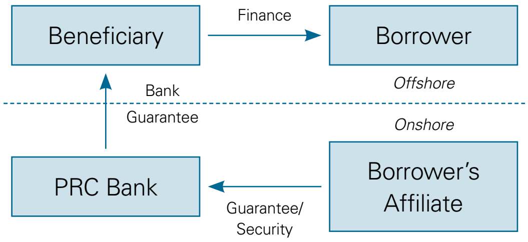
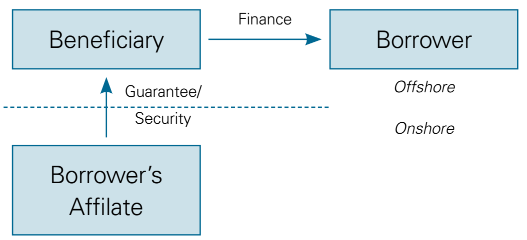
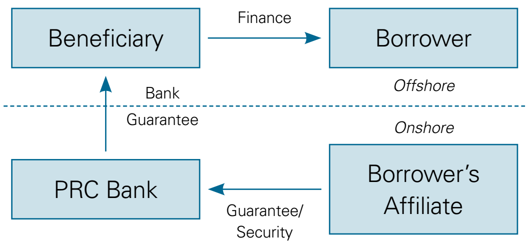
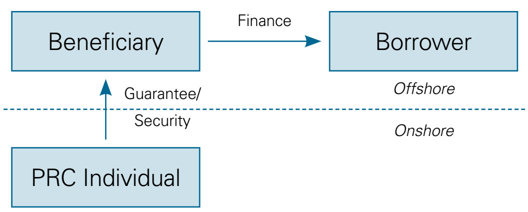
PBOC refers to People's Bank of China.

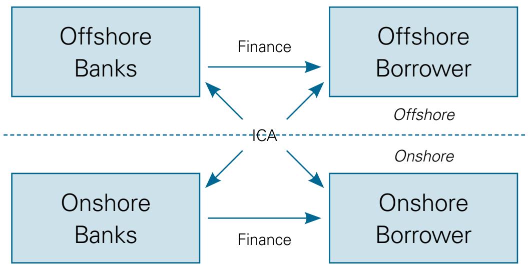
Ratio Self-disciplinary Regulation refers to the restriction under the Draft Rules that for a bank to issue outbound bank guarantee for financing purposes, (a) it must have the qualifications to engage in the guaranteeing business (which is a normal business scope for banks) upon the approval of the competent authority and (b) by the end of each working day, the aggregate principal amount of its (actual and contingent) payment obligations under all financing outbound security shall not exceed 50% of the audited amount of its net assets (as of the end of the previous financial year).

II. Basic Financing Structures Before and After the Draft Rules

Structures	Under the Existing Rules	Under the Draft Rules
Corporate Structures (USD or other foreign currencies)		
1) Offshore Finance with USD Upstream Outbound Corporate Security 	■ Generally impermissible	■ Permissible ■ No approval or ratio or quota restrictions for offshore "Loans" (however impermissible for "Bonds" which must have an "offshore sub & onshore parent" structure) ■ No Flow-Back of Loan Proceeds
2) Offshore Finance with USD Non-Upstream Outbound Corporate Security 	■ Permissible but not practical ■ Some large SOEs subject to SAFE approved quota ■ The others subject to SAFE approval on a case-by-case basis which can be very difficult and time-consuming to obtain ■ In general, must be an "offshore sub & onshore parent" structure ■ No Flow-Back of Loan Proceeds	■ Permissible ■ No approval or ratio or quota restrictions (however "Bonds" must have an "offshore sub & onshore parent" structure) ■ No Flow-Back of Loan Proceeds
Bank Structures (USD or other foreign curriences)		
3) Offshore Finance with USD Upstream Outbound Bank Guarantee 	■ Permissible ■ Subject to SAFE approved quota ■ No Flow-Back of Loan Proceeds	■ Permissible ■ Subject to the so-called "ratio self-disciplinary regulation" ■ No Flow-Back of Loan Proceeds

1 See more details in section III below.

Structures	Under the Existing Rules	Under the Draft Rules
4) Offshore Finance with USD Non-Upstream Outbound Bank Guarantee 	■ Permissible ■ Subject to SAFE approved quota ■ No Flow-Back of Loan Proceeds	■ Permissible ■ Subject to the so-called "ratio self-disciplinary regulation" ■ No Flow-Back of Loan Proceeds
RMB Structures		
5) Offshore Finance with RMB Outbound Corporate Security (Upstream or Non-Upstream) 	■ Permissible ■ No approval or ratio or quota restrictions according to PBOC rules (which however is in conflict with SAFE rules)	■ Permissible ■ Difference between PBOC rules and SAFE rules is much less significant ■ Application of the "No Flow-Back of Loan Proceeds" rules not entirely clear
6) Offshore Finance with RMB Outbound Bank Guarantee (Upstream or Non-Upstream) 	■ Permissible ■ No approval or ratio or quota restrictions according to PBOC rules	■ Permissible ■ No approval or ratio or quota restrictions ■ Application of the "No Flow-Back of Loan Proceeds" rules not entirely clear
Individual Structures		
7) Offshore Finance with PRC Individual Outbound Security 	■ Permissible but not practical ■ Only if the such security is granted together with a PRC company for an outbound acquisition ■ Subject to SAFE approval which must be obtained for the individual and corporate security as one package and time-consuming and difficult	■ Permissible ■ No approval or ratio or quota restrictions ■ No Flow-Back of Loan Proceeds

Structures	Under the Existing Rules	Under the Draft Rules
Alternative Structure		
8) Offshore Finance with Onshore Placeholder Loan (i.e. two parallel loans onshore/offshore loans stapled together with an ICA)  	■ Permissible ■ Onshore/offshore separate security packages must be separate ■ ICA requires careful drafting so as not to breach any SAFE regulation	■ Permissible ■ More flexibility to structure the security package and ICA

III. "No Flow-Back of Loan Proceeds" Restriction Before and After the Draft Rules

If an offshore finance is supported by Outbound Security, its proceeds must not flow directly or indirectly back into China in any of the forms described below (except with SAFE approval):

Under the Existing Rules	Under the Draft Rules**
■ Equity investment or shareholder loan into PRC entities ■ Refinancing an existing debt which was originally used for equity investment or shareholder loan into PRC entities ■ Acquisition of an offshore company/group which has most of its assets in PRC	■ Equity investment or shareholder loan into PRC entities ■ Refinancing an existing debt which was originally used for equity investment or shareholder loan into PRC entities ■ Acquisition of an offshore company/group which has more than 50% of its assets in PRC ■ Trade down payment to an PRC entity which (x) is more than US$1m and 30% of the total price, and (y) is made at a time more than 1 year earlier than the date of delivery of goods or service

** We note that (1) if proceeds of the offshore finance are funded into a pool of cash, it will be difficult to distinguish such proceeds from other funds and therefore difficult apply the "No Flow-Back of Loan Proceeds" rules, and (2) short term (i.e. less than 1 year) trade down payment to PRC entities is effectively permitted.

IV. Other Recent Developments

- On 5 July 2013, PBOC issued its "*Circular on Simplifying the Cross-Border RMB Business Procedures and Improving Relevant Policies*" (《关于简化跨境人民币业务流程和完善有关政策的通知》 (See highlights in our China Finance Bulletin issued in August 2013)

- On 2 December 2013, PBOC issued its *Opinions on Financially Supporting the Development of the China (Shanghai) Pilot Free Trade Zone* (《中国人民银行关于金融支持中国（上海）自由贸易试验区建设的意见》) (See highlights in our China Finance Bulletin issued in February 2014)

- On 10 January 2014, SAFE issued its "*Circular on Improving and Adjusting Foreign Exchange Administrative Policies on Capital Account*" (《关于进一步改进和调整资本项目外汇管理政策的通知》). This circular introduced new rules including for example (1) transfer by PRC onshore asset management companies of their NPLs to offshore investors no longer requires SAFE approval, (2) outbound lending by PRC companies can be extended to offshore affiliates (rather than "subsidiaries only" as per the previous rules) and the tenor may exceed the previous 2-years' limit.

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