Regulatory Moves HIGHLIGHT ISSUES in Cross-Border PRC Financings

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Historically low interest rates resulting from quantitative easing in the developed markets have afforded relatively easy access to capital, making it possible for distressed companies around the globe to refinance rather than restructure as capital markets continue to flow. In China, bank capital adequacy pressures coupled with alternative credit providers hunting for yield in emerging markets continue to propagate distressed investment and restructuring opportunities. However, growth in China has slowed to a long-term low, and the appetite for state- and government-backed bailouts has perhaps been tempered.

Some recent legal and regulatory changes implemented and proposed in the People's Republic of China (PRC) in relation to foreign investment provide a backdrop to highlight where some issues lie in relation to a foreign investment in China and how things may develop in the future.

Typical Structural Issues

In most instances, overseas investors are structurally subordinated in the capital structure of PRC companies. Foreign investors generally acquire no direct ownership rights in the operating companies that run the business or otherwise direct recourse to tangible assets in the PRC or to Chinese entities that hold them.

Loans originate from both onshore entities, such as domestic Chinese banks and other financial institutions, including shadow banking, and offshore entities, such as non-domestic banks, private equity firms, and other credit providers. Given the competing interests of these parties and the structural subordination of most foreign investors, conflict can arise between domestic and offshore creditors when a debtor group runs into trouble.

Strict capital controls have prevented many mainland companies from borrowing from foreign lenders directly, so they have used offshore structures to channel onshore the loans received. Offshore loans are also typically injected into a PRC business as equity capital and will therefore often be unrecoverable by the holding company unless there is ultimately surplus value available for distribution to shareholders.

Even before the spectre of collapse looms, moving money offshore from PRC entities to service interest and principal on loans from foreign investors is a challenge. Onshore profits and cash flows need to be sufficient to allow dividends in amounts to cover such repayments offshore; otherwise additional borrowing will be required, potentially precipitating a downward spiral.

Variable interest entity (VIE) structures have developed that involve contractual arrangements intended to allow foreign investors to enjoy economic but not legal ownership and contractual but not constitutional control of businesses in the PRC.

Foreign investors in a VIE acquire no direct ownership rights in the operating companies that run the business. All they have are contractual claims to the economic benefits of ownership and to control the business. The enforceability of these claims in the PRC remains uncertain. Investors in these arrangements must factor in the risks that the underlying operating companies, or their creditors, may simply ignore the VIE control structure.

Changing Landscape

Two recent developments regarding foreign investment in the PRC are of particular interest to investors: (i) a relaxation of regulatory restrictions on granting security and giving guarantees, which has been implemented; and (ii) a draft new Foreign Investment Law (FIL).

The security regulations are likely to impact how cross-border financings involving PRC entities are structured, but some conditions imposed concurrently will perhaps limit the extent of the potential benefits of the changes.

The draft laws on foreign investment offer evidence of an apparent continuing trend that reflects a desire to shape the PRC's foreign investment regime in line with generally accepted

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international practice. However, it is likely to take some time before they come into force, and in any event, a consolidation of a large number of laws and regulations under the auspices of a variety of regulatory bodies will inevitably take time to bed down once a new law is enacted, as will an evolution of accepted practices.

Security and Guarantees. China's State Administration of Foreign Exchange (SAFE) introduced the "Regulations on Foreign Exchange Administration of Cross-Border Guarantee and Security," which came into effect on June 1, 2014. The new regulations aim to lower some applicable thresholds and to streamline certain administrative procedures for easier provision of cross-border security and guarantees.

Transactions falling under SAFE's oversight cover (i) onshore guarantees/security for an offshore loan (outbound security); (ii) offshore guarantees/security for an onshore loan; and (iii) other cross-border guarantees/security.

Prior to the new regulations, Chinese onshore entities required pre-approval from SAFE, subject to a quota limitation, to provide onshore security to support debt incurred by offshore debtors outside the PRC. Previously credit support would generally fall short of direct guarantees.

As a result of the new regulations, failure to register outbound security with SAFE will no longer invalidate the onshore security (as was previously the case), although transfer of proceeds of enforcement overseas might be blocked in the absence of such registration.

The new regulations apply the outbound security relaxation to bond issuances with certain additional restrictions:

- The bond issuer must be directly or indirectly owned by an onshore entity
- An onshore entity must hold an equity interest in the offshore investment for which the proceeds from the bonds are used
- The relevant offshore entity or project must have been approved or be registered by the appropriate Chinese authorities overseeing outbound investment

The new regulations also impose certain restrictions on the use of funds raised offshore against outbound security, including that the funds cannot be directly or indirectly repatriated onshore by way of debt, equity investment, securities investment, or any other means unless specifically approved by SAFE.

In practice, the new regime for outbound security will only assist acquisitions of purely offshore assets, giving lenders direct upstream protection from onshore subsidiaries. It does not benefit lending arrangements in which the proceeds will be applied by capital injection back into the PRC. This poses a difficult challenge for monitoring the application of, and precluding the repatriation of, funds that could affect the security.

Draft Foreign Investment Law. China's Ministry of Commerce (MOFCOM) issued a draft FIL on January 19, 2015. If passed substantially in its current form, the FIL would modernize and largely replace the variety of laws and regulations that govern foreign investment and foreign invested companies in China, providing for unified regulation of direct and indirect foreign investment.

The aim seems to be to continue efforts to make foreign investment in the PRC appear more attractive if what is currently a fragmented regulatory framework can be streamlined in a manner familiar to foreign investors.

The draft FIL currently provides that offshore transactions involving a direct or indirect change of control of a PRC entity whose operations fall within a restricted sector (the "negative list") will trigger a foreign investment approval requirement in China. This is a notable extension from the current requirement, under which only a direct change of control of a PRC entity necessitates MOFCOM approval.

Under the current regulatory regime, the Catalogue of Industries for Guiding Foreign Investment classifies industries according to whether foreign investment is encouraged, restricted, or prohibited. Restricted categories include finance-related activities, such as insurance and banking; prohibited categories include culture-related activities, such as publishing.

Another area that has drawn considerable interest in connection with the FIL relates to VIE structures, a setup designed to avoid those restrictions. It is used by numerous NASDAQ and New York Stock Exchange listed companies that have investments in the PRC.

The proposed FIL raises issues about how formation of new VIEs will be addressed in the future and what treatment will be afforded to existing VIEs. The definition of "foreign investment" under the draft FIL would extend control beyond mere equity ownership. A domestic PRC company under the *de facto* control of a foreign investor would likely be deemed to be a foreign investment, even if the PRC company is directly owned by PRC equity holders.

A separate explanatory note from MOFCOM contemplates three approaches that may be taken with respect to existing VIE structures if the FIL is implemented:

1. An existing VIE could notify MOFCOM of its control by Chinese investors and thereby retain its ability to continue operations under the VIE structure

2. A VIE could notify MOFCOM of its control by Chinese investors but await confirmation that the company is indeed controlled by Chinese investors

3. All existing VIEs could be required to apply for foreign investment approval from MOFCOM, which would assess relevant facts, including controlling parties, when giving its decision

Grandfathering existing VIE structures is not believed to be realistic, but conversely, the forced closure of all existing VIEs would likely be a step too far, given the number and size of operations that are known to have used the structure in the public markets.

What's Next?

The new regulatory reforms in the foreign investment arena are a welcome sign of China's continued focus on addressing issues of concern to foreign investors, but they also highlight the uncertainties that will likely continue to dog such arrangements in terms of applying and interpreting some of the intended remedies.

The PRC operates a civil law based system without binding judicial precedent. Though highly persuasive, higher courts' interpretations of particular laws and issues are not binding on lower courts. Consistency of approach across provinces and regions varies and is influenced by the specific experience/competence of the overseeing judge or by local political interests and concerns.

Following China's first domestic bond default (Chaori Solar in 2014), the markets have seen the Kaisa Group become the first PRC property developer to fail to pay a coupon on its U.S. dollar bonds in 2015. This year has also seen Baoding Tianwei Baobian Electric become China's first state-owned entity to default.

It is understood that Kaisa's offshore creditors do not have direct recourse to its assets, which are located in China and so would be structurally subordinated to the developer's domestic creditors. Kaisa's default will remain of interest, as its treatment of offshore bondholders may be indicative of how similar situations will be dealt with in the current climate.

These corporate failings perhaps demonstrate Beijing's increasing willingness to allow defaults in an effort to reform the market and incentivize domestic issuers and lenders to exercise greater prudence in their credit arrangements.

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