

Legal Commentary

February 13, 2020

Capital Markets Law

Being a Good “Gatekeeper” for Corporate Bond Underwriting - the Securities Association of China Issues New Due Diligence Rules for Corporate Bond Underwriting Services

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On 28 December 2019, the 15th Meeting of the Standing Committee of the 13th National People’s Congress adopted revisions to the *Securities Law of the People’s Republic of China* (《中华人民共和国证券法》) (the “**Securities Law 2019**”). The Securities Law 2019 will comprehensively implement a new registration system following its effectiveness on 1 March 2020. In response, the Securities Association of China (“**SAC**”), in consideration of the development practices and characteristics of the corporate bond market, revised the *Guidelines on Due Diligence for Corporate Bond Underwriting Services* (《公司债券承销业务尽职调查指引》) initially published on 16 October 2015 (the “**Due Diligence Guidelines 2015**”), and further issued the *Guidelines on Due Diligence for Corporate Bond Underwriting Services (Revised Version)* (《公司债券承销业务尽职调查指引（修订稿）》) (the “**Due Diligence Guidelines 2020**”) on 22 January 2020. On the same date, SAC issued for the first time the *Guidelines on the Content and Catalogue of Working Papers for Corporate Bond Services* (《公司债券业务工作底稿内容与目录指引》) (the “**Working Paper Guidelines**”) which came into force on the date of issuance.

The Due Diligence Guidelines 2020 further refine and adjust the requirements for underwriters in providing corporate bond services, strengthen the requirements for verification and analysis of key issues such as the issuer’s solvency, and put forward higher requirements for due diligence and work practices of corporate bond underwriters, to comprehensively implement the securities issuance registration system and increase the responsibilities of intermediaries, in line with the overall concepts of the Securities Law 2019.

In this legal commentary, we will analyze key revisions of the Due Diligence Guidelines 2020 based on the Due Diligence Guidelines 2015 and their impact on underwriters of corporate bonds by reference to the

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significant revisions to the corporate bond issuance and trading system in the Securities Law 2019, and further analyze the trend of the subsequent revisions and adjustments to rules relating to the corporate bond issuance and trading system.

The corporate bond public offering and trading system in the Securities Law 2019

We provided a detailed analysis on the specific revisions of the Securities Law 2019 in our previous Han Kun Legal Commentary the [Highlights of the New PRC Securities Law](#). According to the Securities Law 2019, the registration system will be comprehensively implemented in the field of “public securities offerings”, which includes public corporate bond offerings. However, it is stated that “the specific scope and implementation steps of the registration system shall be formulated by the State Council.” Specifically, under the general background of the registration system, the important revisions made to the corporate bond public offering and trading system in the Securities Law 2019 include:

1. Removing certain requirements for public corporate bond offerings. The requirements for the issuer’s minimum net assets and the ratio of outstanding bond balances to net assets of the issuer have been replaced with “having a sound and well-functioning organizational structure”. In addition, the Securities Law 2019 reflects a more market-oriented bond pricing mechanism by removing the previous requirements that: (i) the use of funds raised in the public offering shall be approved, and (ii) the coupon rate of corporate bonds shall not exceed the coupon rate stipulated by the State Council;
2. Imposing new requirements on the disclosure of significant events that may have material impact on the trading prices of corporate bonds;
3. Deleting the provisions of the currently effective version of the Securities Law (as last amended in 2014) in relation to the listing of corporate bonds on stock exchanges, including eligibility requirements for the listing of corporate bonds, application documents to be submitted to stock exchanges for corporate bond listings, circumstances under which the listing and trading of corporate bonds is to be suspended or terminated by stock exchanges, etc.; and
4. Further substantiating the legal liabilities of intermediaries as market “gatekeepers”. The Securities Law 2019 specifies that underwriters and their personnel who are directly responsible bear joint and several liabilities for investors who suffer damages caused by non-performance of their duties and the corresponding rules for waiver of liabilities, and raises the range of punishments for securities service institutions (including bond underwriters, bond trustees, etc.) that fail to perform their due diligence obligations.

The above adjustments made in the Securities Law 2019 leave room to implement the registration system for corporate bond issuances and empower stock exchanges to formulate specific rules for the listing and trading of corporate bonds on stock exchanges.

The Due Diligence Guidelines 2020 were issued around the comprehensive implementation of the registration system in the Securities Law 2019 and aligned with its core concepts. Based on the overall requirements under the registration system and in combination with the characteristics of the bond market and relevant market practice, the Due Diligence Guidelines 2020 set out more detailed requirements for

the practices of underwriters of corporate bonds when engaging in corporate bond services, leverage the initiative, independence, and professionalism of underwriters of corporate bonds, and further urge them to better perform their obligations as bond market “gatekeepers”.

Analysis and interpretation of key revisions in the Due Diligence Guidelines 2020

Compared to the Due Diligence Guidelines 2015, the key revisions of the Due Diligence Guidelines 2020 include the following aspects:

I. Putting forward more explicit requirements for underwriters’ due diligence practices

First, the Due Diligence Guidelines 2020 explicitly require that underwriters to develop an adequate and thorough internal management system for due diligence, maintain a project work log based on the specific phases of due diligence, and provide issuers with necessary training on bond offerings.

Second, the Due Diligence Guidelines 2020 impose new requirements on due diligence for an issuer’s re-financings. Where the same underwriter conducts due diligence on the issuer’s re-issuance of corporate bonds, the underwriter may cite the results of the previous due diligence and supplement the investigation with those parts that have changed.

Third, the Due Diligence Guidelines 2020 further strengthen and specify the duties of intermediaries. The details are as follows:

1. Emphasizing that the principle of due diligence shall be “diligent undertaking and good faith”; the method of due diligence shall be “through various effective methods and steps”; the purpose of due diligence is to “grasp the business conditions, financial conditions and solvency of the issuer” (rather than “know” as prescribed in the Due Diligence Guidelines 2015), and to “analyze the impact on the issuer’s solvency and sustainable operating ability” in combination with the basic conditions of the issuer;
2. Requiring to distinguish whether other intermediaries are providing professional opinions to support the relevant content of the offering documents, requiring underwriters to perform a general duty of care and special duty of care, and to verify the business qualifications, eligibility, compliance, and other conditions of each of the intermediaries during the reporting period;
3. Expanding the scope of due diligence of underwriters from “significant matters that may affect the solvency of the issuer” as prescribed in the Due Diligence Guidelines 2015 to “other matters that may have a significant impact on the solvency of the issuer or investment decisions of the investors”, which materially puts forward broader requirements for the scope of the underwriters’ due diligence; and
4. Underwriters are to perform duties strictly in accordance with the requirements of the Due Diligence Guidelines 2020 and be able to prove no fault in the course of practice. According to the Due Diligence Guidelines 2020, if SAC determines that an underwriter is in violation, it may take self-disciplinary measures against the underwriter, unless the underwriter can prove that it is not at fault.

Fourth, the Due Diligence Guidelines 2020 supplement the verification requirements for the specific issuer’s eligibility requirements for special bond types (such as green bonds and convertible bonds)

and special industries (such as real estate).

Fifth, the Due Diligence Guidelines 2020 apply more broadly to corporate bond offerings. The Due Diligence Guidelines 2020 delete provisions in the Due Diligence Guidelines 2015 that non-public corporate bond offerings are to be carried out by reference. We understand that this revision is intended to unify the due diligence requirements between different types of corporate bond offerings so that due diligence for corporate bond underwriting services will be conducted in a unified manner in accordance with the provisions of the Due Diligence Guidelines 2020.

Sixth, to further clarify the rules that underwriters shall abide by during due diligence, as an industry self-disciplinary organization, SAC provides in the Due Diligence Guidelines 2020 that where there are relevant provisions stipulated in “laws, regulations and normative documents” and other regulatory rules whose level is higher than that of the self-disciplinary rules, such provisions shall prevail; where there are relevant provisions in other self-disciplinary rules for which the Due Diligence Guidelines 2020 do not provide, such provisions shall prevail.

II. Highlighting the concept of bonds, focusing on prevention of credit risk in bond services

In order to improve the verification efficiency in bond services, the Due Diligence Guidelines 2020 strengthen verification and focus on the issues which may affect an issuer’s credit status and solvency, which are mainly reflected in the following aspects:

1. With respect to an issuer’s business operations, underwriters will no longer be required to examine the issuer’s production and sale of its primary products/services and supplies of raw materials/energy; the Due Diligence Guidelines 2020 retain and further refine the requirements that underwriters must verify transactions between the issuer and its major clients and suppliers, in order to judge the impact on the issuer’s solvency caused by reliance on its suppliers and clients;
2. With respect to credit verifications, newly added provisions require that underwriters shall obtain the issuer’s credit reports, and verify their credit status, material litigations and arbitrations involving entities in which the issuer has made significant equity investments. The method of verifying credit status is necessity-oriented. Detailed methods for verification are no longer specified;
3. Specific requirements are newly added for the verification of issuers’ key financial statement items and solvency, and the verification methods and requirements for such items are refined;
4. With respect to verification of the validity of bond guarantors and guarantee measures, requirements are newly added for underwriters to (a) investigate the status of performance guarantees for credit bonds on public markets, and credit standing and solvency of guarantors; (b) verify the legality and validity of guarantee contracts; and (c) investigate certificates of ownership, collateral evaluation reports or other documents that can prove the value of the collateral, and collateral/pledge contracts;
5. With respect to investigating bond ratings, under the Due Diligence Guidelines 2020, if the bond rating is higher than the issuer’s rating, the underwriter is required to pay attention to the reasonableness of the rating; and
6. With respect to risk prevention, a requirement for risk prevention measures is newly added that

requires underwriters to verify the major interests between the issuer and the key personnel of intermediaries.

III. Fully leveraging the initiative, independence, and professionalism of bond underwriters

In the current self-disciplinary rules, the verification requirements for underwriters regarding financial accounting mainly focus on reviewing the materials and professional opinions of other intermediaries. The Due Diligence Guidelines 2020 require underwriters to fully leverage their initiatives, with an emphasis on independent judgment for material irregularities, overall conditions of the issuer, etc. The revisions to the relevant financial accounting provisions in the Due Diligence Guidelines 2020 are mainly in the following aspects:

1. Regarding the major changes in the scope of the consolidated financial statements during the reporting period: first, if there is any significant equity investment in which the issuer holds more than 50% of the total equity but is not included in the consolidated statement, or the issuer holds less than 50% of the total equity but is included in the consolidated statement, the underwriter is required to verify its reasonableness; second, the underwriter is required to verify and analyze the major accounting policies, the changes in accounting estimates, and the material corrections of accounting errors of the issuer during the reporting period;
2. Verification requirements have been newly added for the issuer's key financial statement items. The Due Diligence Guidelines 2020 require underwriters to verify the status of assets that may have a significant impact on the issuer's solvency at the end of the reporting period and to verify high-value non-operating fund occupation or lending during the reporting period;
3. Regarding the issuer's solvency, underwriters are required to verify changes in the issuer's asset-liability ratio during the reporting period and debt at maturity within the next three years. Specifically, if the debt at maturity within one year accounts for a large proportion of overall debts, the underwriter is required to confirm whether there is any repayment protection for the debt at maturity; and
4. Regarding the verification of contingent information: first, the underwriter's verification methods for subsequent events is not limited to reviewing notes to the issuer's accounting statements; second, verification requirements are newly added for the credit and financial status of key guaranteed parties to assess the issuer's compensation risk.

The Working Paper Guidelines to promote digitization and standardization of working papers in corporate bond services

SAC formulated and issued the Working Paper Guidelines to clarify the main content, basic requirements, and documentation standards for working papers in bond services. Meanwhile, the Due Diligence Guidelines 2020 require underwriters of corporate bonds to prepare working papers in accordance with the *Working Paper Catalogue of Corporate Bond Underwriting Services* (《公司债券业务工作底稿目录》) (the "**Working Paper Catalogue**"). The formulation of the relevant rules will help promote the digitization and standardization of working papers in corporate bond services.

Regarding the preparation of working papers, the Working Paper Guidelines set out the main contents of working papers for corporate bond underwriters and trustees. However, the Working Paper Guidelines only set general requirements for the preparation of working papers, while materials and information that may have a significant impact on a corporate bond offering shall also be retained as working papers.

Regarding documentation standards for working papers, the Working Paper Guidelines stipulate that working papers can be retained in hardcopies, as electronic files, or in other forms of media.

Regarding the preparation of working paper catalogues, the Working Paper Guidelines explicitly require that underwriters and trustees of corporate bonds establish a unified catalogue of working papers which is easy to review. The Working Paper Catalogue sets out detailed requirements for (i) due diligence documents for corporate bond underwriting services, (ii) documents at the offering stage for corporate bond underwriting, (iii) documents relating to corporate bond trust management services, and (iv) other documents for reference.

Outlook

As mentioned in Part I, the revisions in the Securities Law 2019 leave certain room for the registration system and detailed system design for corporate bond listings and trading on stock exchanges. We understand, after the implementation of the Securities Law 2019, relevant regulatory authorities will revise the original rules such as the *Measures for Administration of Issuing and Trading of Corporate Bonds* (《公司债券发行与交易管理办法》) (the “**Administrative Measures**”) in relation to the registration system for public corporate bond offerings as well as the listing and trading of corporate bonds on stock exchanges. Meanwhile, relevant supporting regulations and detailed implementation rules will be further revised and/or formulated.

In fact, since the implementation of the Administrative Measures in January 2015, the pre-approval system for the listing of corporate bonds has been gradually implemented in the field of public corporate bond offerings to simplify the approval procedures. The arrangements for the pre-approval system are, to a large extent, close to the requirements of the registration system. The implementation of the Securities Law 2019 will also provide a clear legal basis for the formal implementation of the corporate bond offering registration system. Meanwhile, in the context of the comprehensive implementation of the registration system, with the continuous development of the corporate bond market, we expect that the regulatory authorities will set higher and stricter requirements for bond underwriters, bond trustees, and other intermediaries in areas such as due diligence and standardization of practice, while the role of securities intermediaries as market “gatekeepers” will continue to be strengthened. In light of this, the corresponding rules and supporting systems need to be revised and improved in accordance with the Securities Law 2019 to accompany the implementation of the comprehensive and deepened reform of the securities markets and to safeguard the legitimate rights and interests of investors. We will also further monitor the revisions of the relevant supporting rules and share our views with our readers in a timely manner.

Important Announcement

This Legal Commentary has been prepared for clients and professional associates of Han Kun Law Offices. Whilst every effort has been made to ensure accuracy, no responsibility can be accepted for errors and omissions, however caused. The information contained in this publication should not be relied on as legal advice and should not be regarded as a substitute for detailed advice in individual cases.

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