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Briefing note

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Shanghai's Pilot Free Trade Zone Receives Green Light from China's Highest Authority

Looking to reverse economic slowdown, the new Chinese leadership has been devising a new project since early this year to boost investment by establishing a pilot free trade zone[1] in Shanghai, China's biggest business hub (**Shanghai FTZ**). The plan to form the Shanghai FTZ (**Plan**), jointly proposed by the Ministry of Commerce and the Shanghai municipal government, received State Council's approval on 3 July 2013. It was submitted to the Standing Committee of the National People's Congress (**NPCSC**) for final review and approval on 16 August 2013, following which the NPCSC authorised the State Council to suspend the application of specific foreign investment laws in the Shanghai FTZ as from 1 October 2013.

Key issues

- FIE approval and operational requirements streamlined
- "Negative list" on industries for foreign investment to be released
- Certain service industries to be opened up
- Structural reforms to promote overseas investment, speed up trading transformation, boost financial reform and strengthen policy support in the pipeline
- More favorable tax treatment to be introduced

The regulatory relaxation is expected to highly facilitate the formation and operation of foreign investment enterprises (**FIEs**) within the Shanghai FTZ and hence will attract foreign capital inflow. It is widely contemplated that the Shanghai FTZ will offer a unique and attractive investment environment to investors, featuring streamlined investment and trading procedures, efficient government supervision, standardised legal regime, and potentially a more liberalised financial system. The Shanghai FTZ is also aimed as a testing ground for future investment and financial reforms nationwide, hence policies and rules to be implemented in the Shanghai FTZ are important and may have far-reaching

[1] According to the *International Convention on the Simplification and Harmonization of Customs Procedure*, a free trade zone means a part of the territory of a contracting party where any goods introduced are generally regarded, insofar as import duties and taxes are concerned, as being outside the Customs territory. Goods admissible to a free trade zone which are entitled to exemption from or repayment of internal duties and taxes when exported will qualify for such exemption or repayment after they have been introduced into the free trade zone.

http://www.wcoomd.org/en/topics/facilitation/instrument-and-tools/conventions/pf_revised_kyoto_conv/~/link.aspx?_id=9415CF3F04D44BB1A62B44853A63AAC1&_z=z

implications for foreign investors seeking to establish or expand their business in China.

While the details of the Plan have yet to be officially released, this article seeks to list the key initiatives that reportedly would be implemented under the Plan, and highlight their potential impact on business of foreign investment in China.

Geographic coverage

Geographically, the Shanghai FTZ comprises the following four existing special zones in Shanghai spanning 28.78 square kilometers, currently under the special administration of the PRC Customs:

- Yangshan Free Trade Port Area;
- Shanghai Waigaoqiao Free Trade Zone;
- Shanghai Waigaoqiao Bonded Logistics Zone; and
- Shanghai Pudong Airport Free Trade Zone

Map

Source:www.shftz.gov.cn

Policy breakthrough

Streamlining approval process for FIEs

As mentioned above, NPCSC has officially authorised the State Council to suspend the application of certain foreign-investment laws within the Shanghai FTZ. This special arrangement will be implemented in the Shanghai FTZ on a trial basis for a period of three years, and if successful, extended across China. In order to expedite administrative approval in the Shanghai FTZ, certain matters relating to FIEs that now require prior administrative approval will be reduced to a mere filing requirement with the relevant government authority. Effectively, FIEs established in the Shanghai FTZ will be subject to the same requirements as domestically-invested enterprises and hence enjoy national treatment. This measure will appeal to foreign investors as they may benefit from increased administrative clarity and efficiency. For ease of reference, a list of the matters for which prior approval will not be longer required for FIEs established in the Shanghai FTZ are as follows:

	Matters for which prior approval is not required in the Shanghai FTZ	**Relevant enabling laws to be suspended**
1.	Approval for the establishment of wholly foreign-owned enterprises (**WFOEs**)	Article 6 of the *PRC Law on WFOEs:* "The establishment of a WFOE is subject to the approval of the Ministry of Commerce (**MOFCOM**) and other relevant competent authorities (if any) (**Approval Authorities**)."
2.	Approval for the division and merger of WFOEs and other significant changes in WFOEs	Article 10 of *PRC Law on WFOEs* "A WFOE's division, merger and other significant changes must be approved by the Approval Authorities and registered with the local Administration for Industry and Commerce (**AIC**)."
3.	Approval for the term of operation of WFOEs	Article 20 of the *PRC Law on WFOEs* "The term of a WFOE must be approved by the Approval Authorities and any application for extension must be submitted to the Approval Authorities for separate approval within 180 days before the expiry of the current term."
4.	Approval for the establishment of Sino-foreign equity joint venture enterprises (**EJVs**)	Article 3 of the *PRC Law on EJVs* "The EJV agreements, contracts and articles of associations (**AOA**) must be approved by MOFCOM. Only with MOFCOM's approval may the EJV register with the local AIC and obtain a business license."
5.	Approval for the extension of the term of operation of EJVs	Article 13 of the *PRC Law on EJVs* "Any application for extension of the term must be submitted to the Approval Authorities for review and approval within six months before the expiry of the current term."
6.	Approval for the dissolution of EJVs	Article 14 of the *PRC Law on EJVs* "An EJV may be dissolved in one of the following circumstances upon obtaining the approval of the Approval Authorities: (i) where it suffers from significant losses; (ii) where a party fails to perform its obligations under the EJV agreement, contract or the AOA; (iii) a force majeure event occurs; or (iv) upon agreement of the parties."
7.	Approval for the establishment of Sino-foreign cooperative enterprises (**CJVs**)	Article 5 of the *PRC Law on CJVs* "The CJV agreement, contract and the AOA must be approved

		by the Approval Authorities."
8.	Approval for significant amendments to the CJV agreements, contracts and the AOA	Article 7 of the *PRC Law on CJVs* "Any significant change to the CJV contract within the term of the CJV must be approved by the Approval Authorities and registered with the local AIC and other relevant authorities."
9.	Approval for the assignment of rights and obligations under the CJV contract	Article 10 of the *PRC Law on CJVs* "Where a party intends to assign all or part of its rights and obligations under the CJV contract, it must obtain the consent of the other party and approval from the Approval Authorities."
10.	Approval for the delegation of management of CJVs	Article 12(2) of the *PRC Law on CJVs* "Where the parties intend to delegate the management power of the CJV to a third party, such delegation must be unanimously agreed by the board of directors or the joint management committee and approved by the Approval Authorities."
11.	Approval for the extension of the term of operation of CJVs	Article 24 of the *PRC Law on CJVs* "Where the parties agree to extend the term of the CJV, the CJV must apply to the Approval Authorities within 180 days before the expiry of the current term."

Introducing a "negative list" for foreign investment

In contrast to the Foreign Investment Guidance Catalogue (**Catalogue**) thereby classifying industry sectors in China into the "Encouraged", "Restricted" and "Permitted" categories monitoring how foreigners may invest, a much simpler "negative list" will be devised to apply specifically to foreign investment in the Shanghai FTZ. It is perceived that the "negative list"" will be a much reduced version of the Catalogue. Accordingly, foreign investors may conduct within the Shanghai FTZ any business (except certain reserved sectors) that is not set out in the "negative list" with minimal restrictions, such that they will only be required to arrange a filing with the Shanghai municipal government and that no prior government approval will be required. The Shanghai municipal government is also considering rolling out a new "commercial registration" (商事登记) system in the Shanghai FTZ, which is much simpler compared to the existing AIC registration system[2]. With much fewer administrative hurdles, more foreign investors are likely to be attracted into the Shanghai FTZ.

Further opening-up of certain service industries

The Plan also envisages certain restricted industries to be opened up to foreign investment within the Shanghai FTZ. They cover financial services, shipping services, commercial trading services, professional services, cultural services and other social services industries. All investors, domestic or foreign, will enjoy equal market access to these sectors within the

[2] Under the existing AIC registration system, all companies established in China must specify its paid-in capital and business scope, and any change in their business license must be approved by/or registered with AIC. However, under the "commercial registration" system, enterprises will not be required to register their capital in their business license. They may also conduct any business without the need for approval from/or registration with AIC, as long as such business does not trigger any prior approval requirement from the competent authorities. The "commercial registration" system has already been implemented in Shenzhen and Zhuhai on a trial basis since 2012.

Shanghai FTZ. Except for the banking and telecommunications industry, investors will no longer be subject to eligibility requirements, shareholding limit and restrictions on business scope. The radar of such opening-up policies are likely to cover the following sectors:

Sectors	Opening-up policies to be introduced in the Shanghai FTZ
Banking	Chinese-funded banks will be allowed to conduct offshore business.
Insurance	Foreign-owned healthcare insurance companies will be allowed.
Payment	Foreign-invested payment institutions may apply for payment permits.
Futures	Foreign commodities exchanges will be permitted to open futures delivery warehouses.
Cargo shipping	The shareholding of foreign investment in cargo shipping joint ventures will be raised.
Ship management	Wholly foreign-owned shipping companies will be allowed.
Credit investigation	Foreign-invested credit investigation companies will be allowed.
Investment services	Joint-stock foreign-invested investment companies will be allowed.
Medical services	Foreign investors may set up wholly-owned medical institutions.

Potential structural reforms

The Plan further contemplates developing the Shanghai FTZ into a pilot location for promoting overseas investment, expediting trading transformation, boosting financial reform and strengthening policy support through the measures below. These initiatives are also expected to be achieved gradually within the trial three-year period, details as follows:

Item	Policy	Detail
Promote overseas investment		
1.	Promote overseas investment	Filing of outbound investment projects Outbound investment projects in the Shanghai FTZ will not be subject to complicated screening and approval by multiple regulators. Mere filing with the Shanghai municipal government will suffice.
		Private equity (**PE**) funds: encouraging outbound PE houses to set up SPVs and/or fund of funds
Speed up transformation of trading		
2.	International trading center	Headquarters: encouraging transnational companies to set up their Asian-Pacific headquarters in the Shanghai FTZ
		International trading settlement center: expanding the functions of special accounts for cross-border receipt/payment and financing
		Commodities trading: exploring a platform for large-sum international commodities trading (including energy products, raw materials and agricultural products)

		Outsourcing services: biomedicine, IT software, management consulting and data processing
		Leasing industry: encouraging various leasing companies to set up SPVs to conduct onshore and offshore leasing business
3.	International shipping center	Coverage: shipping finance, international shipping transportation, international shipping management and international shipping brokerage, etc.
		Promoting shipping-linked derivatives instruments
		Transit shipment: encouraging non-five-star flag ships owned or controlled by Chinese-funded companies to transit import-export containers between Shanghai ports and other mainland ports
		Ship registration: offering favorable tax treatment to ships with flag of convenience and streamlining international shipment licensing and ship registration process (This will largely follow the Tianjin approach.)
Boost financial reform		
4.	Financial initiatives	RMB capital account conversion allowed on condition that any risks remain controllable. RMB cross-border transfer and reform of foreign exchange control will also be introduced
		Liberalization of financial market interests, which is the key step to moving towards the free conversion of the capital account
		Reform of foreign exchange control regime: reforming foreign debt administration to facilitate cross-border financing and expanding foreign currency cash pooling management for transnational companies
5.	Financial services	Opening up to private capital and foreign capital: foreign investors will be encouraged to set up foreign-funded banks and Sino-foreign joint venture banks in the Shanghai FTZ
		Allowing foreign enterprises to gradually participate in commodity futures transactions in the Shanghai FTZ.
		Encouraging financial market product initiatives
		Supporting RMB cross-border reinsurance business
Strengthen policy support for the Plan		
6.	Administrative system reform	Simplifying the administrative approval procedures, setting up coordinative administration mechanism and unifying enforcement systems, etc. Foreign investors will be able to enjoy a more efficient and centralised administrative system
		Protecting the legal interest of investors and allowing qualified

		foreign investors to freely transfer their investment proceeds
7.	Simplified legal regime	Implement pre-entry national treatment and adopt a "negative list" approach
		Introducing local rules to support the operations of the Shanghai FTZ

Among the reforms above, the proposed financial initiatives apparently attracts investors the most. The Shanghai municipal government is determined to drive the reform and has issued a guidance plan on 9 August (**Guidance Plan**) to introduce 42 new measures to boost the city's financial industry including financial initiatives contemplated specifically for the Shanghai FTZ. According to the Guidance Plan, the Shanghai municipal government and other local authorities must explore and propose new rules to launch the financial initiatives in the Shanghai FTZ before the central government issues any further clarification or implementing rules.

Favorable tax treatment

The Plan also contemplates introducing several favorable tax treatments to attract domestic and foreign investors and promote international trading in the Shanghai FTZ.

In relation to investment:

- enterprises established in the Shanghai FTZ and their individual shareholders may pay income tax by way of installments for up to five years in respect of the proceeds derived from the overseas investment and other asset restructuring transactions invested with their non-cash assets; and
- by reference to the relevant pilot program in Zhongguancun, individuals in Shanghai FTZ may pay income tax by way of installments in respect of proceeds they receive from share incentive plans.

In relation to trading:

- financial leasing companies established in the Shanghai FTZ and their SPVs may be able to enjoy export tax rebates;
- if domestic leasing companies established in the Shanghai FTZ or their SPVs purchase aircrafts with net weight of 25 tons or above from offshore and in turn lease such aircrafts to domestic airlines, they may enjoy a reduced 4% import value added tax; and
- manufacturing enterprises and manufacturing service enterprises established in the Shanghai FTZ may be exempted from paying tax, for example, in respect of the machines and equipment to be used for conducting the manufacturing activities.

Comparing with Qianhai

Many market observers have compared the Shanghai FTZ with the Qianhai Shenzhen-Hong Kong Modern Service Industry Cooperation Zone (**Qianhai Zone**), approved by the State Council in 2010, which is located in the Guangdong Province of Southern China. Both the Shanghai FTZ and the Qianhai Zone target at reforming the service sector, promoting financial innovation and liberalising the RMB capital account. In contrast, however, Qianhai's initiatives are aimed more at cooperating with Hong Kong and facilitating trade around the Pearl River Delta (such as allowing Hong Kong banks to offer cross-border RMB loans to companies operating in Qianhai). The Plan involves much broader and deeper policy reforms and innovations, and is generally believed to have secured greater support from the central Chinese leadership. In comparison, the Shanghai FTZ is likely to be more representative of the forthcoming regulatory and economic reform nationwide.

Conclusion

The relaxation of restrictions on foreign investment and the adoption of a "negative list" approach form the skeleton of reforms to be piloted in the Shanghai FTZ. With much looser regulations in place, the Shanghai FTZ is expected to create a more investor-friendly environment for foreign investors from different sectors, offering them more attractive business opportunities.

Financial reform under the Plan is also one of the areas that have garnered the highest anticipation, with full RMB convertibility, interest rate liberalization and offshore RMB business all possibly implemented on a trial basis in the next couple of years. If this realises, foreign investors would have greater exposure to onshore financial transactions and be able to enjoy a more relaxed foreign exchange control regime. Since the drafting work of supporting rules is still in the pipeline, it is uncertain how far the reform will go in the end. Despite this uncertainty, it is generally perceived that the regulatory changes to be introduced within the Shanghai FTZ will be broad and significant, hence foreign investors should stay alert for its latest development.

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