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New Business Model in China - Shanghai Free Trade Zone

On September 29, 2013, a 28.78 square kilometer Shanghai Pilot Free Trade Zone (the "Shanghai FTZ") was officially launched within Pudong New District of Shanghai. The Chinese government unveiled the Shanghai FTZ with the ostensible purpose of accelerating the transformation of government functions, further opening up the service and finance industries, and laying the groundwork for greater nationwide reforms and a restructured Chinese economy while government control and policy are still kept intact.

Legal Framework

Negative List

Foreign investors may conduct within the Shanghai FTZ any business (except for certain investment projects reserved by the State Council) that is not set out on the Negative List, with minimal restrictions. New proposed investment projects in sectors that are specified on the Negative List will continue to be subject to existing laws and regulations.

The Negative List, which is currently quite broad, but is expected to be narrowed later, covers 16 industrial sectors and maintains a ban on foreign investment in traditionally prohibited cultural, sports and entertainment industries (for example, news agencies, radio and film companies and publishing), while relaxing restrictions in other sectors.

Administrative Measures for the Shanghai FTZ ("Measures")

According to the Measures, the Shanghai FTZ will strengthen open access in the following areas: international transportation, commercial and trade services, financial services, professional services, culture and social services, which, it is hoped, will help to attract investors to set up regional headquarters for investment and cash management and promote trading, logistics and shipping and other items in the Shanghai FTZ.

The Shanghai FTZ will suspend or cancel the entry requirements on investors' qualifications, as well as restrictions on shareholding proportions and business scope.

National-level administrative regulations and pilot full implementation are expected to be promulgated in the first quarter of 2014.

Relevant regulations regarding M&A, strategic investments in listed companies, capital contributions using equity interest of domestic companies, national security or antimonopoly investigations are still applicable for cases in the Shanghai FTZ. Currently, the market awaits the national-level administrative regulations and full implementation rules to follow and carry out the Measures in practice.

Notification Filing System for Inbound and Outbound Investment

The milestone change of the Shanghai FTZ reform is the switch from a pre-approval system for foreign investment to a filing and notification system for all projects established in the Shanghai FTZ and engaging in sectors which are not on the Negative List.

Now relevant foreign investors only need to fill in an integrated declaration form online for integrated review by the Shanghai FTZ authorities. And no prior government approvals are required. For most new companies set up in the Shanghai FTZ, it only takes seven business days to go through the process. It takes from one to several months for the foreign investment in the existing approval and registration system outside the Shanghai FTZ, which requires prior approval by the Ministry of Commerce ("MOFCOM") or its local counterparts, registration with the Administration of Industry and Commerce or its local counterparts and other post-registration items for foreign investment. There are much fewer administrative hurdles within the Shanghai FTZ to save the business cost for foreign investors.

Furthermore, only filings with, instead of having to obtain approvals from, the competent Shanghai authority are required for outbound investments made by companies set up in the Shanghai FTZ. This method significantly simplifies the regulatory clearance process (approvals from MOFCOM, the National Development and Reform Commission and the State Administration of Foreign Exchange) for outbound investments and could potentially establish the Shanghai FTZ as a hub for outbound investments by Chinese companies.

Financial Reform

Free convertibility of the Renminbi ("RMB"), interest rate liberalization, cross-border RMB financing and other financial changes will be implemented on a trial basis in the Shanghai FTZ. Under the current regulatory regime, conversion between RMB and foreign currency is subject to approval for capital account transactions, such as foreign equity investment and registered foreign debt. In addition, RMB converted from foreign currency is restricted from certain purposes of use. For example, foreign-invested enterprises are generally not allowed to use those converted RMB for the investment in other Chinese companies or the real estate industry.

Commercial banks will be able to freely determine interest rates in the Shanghai FTZ. And it will be easier to remit RMB overseas and to China. Currently, it is still hard to predict how those policies will play out until the issuance of more detailed implementation rules by relevant authorities. However, the proposed financial reform does offer great service opportunities in relation to the establishment of global/regional settlement and treasury centers and fund management business in the Shanghai FTZ. It may also expand financial products and instruments for foreign banks to conduct business in the Shanghai FTZ and potentially allow local private institutions to invest in foreign banks.

Supporting Tax Tool

Preferential tax treatment only serves as the supporting tool to attract investors because the Chinese government intends to carry out similar rules and incentives to areas outside the Shanghai FTZ as well after the trial.

The widely anticipated 15 percent Enterprise Income Tax rate was not adopted in the Shanghai FTZ. Instead, there are some other preferential tax policies; for example, companies and individuals will be able to pay income taxes by installments over a five-year period for revaluations arising from asset restructuring. Such other preferential tax policies will also help to boost investment and promote trade in the Shanghai FTZ.

Recommended Approach and Actions

Preferential An important aspect of the Shanghai FTZ is the government's stated intention to have a more open approach to discussing potential investments with potential investors in the zone.

Previously, investors needed to fit their business models within the existing rules with respect to different types of investment vehicles. However, the government is now inviting investors within the Shanghai FTZ to approach the authorities to discuss their proposed business model, potential options and strategies, and to participate in what the government intends to be more open and constructive discussions with them.

Accordingly, investors who wish to explore business models that currently do not fit within existing rules are recommended to approach the government at an early stage to discuss their potential investment with them.

As of November 22, 2013, the Shanghai FTZ had received more than 58,000 inquiries and business applications from both companies and individuals. There are more than 1,434 newly established companies, among which, domestic companies account for 1,396 while foreign-invested companies account for 38. Most of those companies are in trade and service industries, respectively accounting for 69 percent and 26 percent. The registered capital of those new foreign-invested companies is more than USD560 million in total and it is more than RMB34,700 million (approximately USD5,783 million) of those new domestic companies in total.

Recently, the reform blueprint issued after the Third Plenum of the 18th Communist Party of China Central Committee in November listed accelerating construction of free trade zones as one of the aims of China's next opening-up phase. Only time will tell how quickly and to what extent the Shanghai FTZ, and other possible future free trade zones, will have a meaningful impact in furthering the Central Committee's stated intention of further opening up the Chinese economy and the stated goal of having the market play a "decisive role" in China's continuing economic development.

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