Client Alert

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Breakthrough Reform? Shanghai's New Free Trade Zone

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China officially launched the China (Shanghai) Pilot Free Trade Zone (the "*SHFTZ*") on September 29, 2013 and on the same day published a long-awaited and longer-than-expected "negative list" setting forth industry sectors that will remain subject to restrictions or prohibition from foreign investment in the SHFTZ.

The announcements culminate a series of actions by the PRC government beginning in mid-summer:

- Following an internal resolution on July 3, the PRC State Council on August 22, 2013 officially approved the establishment of the SHFTZ in a 28.78 sq. km area covering the Waigaoqiao Bonded and Bonded Logistics Zones, the Yanshan Deep Water Port Area and the Shanghai Pudong Airport Free Trade Zone;
- On August 30, 2013, the Standing Committee of the National People's Congress released its *Decision Authorizing the State Council to Temporarily Adjust Administrative Approvals Under Relevant Laws Within the China (Shanghai) Pilot Free Trade Zone* (全国人民代表大会常务委员会关于授权国务院在中国（上海）自由贸易试验区暂时调整有关法律规定的行政审批的决定; the "*Decision*");
- On September 27, 2013, the State Council enacted the *General Plan for the China (Shanghai) Pilot Free Trade Zone* (中国（上海）自由贸易试验区总体方案; the "*General Plan*"), which outlines initiatives to be implemented in the SHFTZ and includes a list of industrial sectors where foreign investment in the SHFTZ will be further liberalized; and
- On September 29, 2013, the Shanghai Municipal People's Government issued the *Special Administrative Measures on the Entry of Foreign Investment into the China (Shanghai) Free Trade Zone (2013 Negative List)* (中国（上海）自由贸易试验区外商投资准入特别管理措施（负面清单）（2013年）; the "Negative List") and an initial set of six implementing regulations effective as of October 1, 2013.

NOTIFICATION FILING SYSTEM SUPERSEDES PRE-APPROVAL REVIEW

The centerpiece of the SHFTZ reforms is a change from a pre-approval system for foreign investment to a filing and notification system for all projects established in the zone and operating in industry sectors which are not covered on the Negative List. The Negative List is a list of industry sectors that the PRC authorities deem sensitive due to national security or other policy reasons, and classify as prohibited or restricted for foreign investment purposes. New proposed investment projects in the SHFTZ in sectors that are specified on the Negative List will continue to be subject to existing laws and regulations, as modified per the terms of the Negative List.

The practical effect of these reforms is that new foreign investment projects that do not appear on the Negative List will receive national treatment, meaning that they will be able to be established quickly (reportedly within a week) upon completion of post-transaction notice filings with relevant SHFTZ authorities, instead of being subject to advance review and approval by the Ministry of Commerce ("*MOFCOM*") or its relevant local counterparts. Also, key investment documents such as joint venture contracts and articles of incorporation governing new companies established in the SHFTZ, as well as subsequent changes to such companies such as capital increases or dissolution, are also no longer subject to MOFCOM pre-review or approval.

As a result, joint venture investors in liberalized sectors in the SHFTZ should have significantly more flexibility in negotiating joint venture terms, including (subject to the constraints of PRC joint venture legislation) in relation to board composition, management structure and methods to deal with board deadlocks and other governance issues as well as exits.

NEGATIVE LIST

The Negative List 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 loosening restrictions in other sectors:

- Importantly, while foreign investment in certain other sectors may be liberalized significantly, the Negative List preserves many of the restrictive policies currently applicable throughout China in respect of value-added telecommunications services ("*VATS*"). For example, foreign investment in Internet Data Center ("*IDC*") services and online gaming is still prohibited[1] and foreign investment in data processing and transaction processing services is still subject to a cap of 50% foreign ownership. Interestingly, however, the Negative List also increases the previous 50% foreign investment limit on operating e-commerce investments to 55%, creating for the first time the possibility of foreign equity control of companies licensed to operate in China's rapidly growing online B2C sector.
- The Negative List also preserves an approval requirement in respect of a number of industry sectors, as well as, in many cases, related limits on foreign equity ownership percentages. For example, the Negative List includes manufacturing of vehicles, special vehicles and farm vehicles (specifying that the Chinese partner shall hold the majority of the equity ownership), manufacturing and R&D in relation to electronic automotive components (specifying that investment must be through a joint venture with a Chinese partner), manufacturing of power batteries for new energy vehicles (specifying a maximum 50% foreign investment ratio), design and manufacturing of civil satellites and manufacturing of civil satellite effective payload (specifying that the Chinese partner shall hold the majority of the equity ownership) and manufacturing of equipment for air traffic control systems (specifying that investment must be through a joint venture with a Chinese partner).

[1] Since the Negative List is subject to China's treaty and similar obligations, it seems likely that qualified Hong Kong service providers will still be permitted to invest in IDC services in the SHFTZ, even though the Negative List provides that foreign investment in IDC services is not permitted.

- The Negative List also preserves current bans against foreign investment in a number of sectors within China's tightly controlled cultural, sports and entertainment industries, including news agencies, radio and film companies, publishing, gambling and Internet cafes.

The Negative List in its current form remains effective through December 31, 2013, and will be further updated, presumably with increasing liberalization, beginning in 2014.

NATIONWIDE OPERATING SCOPE FOR SHFTZ ENTERPRISES

The General Plan includes a general policy statement to the effect that enterprises established in the SHFTZ "in principle" will not be subject to geographical operating limits (within China) and specifically may reinvest and conduct business outside of the SHFTZ. This policy has yet to be reflected further in any specific administrative rules or guidance, but is expected to be implemented in practice by SHFTZ authorities.

OUTBOUND INVESTMENT APPROVALS

As with inbound foreign investment, the General Plan contemplates notice filings with SHFTZ authorities instead of requiring advance approval from MOFCOM, as is generally the case elsewhere in China. The General Plan also encourages the set-up of project companies as well as funds established for the purpose of outbound equity investment within the SHFTZ.

TAX REFORM

One policy measure that was widely expected to be adopted in the SHFTZ was implementation of a preferential 15% Enterprise Income Tax rate. This policy has not been included in the General Plan.

The General Plan nonetheless does offer a number of other preferential tax policies. For example, in order to promote investment in the SHFTZ, companies and individuals will be able to pay income taxes by installments over a five-year period for revaluations arising from asset restructuring.

The General Plan also offers further tax incentives for trade. For instance, tax exemptions are to be granted to manufacturing companies registered in the SHFTZ on their importation of machinery and production equipment.

The General Plan also expressly contemplates future adjustments in tax policies within the SHFTZ, stating that, "in line with the direction of tax reform and international practice," tax policies will remain subject to study and adaptation so as to align them with China's overall tax system, under the condition that such tax policies do not erode the tax base or lead to profit shifting.

EASED CONVERTIBILITY OF RMB, INTEREST RATE AND OTHER FINANCIAL REFORMS

A key element of the General Plan is the liberalization of the financial system with the SHFTZ. Various measures are called for, including capital account convertibility for the RMB and a freer market for setting interest rates. The General Plan also contemplates an expanded scope for private investment and foreign investment in the banking sector within the SHFTZ. Relevant provisions of the General Plan are at a policy level only, with implementing regulations needed from the State Administration of Foreign Exchange and other agencies. Nonetheless, the General Plan does reflect a policy commitment to implement a wide range of financial reforms on a trial basis in the SHFTZ.

The General Plan also allows foreign-invested professional health insurance institutions to be set up in the SHFTZ.

CONCLUSION

The opening of the SHFTZ signals the PRC government's recognition of the continuing importance of foreign direct investment (FDI) as an engine for growth within China's economy. The SHFTZ will function as a de facto litmus test of China's commitment to ongoing regulatory and financial liberalization measures on a broader national level. As is frequently the case with legal and investment reforms in China, the initiatives contemplated by the General Plan are likely to be implemented in a gradual manner in the coming months and years. Many important details remain to be confirmed, such as the scope of e-commerce investments and convertibility of the RMB or interest rate liberalization. Also perhaps reflecting the continuing political sensitivity of the reforms was the fact that neither Premier Li Keqiang nor Vice Premier Wang Yang, who had been expected to preside, was present at the SHFTZ opening ceremonies.[2] Nevertheless, if implemented in the comprehensive manner intimated by the General Plan, the SHFTZ could represent an important further step in China's continuing journey toward a more flexible, open market and further growth as a result.

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[2] *South China Morning Post*, Sept. 30, 2013, http://www.scmp.com/business/economy/article/1320817/reform-showcase-becomes-part-intensifying-political-struggle