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Shanghai Free Trade Zone: what you need to know to date and what to expect

Introduction

Since its official launch on 29 September 2013, the China (Shanghai) Free Trade Zone (the "**Zone**") has been one of China's most significant economic and regulatory developments. The Zone has ushered in important changes to China's inbound and outbound investment landscape, foreign exchange regulatory regime and regulation of imports and exports beyond its own boundaries. In addition, the Zone is triggering other incentive policies across China's investment map as other Chinese local government authorities, such as those of Chengdu, Qingdao, Wuhan and Xiamen, work on competing initiatives to keep pace with Shanghai in developing their local economies. Just this month, the State Council consented to plans for free trade zones modelled on the Zone to be set up in Tianjin, Guangzhou and Fujian. In this alert, we assess the general impact of the reforms introduced in the Zone during the course of 2014, and consider the next steps of reform which may be expected in the Zone going forward.

Reforms in the real economy

- **Foreign investment**.
  - The Zone pioneered a "negative list" approach to foreign investment, which simplifies the administrative procedures applicable to foreign-invested entities ("**FIEs**") setting up in the Zone. Investment approvals from the Ministry of Commerce of the People's Republic of China ("**MOFCOM**") or the National Development and Reform Commission ("**NDRC**") are no longer required in respect of the establishment of FIEs in industries outside the negative list in the Zone, and have been replaced by more straightforward filing requirements. In July 2014, the negative list was shortened from 190 to 139 sectors. For more details, see our August 2014 client alert, "China: 2014 Negative List for the Shanghai Free Trade Zone – Fulfilling the promise of greater liberalisation?".
  - The potential of the negative list is shown by a subsidiary of Microsoft having invested in the Zone to manufacture Xboxes (100,000 consoles having been sold on the first day of sales alone, according to Shanghai Media Group) as the restrictions

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applicable elsewhere in China on FIEs selling gaming and entertainment consoles to the Chinese market were removed in the Zone following release of the negative list.

– In addition to the negative list, the Zone has frequently led the rest of China in relaxing the foreign ownership limits in specific sectors. Examples include value-added telecommunication services (such as e-commerce platforms and call centres) from January 2014 (for more details, see our January 2014 client alert, "The Shanghai Free Trade Zone opens up to foreign investment in value added telecoms services"), international shipping transportation joint ventures in which previous maximum foreign shareholdings of 49% have been relaxed from January 2014, and allowing the establishment of wholly foreign-owned hospitals with lower minimum foreign investment capital conditions.

– In 2014, the implementation of the above reforms was met by a significant increase in foreign direct investment in the Zone. In the first half of 2014, contracted foreign investment into the Zone reached a total of US$5.4 billion, representing 6.8 times more investment in the Zone compared to the same period last year[1], whilst nationwide contracted foreign investment was US$117.3 billion, which represents a year-on-year increase of only 9.5%[2].

- **Outbound investment**.

  – The Administrative Committee of the Zone (the "**Committee**") has led the way with a shortened review and simplified filing process for overseas investment from the Zone. Applicants no longer need to submit a detailed project report, which is usually time-consuming to prepare. Instead, they only need to submit a filing form together with the relevant supporting documents, such as the investing entity's business licence and articles of association. For an investment under US$300 million, the review only takes five working days.

  – These streamlined review and filing procedures are further enhanced by associated reforms that enable the Zone's banks to process cross-border payments directly upon sighting the filing document issued for the investment, without further registration with the foreign exchange authorities.

  – The Zone also encourages the establishment of new investment vehicles focused on investing outside China, and supports the setting up of funds to serve the foreign investment needs of domestic qualified investors.

[1] Click here to access the article from Zhejiang Provincial Development and Reform Commission (Chinese)
[2] Click here to access the article from MOFCOM (Chinese)

– The implementation of the above reforms was met by an increase in outbound investment in 2014. Statistics show that the total outbound investment from the Zone for January to August 2014 totalled US$1.7 billion. Whilst the area of the Zone is less than 1% of the total area of Shanghai, this figure makes up approximately 21.5% of the total outbound investment from Shanghai during that time[3].

– One recent example of a completed outbound investment by a Zone entity is the acquisition of a US pharmaceutical company by Shanghai Tenry Pharmaceutical Co., Ltd. As the transaction was conducted by way of auction, the seller of the target company required payment to be made within 10 days of signing the purchase agreement. Without the streamlined approval and funding processes available to entities established within the Zone, a Chinese buyer would not have been able to successfully compete in such an auction because the approval process applicable outside the Zone would have taken at least two months.

- **Customs**. Throughout 2014, Shanghai Customs has rolled out reform measures aimed at improving the efficiency and productivity of customs clearance and supervision in the Zone. These measures include:

– streamlining customs supervision procedures to include a single filing of customs information at the time of an entity's registration in the Zone, which allows reuse of information at each import or export transaction;

– allowing the settling of customs tax via deduction from a security deposit, which can be "topped up" as necessary, to allow customs tax to be deducted in aggregate for multiple transactions rather than paying tax each time a transaction takes place;

– paperless filings and disclosure to Shanghai Customs of, for example, relevant credit information, transport methods, warehousing details and sanctions imposed on a Zone entity, with such information to be made available to other Zone entities to promote greater transparency;

– granting favourable customs clearance treatment in the Zone to goods imported from an authorised economic operator (an "**AEO**") in countries or regions where AEO mutual recognition agreements with China have been entered into (currently Singapore, South Korea and Hong Kong); and

[3] Click here to access the *Yicai.com* article (in Chinese)

– designating specific Zone officers as “coordinators” to deal with general day-to-day queries by pilot enterprises through the Shanghai Customs website.

In line with the pace of customs reform, Shanghai Customs reported an increase in the Zone’s imports and exports with a total trade value of RMB747.5 billion from September 2013 to September 2014. This growth in total trade value is 2% higher than the growth in total trade value across Shanghai over the same period. In particular, customs officials reported that this rate of growth accelerated from March 2014 through August 2014 outstripping the volume from September 2013 through February 2014 by 7.6%[4].

- **One-stop filing and approval process**. In common with certain free trade zones and economic zones worldwide, the Zone also introduced the concept of a one-stop agency able to process multiple regulatory applications.

  – For both inbound and outbound investments, investors can submit a single application through the common Zone platform, without having to make separate applications to NDRC and MOFCOM which would be the case outside the Zone. Approvals from other authorities are still required in specific cases (for example, outbound investments in basic telecommunications, power grid operations and the energy and resources sectors require the separate approval of NDRC).

  – The same one-stop channel applies for submission of applications for industrial and commercial, tax, customs, quality supervision and other registrations which are required for Zone enterprises to conduct business in China.

  – Following other jurisdictions with established systems for protection of intellectual property rights (“**IPRs**”) such as the United Kingdom and Hong Kong, in September 2014, the Zone set up a single independent office with responsibility for management and enforcement of copyright, patents and trademarks. This represents an attempt to harmonise China’s different registration and enforcement regimes. Only Shanghai Customs will continue to maintain its own supervision of IPR infringements at the Zone’s borders. This one-stop approach is expected to encourage greater creation, application and protection of IPRs in the Zone through the phasing out of overlapping investigations and unification of enforcement standards.

[4] Click here to access the statistics published by Shanghai Customs (Chinese)

Reforms in the financial economy

2014 saw the introduction in the Zone of a basic framework for financial reform and the cross-border flow of funds. The Shanghai gold market was opened up to participation by international members in the Zone and further opening up to foreign participation in other commodities markets is expected in 2015.

- **Cross-border funds flow**.
  - The unrestricted cross-border flow of RMB is a benefit available nowhere else in China but the Zone, through the use of a special free trade bank account opened with a Shanghai-based bank (an "**FTA**"). Restrictions on cross-border capital flows have been lifted in the Zone, enabling RMB to move freely between FTAs and also between an FTA and an offshore bank account. However, the flow of funds between an FTA and the account holder's other accounts in the Zone, and between an FTA and other accounts in the rest of China, remains subject to controls.
  - Banks in the Zone are also permitted to provide a full range of cross-border RMB clearing services. The provision of these services outside the Zone to onshore Chinese domestic individuals is subject to restrictions.
  - More than 10 Chinese banks and 20 foreign banks have registered with the People's Bank of China (the "**PBOC**") Shanghai Head Office for supervision under the new system. According to Zone officials, by the end of October 2014, 6,011 FTAs had been opened, increasing from 4,110 in the previous month.
  - Enhanced RMB cash pooling services can be provided by banks, enabling companies established in the Zone with operating businesses or investments to centrally manage the RMB operating funds of their subsidiaries and affiliates (including onshore entities outside the Zone and offshore entities), through intra-group transactions without any restriction on cross-border RMB payments and intragroup lending as long as no funds derived from financing activities are introduced into the cash pool (for more details, see our April 2014 client alert, "Internationalisation of the RMB in the Shanghai Free Trade Zone – A Step Forward"). According to press reports, foreign banks in the Zone have already assisted various multinationals such as Saint-Gobain (a French building materials company) and Sonepar (a French electronics distributor) to establish RMB cash pool arrangements.

- Foreign-invested entities in the Zone are now able to convert all foreign exchange equity capital into RMB at will and use the funds for equity investment and other activities falling within the entities' business scope.
- Eligible multinationals and other corporate headquarters located in the Zone also enjoy the ability to freely transfer foreign currency between special accounts known as international foreign trade accounts, and their overseas bank accounts outside the Zone. Another type of account, a domestic foreign exchange account, can be used by the multinational/ headquarter entity to pool the foreign exchange funds of the group's China activities and allocate the funds among its China subsidiaries and affiliates. While restrictions have been lifted in respect of transfers of foreign exchange between a domestic foreign exchange account and onshore accounts and an international foreign exchange account and offshore accounts, transfers between the two foreign exchange accounts remain subject to quotas, in common with cross border transfers of funds generally (for more details, see our April 2014 client alert, "Shanghai Free Trade Zone's New Foreign Exchange Regime").
- Foreign exchange restrictions have been further relaxed in the Zone, in that both the RMB and foreign currency cash pools allow the operators of the cash pools to settle current account transactions on behalf of their respective groups, either on a gross or a net basis. This helps reduce overall settlement, payment and transaction costs as well as currency conversion risk.
- Statistics from January to August of this year released by the Committee show companies reacting positively to, and taking advantage of, these reforms. In this period, the settlement amount for cross-border RMB in the Zone was RMB156.3 billion, being 15% of the total in Shanghai, with the settlement amount of RMB in relation to foreign debt standing at RMB17.4 billion[5]. Zone officials also reported that the size of cross-border cash pools increased almost ten-fold from RMB4.6 billion in April 2014 to RMB49.9 billion in October 2014.
- In 2015, we look for the Zone to be leading the introduction of additional measures to further liberalise the cross-border movement of capital in China, including by introducing greater convertibility between the RMB and foreign currencies in the Zone and allowing greater flexibility for corporate headquarters in the Zone to manage their treasury operations.

[5] Click here to access the *Xinhuanet* article (Chinese)

Opening up of financial markets

- In early September 2014, the Shanghai Gold Exchange officially launched its international platform in the Zone. The rules released for international members to join the Shanghai Gold Exchange, which extensively supplement the existing rules for domestic members, include details on members' rights and obligations, central clearing, warehousing and delivery. Goldman Sachs, HSBC and Standard Chartered are among the 40 international members which are understood to be eligible to participate in gold trading through the Shanghai Gold Exchange's platform in the Zone.
- The development of the gold trading market is expected to lay the foundations for other commodities markets to be established in the Zone. Central government has made a commitment to establish international trading platforms for the trading of commodities such as oil and gas, iron ore, cotton, liquid chemicals, silver and non-ferrous metals in the Zone during the course of 2015. High-level, general market rules were released in November 2014 containing broad principles in relation to the roles of market operators, brokers and warehousers in the spot commodities markets in the Zone. We expect that further specific rules governing the markets for internationally-traded commodities will be developed, following the lead which has been set by the Shanghai Gold Exchange's international rules.
- Already this month, the trading of crude oil futures in the Zone on the Shanghai International Energy Exchange has been approved by the China Securities Regulatory Commission ("**CSRC**"). As a next step, the CSRC is expected to jointly publicise with other relevant departments and authorities various supporting policies and administrative measures concerning crude oil futures business.
- Other aspects of financial market reform in 2014 include the deregulation of interest rates paid on small foreign currency deposits, the announcement that qualified banks would be permitted to issue high value negotiable certificates of deposit in the Zone (expected to be rolled out in early 2015), and the continued encouragement given to parent companies of Zone enterprises to issue "panda" bonds.

Reform of the underlying legal framework

As various institutional and procedural reforms continue to be rolled out in the Zone to improve its business and investment climate, we are also seeing parallel efforts to foster an improved enforcement, practice and application of law within the Zone's borders, in order to make the Zone a preferred centre for the resolution of commercial disputes.

- **Arbitration**. The Shanghai International Economic and Trade Arbitration Commission ("**SHIAC**") has established the first foreign-related arbitral institute in the Zone. Issued in April 2014, the institute's arbitration rules bring the arbitration system in the Zone closer to international rules and practices. Parties to a dispute have the flexibility to appoint outside arbitrators who are not members of the officially designated panel and, while awaiting formal arbitration proceedings, may request interim measures such as injunctions and restraining orders. Significantly, the Zone's tribunal is open to hearing cases regardless of whether there is any connection with the Zone, provided that the parties involved agree to refer their disputes to the SHIAC (see our July 2014 client alert, "Shanghai Free Trade Zone implements modern arbitration rules", for more detail).

- **Court**. A court to handle disputes arising in the Zone was established in early November 2013. From its date of establishment until the end of October 2014, it had accepted and heard 380 cases with a total value of RMB1.3 billion [6]. The Zone court provides greater convenience and efficiency for Zone litigants, though the hierarchy of the court (being a first instance court) affords only limited protection, as all appeals from the Zone are handled by the Shanghai No.1 Intermediate People's Court. Given the varied and complex foreign elements likely to feature in many Zone cases, setting up a specific appeal court for the Zone may be desirable.
- **Legal services.** In November 2014, the legal services market was further opened up in the Zone through new measures allowing Chinese and overseas law firms to cooperate by means of secondments and business alliances in the Zone. The new measures permit Chinese and overseas firms to establish jointly operated and branded offices in the Zone. The offices can handle cross-border work, and advise on Chinese and overseas legal matters as one team with jurisdictional responsibility divided between the two firms. These measures may encourage investment by law firms and a greater demand for cross-border legal services in the Zone, further enhancing the Zone's role as a centre for international dispute resolution.

Overall assessment

An assessment of progress made in the achievement of the objectives planned for the Zone at the time of its launch in September 2013 would suggest that the pace of implementation has been slow. For example, despite broad principles being announced in a blueprint for the Zone launched by the PBOC in 2013, rules have still yet to be put in place governing the use of the FTA by eligible individuals of the Zone to make investments outside China (noting that while these rules have yet to be put in place, eligible investors can already invest in the overseas markets though the recently launched Shanghai-Hong Kong Stock Connect (for more information see our September 2014 client alert, "China - Shanghai-Hong Kong Stock Connect: Are You Ready for the "Through Train" to Shanghai?", as well as the Qualified Domestic Institutional Investor scheme), and as a channel to invest in the Chinese securities markets. This is in part to be expected, as the

[6] Click here to access the article published on *Chinacourt.com* (Chinese)

implementation of the reforms envisaged for the Zone requires careful coordination among different regulators, such as the PBOC, CSRC and State Administration of Foreign Exchange. More needs to be done to ensure that this coordination does not slow down the progress of the reforms.

That said, the Zone is still the test bed for the lion's share of new reforms, and is expected to be China's main platform to market test its future policy innovations before they are extended to other parts of China. An investor in the Zone will thus be able to assess the benefit of the new policies first, and enjoys a first-mover position relative to counterparts outside the Zone who has to wait for policies to be introduced in the Zone and extended on an incremental basis (as shown by the liberalised "at-will" foreign exchange conversion and customs reform in 2014, which have been expanded beyond the Zone but are still limited in their application to designated pilot regions). It is also apparent that the ongoing rollout of the Zone's reforms on a nationwide level in 2014 (including removal of minimum capital requirements, reform of annual corporate inspections and the introduction of cash pooling facilities for multinationals and corporate headquarters), together with the prospect of competition from new economic zones in other regions of China, are themselves powerful catalysts which should spur further and faster reform in the Zone.

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