An overview of Shanghai Free Trade Zone: What it means to foreign investors?

Corporate Update

29 OCT 2013

By: Roy Chan

Since the China (Shanghai) Free Trade Pilot Zone ("Shanghai FTZ") was approved by the State Council on 22 August 2013, investors have awaited detailed policies and regulations to be issued. In early September 2013, the Standing Committee of the National People's Congress issued a decision authorizing a filing-based system to replace the approval-based system for foreign investments registered in the Shanghai FTZ so long as they do not fall within the "negative list" ("NPC Decision") (please refer to our previous newsletter, click here).

With the formal launch of the Shanghai FTZ on 29 September 2013, various government bodies have released a series of rules and regulations from the end of September 2013 to early October beginning to form the legal framework of the Shanghai FTZ. These regulations mainly include:

- The Framework Plan of the Shanghai FTZ issued by the State Council ("Framework Plan"),
- Several rules issued by sector regulators to support and implement the Framework Plan (including China Banking Regulatory Committee ("CBRC"), China Securities Regulatory Committee ("CSRC"), China Insurance Regulatory Committee ("CIRC"), Ministry of Transport, Ministry of Culture and General Administration of Quality Supervision, Inspection and Quarantine ("GAQSIQ"), etc),
- A "negative list" issued by the Shanghai Municipal Government,
- Five administrative rules issued by the Shanghai Municipal Government, including an rule on the overall administration of the Shanghai FTZ and four rules on the filing procedures for foreign investment and outbound investment ("Filing Procedures Rules");
- Several rules regarding company registration issued by the State Administration for Industry and Commerce ("SAIC") and Shanghai Administration for Industry and Commerce ("Shanghai AIC").

We set out below an overview of the key points provided in the above rules and regulations and their potential impacts on foreign investors considering the Shanghai FTZ.

Overall objectives

The Framework Plan is the over-arching regulation which sets out the objectives of the Shanghai FTZ for the next 2-3 years, such as:

- Transforming government's role from the pre-registration approval authority to the post-registration supervisory authority,
- Further opening up service sectors to foreign investor and reforming the administrative system on foreign investments,
- Developing "headquarter economy (总部经济)" and exploring new forms of trading,

- Accelerating RMB convertibility for capital account items and further opening up the financial service sector to foreign investors,
- Setting up new models for customs monitoring on goods; and
- Setting up new policies to facilitate investments and innovation.

Further opening up service sector

As one of the overall objectives set out in the Framework Plan for the Shanghai FTZ, the zone will be further opening up service sector to foreign investors. The Framework Plan sets out 18 service industries to which more relaxed policies will be offered in terms of investors' qualification, equity ratio ,business scope, etc.

To implement the policies in the Framework Plan, various sector regulators, such as CBRC, CSRC, CIRC, Ministry of Transport, Ministry of Culture and GAQSIQ, have also promulgated specific rules to provide support and guidance, although most of them still provide only very general terms.

We summarize in the Appendix [1] to this newsletter the opening up measures of the various sectors for your easy reference. Detailed information on these rules will be available upon request. We anticipate more implementation rules to be released in the near future.

Simplification of foreign investment administration

Under the current regime, on a national basis, incorporating a foreign-invested enterprise ("FIE") is not a straightforward process and is usually time consuming. In general, an FIE is subject to a three-step approval/registration procedure: (i) project verification by the National Development and Reform Commission (or its local branches) ("NDRC"); (ii) approval by the Ministry of Commerce (or its local branches) ("MOFCOM"); and (iii) registration with SAIC (or its local branches).

According to the Framework Plan and the NPC Decision, the above procedure are to be substantially liberalized in the Shanghai FTZ for a 3-year trial period starting from 1 October 2013. For FIEs to be established in the Shanghai FTZ that do not fall within the "negative list", the approval procedure is now replaced by a filing system, as explained below.

The negative list

The negative list consists of 18 broad sector categories, and under each category, there are special administrative measures (特别管理措施) applicable to certain subcategories. Most of the industries on the negative list are identical to the existing restricted industries for foreign investment as set out in either the Foreign Investment Industry Catalogue ("Investment Catalogue") or other industrial regulations. This means most foreign investment subject to existing industrial restrictions will still need to go through an approval procedure even if it is registered in the Shanghai FTZ. According to an official at the Shanghai FTZ, the negative list may be adjusted and shortened in the future. Please contact us if you would like to have a complete negative list.

For foreign investment in the Shanghai FTZ that are not on the negative list, only filings (instead of approvals) are required for initial incorporation and any subsequent change of registration.

The filing procedure

According to the Filing Procedures Rules, the NDRC verification on foreign investment is now replaced by the project filing procedure (外商投资项目备案) and the MOFCOM approval is replaced by the enterprise filing procedure (外商投资企业备案). Both filings together with the SAIC registration can be submitted either at the same time or separately through a centralized filing system (as discussed below).

The filing procedures are quite straightforward. For example, if a foreign investor would like to set up a consulting FIE in the Shanghai FTZ, the following procedure should be followed:

- Name verification with the local branch of SAIC regarding the company name of the consulting FIE,
- Signing a lease agreement for the consulting FIE's office address (a virtual office is not allowed),
- Online checking the FIE's business scope against the negative list (to make sure it is not on the list),
- Completing an online filing form to provide basic information on the investors, the de facto controller and the FIE to be established (e.g. its registered capital, total investment amount and business scope),
- Submitting a few required hard-copy documents to a single government channel (discussed below); and
- Business license together with the organization code and tax registration certificate will be issued.

To further improve efficiency, the Shanghai FTZ has implemented a centralized system, where all filing will be submitted and handled through a single government channel. This should free investors from the burden of having to deal with various government authorities. It is reported that a business license may be obtained as quickly as four working days once a filing is accepted.

Operating outside the Shanghai FTZ

At the official press conference of the Shanghai FTZ held on 29 September 2013, an official confirmed that in principle companies established in the Shanghai FTZ are permitted to conduct business outside the zone, however, certain industries may be subject to restrictions.

The deputy director of the Shanghai FTZ indicated that existing restrictions regarding conducting business outside the registered place of business should be followed when deciding whether branches may be set up outside the zone. For example, an educational training institution may not provide training outside of its approved registered place according to the regulations governing education sector. However, this question remain unanswered for certain sectors where it is difficult to refine business operation within a certain area, such as value-added telecommunication, legal service, etc.

Flexible registration regime for company incorporation and on-going compliance

Company Incorporation

Under the current regime, on a national basis, any company incorporated in PRC (whether an FIE or a domestic company) is subject to various restrictions on the company's capital, including minimum capital contribution, mandatory timetables for investors to pay up their capital contribution, etc. Such regime makes the PRC company incorporation system relatively rigid and less competitive.

In order to provide more flexibility to investors, SAIC issued a circular on 26 September 2013 ("SAIC Circular") adopting a new capital registration system in the Shanghai FTZ as follows, which is similar to that of most common law jurisdictions:

- Companies are no longer subject to any minimum registered capital, including the current minimum registered capital for ordinary limited liability companies (RMB 30K), single-person limited liability companies (RMB 100K) and companies limited to shares (RMB 5million). Investors are free to decide the registered capital amount based on business needs. We understand that for FIEs, the mandatory ratio between registered capital and total investment amount is still applicable,
- In general, a company's registered capital will be based on the capital amount subscribed (committed) by its investors. Although a company's registered capital amount and total investment amount still need to be registered with local branch of SAIC, it is no longer required to file the amount of paid-up capital by the investors,
- The mandatory requirements on capital contribution timetable are also cancelled for companies in the Shanghai FTZ and investors may decide the timetable freely. This means foreign investors do not need to follow the current requirement of contributing 15% capital within 3 months and 100% capital within 2 years from the FIE's establishment,
- The 70% cap on non-currency registered capital is also lifted by the SAIC Circular. Investors are free to decide the proportion among cash and in-kind capital; and
- Investors are free to decide on the above items and should provide such arrangement in the company's articles of association, which will be made available to the public.

Please note that the above may not apply to companies in certain industries where laws, administrative regulations or specific industrial requirements imposed by the State Council provide specific requirements on registered capital (such as banks, insurance firms, securities companies, futures companies, fund management companies, direct sales enterprises, foreign labor service cooperation enterprises and joint stock limited company established by way of share offer). Investors in such industries should always check with the relevant regulators in advance.

On-going compliance

The SAIC Circular replaces the company annual inspection system with an annual reporting system for companies in the Shanghai FTZ. The information reported will be made available to the public. Shanghai AIC will monitor the information reported by the companies for any violation of laws and regulations, penalties such as recordation on a blacklist and administrative fines will be applicable.

Simplification of outbound investment administration

The Shanghai FTZ encourages companies in the zone to make outbound investments by simplifying the administrative regime in this regard. In general, companies registered in the Shanghai FTZ are no longer subject to approval for their outbound investment, instead, a straightforward filing procedure is put in place. Detailed information on outbound investment policy in the Shanghai FTZ is available upon request.

Tax Policies

The Framework Plan provides certain preferential tax policies in the Shanghai FTZ, including: allowing instalment payment of income taxes on proceeds generated from certain outbound investment and individual income taxes on qualified bonus scheme, VAT tax refund policies for financial leasing companies, and tax exemption for imported equipment of manufacturing enterprises or service companies in the manufacturing sector. The Shanghai FTZ will also explore tax reforms relating to overseas equity investment and offshore business.

However, to many people's disappointment, there is no material tax preferential treatments in the Framework Plan such as lower tax rates. The Shanghai FTZ official confirmed at the press conference that the speculated 15% enterprise income tax rate will not be implemented in the Shanghai FTZ.

Reform in financial, trading and shipping sectors

The Framework Plan also highlighted financial, trading and shipping sectors as areas for reform in the Shanghai FTZ. Relevant industrial regulators, including CSRC, CBRC, CIRC, Ministry of Transportation and GAQSIQ, have released separate rules to compliment the Framework Plan and support reforms in these areas, even though most of such rule are still high-level with very general terms.

Highlights in these industrial rules include:

- Measures to encourage futures trading, such as setting up international oil futures trading platform in the zone, encouraging qualified institutions and individuals in the zone to conduct futures trading in offshore and domestic markets,
- Encouraging foreign investors to set up banks in the Shanghai FTZ which may engage in broader range of business, and lowering certain operational qualifications for foreign-invested banks,
- Encouraging banks in the Shanghai FTZ to develop cross-border financing services,
- Relaxing the equity ratio on foreign investment for sino-foreign international vessel transportation enterprises; and
- Allowing foreign investors to set up wholly foreign-owned international ship management companies.

We anticipate more detailed industrial rules and regulations to be released in the near future.

Observation

At the Shanghai FTZ's inauguration ceremony on 29 September 2013, the first batch of entities that have been successfully registered in the zone were announced, which includes 9 FIEs, 16 domestic companies and 11 banks (including 2 foreign-invested banks). The information on the Shanghai FTZ's website shows that as of 21 October 2013, around another 70 enterprises have been filed since the zone's establishment. Most of these companies are in the consulting and trading industries and a large number of them are FIEs.

There is no doubt that the Shanghai FTZ has attracted global attention to this 28.78-square-kilometres area. The Chinese government has shown its determination to explore fundamental reforms in the zone, making the zone an international economic centre and eventually duplicate the successful models on a nationwide basis.

However, as one may expect, this is likely to be a gradual process with resistance and setbacks from regulatory bodies at different levels. At this stage, most of the proposed reforms in the Framework Plan are still general outlines without detailed policies and rules, especially for industries where foreign investors have intensive interests, such as value-added telecommunication, medical service and education. It is expected that more implementing rules will be released in the near future. We will be closely monitoring any new development in the Shanghai FTZ and provide more updates on a regular basis.

[1] Appendix - Opening-up measures for service sectors

AUTHORS

Roy Chan
Senior Partner
Shanghai | T: +86 21 3852 2111
roy.chan@dlapiper.com