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China (Shanghai) Pilot Free Trade Zone (II): New Developments

Legal Update
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It has been just over three months since the China (Shanghai) Pilot Free Trade Zone (the Shanghai FTZ) was officially opened on September 29, 2013. In that time, new rules have been released and more than a thousand new enterprises have been established. This article aims to provide an update on the most important developments in the Shanghai FTZ. For additional information regarding the Shanghai FTZ's special rules and potential advantages as a location for foreign-invested enterprises (FIEs), see "China (Shanghai) Pilot Free Trade Zone: A New Landscape for Foreign Investment," our first Shanghai FTZ alert.

New Enterprises Registered in Shanghai FTZ

Local media has reported that 1434 new enterprises, including 38 FIEs, have been established as of November 22, 2013. The total amount of registered capital of the 38 FIEs is more than USD 0.56 billion while that of 1396 domestic enterprises is more than RMB 34.7 billion (equivalent to USD 5.6 billion). The average registered capital of these FIEs is approximately USD 15 million and the average for the domestic enterprises is RMB 25 million (USD 4 million). 69 percent of the new enterprises engage in trading business, 26 percent do business in service sectors and the rest are either financial or logistics enterprises.

Negative List

As discussed in our first alert, the Shanghai FTZ uses a "negative list" structure to regulate foreign investment, with the Shanghai government unveiling its first negative list last year (the 2013 Negative List). For the establishment or alteration of an FIE in an industry sector not on the 2013 Negative List, the comparatively cumbersome and time-consuming approval process that has existed for decades is replaced by a simplified "one-stop" filing procedure. Foreign investments on the 2013 Negative List will not qualify for the simplified filing procedure and will be subject to the existing approval process.

As of November 22, 2013, the Shanghai FTZ received 67 new FIE establishment applications. As noted above, 38 of these applications have been approved with FIEs being established. 55 of the applications (82 percent) are not on the 2013 Negative List.

Local media reported that the Shanghai government is soliciting opinions for a new negative list for 2014 that some commentators expect to be a shortened version of the 2013 Negative List.

Enforcement of Opening Measures in Services Sectors

As discussed in our first alert, the General Plans for the Shanghai FTZ include opening measures for 18 service industries across six broad service areas that will be implemented through 23 specific actions, which aim to eliminate or relax various foreign investment restrictions. Among these 23 actions, 13 have been in effect, six (including value added telecommunications, performance brokerage, entertainment venues, sales and services of entertainment and game consoles, educational training and vocational training) are pending the release of implementing rules expected to be issued around the beginning of 2014, and for the remaining four actions (foreign-invested bank and pilot banks with restricted business, ocean cargo transportation, international vessel management and legal service) the timing for the release of related implementing rules is more uncertain. Please refer to Appendix A for a detailed summary of these opening measures and the status of their implementation.

New Rules on Establishment of Wholly-Foreign Owned Medical Institutions

The long-awaited *Interim Administrative Measures for Establishment of Wholly-Foreign Owned Medical Institutions in the Shanghai FTZ* was released by the Shanghai municipal government on November 13, 2013 (the Measures). The Measures permit wholly-foreign owned medial institutions in the Shanghai FTZ, thus implementing one of the opening measures mentioned in the section above regarding medical services. In addition, the Measures have made two main differences regarding foreign-invested medical institutions.

- **Minimum Registered Capital Lowered**. The Measures require minimum total investment of RMB 20 million (3.2 million USD), as opposed to a minimum registered capital of RMB 100 million (about 16 million USD) under the existing legal regime.
- **Simplified Approval Procedures**. The one-stop service platform in the Shanghai FTZ (as noted above and discussed in Section 3 of our first alert) applies to foreign-invested medical institutions established in the Shanghai FTZ. The applicant will need to submit the application only to the Shanghai FTZ, as opposed to the current requirement to submit separate applications to various government departments. It is expected to take around 40 working days for a foreign-invested medical institution to obtain a business license permitting it to

commence business in the Shanghai FTZ.

While many see the Measures as a positive development for foreign companies, caution is in order as there are still important questions that remain unanswered pending the release of further implementing rules, including rules on development and operation, access to doctors, tax treatment, and use of medical insurance, among others.

Important Financial Support-Opinions Issued by PBOC

The People's Bank of China (PBOC) issued its *Opinions on the Financial Support for the Building of the Shanghai FTZ* (the Opinions) on December 2, 2013. The Opinions include 30 articles and aim to facilitate cross-border investment and trade, payment and settlement, and further relax foreign exchange regulation. The Opinions set forth certain guiding principles to be used until detailed implementing rules are issued. According to local media reports, the Shanghai branch of the PBOC aims to issue implementing rules in the coming three months. The China Securities Regulatory Commission will in turn work on its own implementing rules for the Opinions. Set forth below are highlights of the Opinions.

- **Changes and Benefits for Overseas Investment**
  - **Direct Outbound Investment**. To make a direct outbound investment, enterprises registered in the Shanghai FTZ will now only need to go through a simplified record-filing procedure, as opposed to the existing more time-consuming approval process with multiple government departments (including approval by the competent level of the Ministry of Commerce, approval by the competent level of the Development and Reform Commission, if applicable). Also, the existing approval by the competent level of the Administration of Foreign Exchange (AFE) will be eliminated and the enterprise in the Shanghai FTZ will go directly to the bank to process the cross border currency exchange, payments and receipts for direct outbound investment.
  - **Securities and Derivatives**. Under the existing legal system, Chinese entities can invest in securities and derivatives overseas only through a Qualified Domestic Investment Institution (QDII) such as certain banks and investment fund companies. Entities in the Shanghai FTZ, however, will be permitted to make such overseas investments in securities and derivatives directly without using a QDII in accordance with relevant regulations and rules. Such overseas investment will likely still be subject to quota regulations similar to that applicable to QDIIs.
- **Changes and Benefits for Individuals' Overseas Investment**
  - **Direct Outbound Investment**. "Qualified" Chinese individuals "working in the Shanghai FTZ" will be permitted to make direct outbound investments, which are not currently permitted under the existing system. "Qualified" and "working in the Shanghai FTZ" are expected to be defined in future implementing rules.

  - **Securities and Derivatives**. "Qualified" Chinese individuals "working in the Shanghai FTZ" will be permitted to directly make various investments overseas including securities. Under the existing system, individuals may make such investment only through a QDII.
- **Overseas Financing.** Non-bank entities registered in the Shanghai FTZ will be permitted to obtain financing from overseas in RMB or foreign exchange according to their operational needs and applicable regulations. This will enable entities in the Shanghai FTZ to borrow loans from overseas that are generally offered at a lower interest rate than domestic loans. Under the existing system, only FIEs are allowed to obtain financing from overseas subject to a limit equal to the difference between their registered capital and total investment. The Opinions expressly prohibit any use of borrowed funds denominated in RMB for investment in securities or derivatives or lending to other parties. Borrowed funds denominated in foreign exchange will likely be subject to the same prohibition in order to limit speculation.
- **Open Domestic Capital Market to Foreigners**
  - **Enterprises**. Financial institutions and enterprises registered in the Shanghai FTZ will be permitted to invest in and trade in securities and futures listed on Shanghai exchanges. Under the existing laws, overseas enterprises may invest in securities only in China and such investments have to be made through a Qualified Foreign Investment Institution (QFII).
  - **Individuals.** "Qualified" overseas individuals "working in the Shanghai FTZ" will be allowed to open investment accounts with financial institutions in the Shanghai FTZ to make various inbound investments, including investing in A Shares (shares denominated in RMB in Chinese companies listed and traded on a stock exchanges in mainland China), which currently only Chinese residents can purchase.
- **Expand Panda Bond Issuance**. Foreign parents of enterprises registered in the Shanghai FTZ will be permitted to issue "Panda Bonds" on stock exchanges in mainland China. A Panda Bond is a RMB-denominated bond from a non-Chinese issuer, sold in China. Ever since the Chinese government began approving Panda Bonds in 2005, only a few international financial institutions (such as the International Finance Corporation and Asia Development Bank) have been approved to issue Panda Bonds.
- **Capital Pool.** The Opinions will expand the use of capital pools that may attract multinational companies to set up capital headquarters in the Shanghai FTZ. Enterprises in the Shanghai FTZ will be allowed to set up an inter-group RMB capital pool based on operational needs to proceed with payment and receipt for the current accounts of its onshore and offshore affiliates. The Opinions will allow two way flows between RMB capital pools and affiliates' accounts (either onshore or offshore). The existing legal system only allows for the outflow of RMB capital to offshore affiliates' current account but not inflows of RMB. Foreign exchange capital pools are only available to a short list of pilot enterprises subject to governmental approvals. Under the Opinions, the foreign exchange capital pool

will become a regular item available in the Shanghai FTZ subject to simplified approval procedures. It is expected that with both RMB and foreign exchange capital pools, multinational companies will be able to manage and make better use of their capital and will likely be permitted to engage in cross-border financing and investment for a reasonable return, as opposed to limited investment channels under the existing system.

- **More Foreign Exchange Relaxation**

The Opinions indicate further relaxation on foreign exchange regulation. For instance, registration with the competent AFE applicable to foreign exchange settlement under the direct foreign investment rules will be eliminated and FIEs will be permitted to go directly to banks for settlement of foreign exchange into RMB. In addition, enterprises in the Shanghai FTZ will not need to obtain current approval by AFE in order to purchase foreign exchange to pay overseas fees related to corporate guarantees.

Once implemented, it is expected that these reforms will present significant new business opportunities and advantages for both foreign and domestic companies. We will continue to monitor developments in the Shanghai FTZ and will issue follow-up alerts as appropriate.