Shanghai Free Trade Zone: A Bold Work in Progress

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For foreign investors, one of the biggest China news stories last year was the official launch on September 29 of the China (Shanghai) Pilot Free Trade Zone (the "SFTZ").

The SFTZ has been heralded as a testing ground for freeing up key sectors of the Chinese economy from direct state control and allowing overseas companies greater access to China's domestic markets. Backed by the State Council (China's cabinet), the SFTZ is meant to follow the pattern set by the successful reforms piloted in China's Special Economic Zones in the 1980s. These spurred China's miracle transformation from economic backwater to the world's second largest economy.

Readers will be aware that in September, a flurry of bold new policies were introduced for the SFTZ but since then, alarmingly few concrete implementing regulations have materialized. This has fueled doubts within the international business community about the PRC government's commitment to spearheading reforms in the SFTZ.

The purpose of this article is to briefly discuss the legal and policy framework underpinning the SFTZ and identify opportunities that are currently available to foreign investors as well as those that will hopefully be phased in soon.

Shanghai's "New & Improved" Bonded Zones

The SFTZ is comprised of the Waigaoqiao Bonded Logistics Park, Waigaoqiao Bonded Zone, Yangshan Bonded Port Zone and the Pudong Airport Comprehensive Zone, all situated within 29 sq km along the Eastern edge of Pudong. None of these were runaway successes in attracting foreign investment as bonded zones but in their current incarnation as the SFTZ, they serve as a 29 sq km special investment zone.

Pre-existing regulations within the four constituent zones remain in place so they will continue to function as bonded customs areas and officials plan to eventually introduce new customs and quarantine policies to modernize import/export operations within the SFTZ. Nevertheless, for most investors, the main attraction is expected to be the SFTZ's preferential market access (in a handful of key sectors) and financial reforms benefitting businesses established within the SFTZ.

Preferential Market Access

Currently, the legal framework for the SFTZ reforms consists of the *General Plan for the Shanghai Free Trade Zone,* six sets of administrative regulations issued on the launch date, and separate regulations governing banking, shipping, healthcare and telecommunications.

Officials in the SFTZ are taking a two-pronged approach to attracting foreign know-how and capital: on the one hand, overseas investors can establish any kind of business provided that it is not listed in the so-called 'negative list' of sectors/activities from which foreigners are banned. On the other hand, certain activities are earmarked with lower market entry barriers and other advantages, allowing investors a head start in these sectors by setting up in the SFTZ.

Preferential market access opportunities are offered in the following 12 sectors:

• Banking & Financial Services	• Value-added Telecommunication Services
• Shipping & Logistics	• Credit Investigation/Reporting
• Engineering & Construction	• Medical/Healthcare Services
• Insurance	• Educational & Vocational Training
• Legal Services	• Recruitment
• Video Game Console Sales & Services	• Travel Agencies

At first glance, these market access opportunities appear to be a huge step forward. After all, most of these are currently off-limits to foreign investors outside the SFTZ, and besides lower hurdles on investor qualifications, investors stand to benefit from more flexible capital requirements and more freedom to conduct business in China.

However, on closer scrutiny, only a limited number of these opportunities have actually gone 'live' because enabling legislation has not been forthcoming and, for the 3 sectors which are open (ie: banking, medical/healthcare, and telecommunications), it is still unclear what companies will be permitted to do once they have set up in the SFTZ.

In practice, prospective investors are either being told that they must wait for new rules to be issued before they can incorporate or, like the 12 overseas banks that were among the first to establish beachheads in the SFTZ, investors are permitted to incorporate but are unable to conduct business because crucial operational guidelines are still pending.

Financial Reforms

In November 2013, the People's Bank of China issued its *Opinion Concerning Financial Support for Development of the SFTZ* which introduces an aggressive package of reforms including the scrapping of nearly all pre-approval requirements for companies in the SFTZ to conduct cross-border foreign exchange settlement and exchange deals.

In principle, these reforms will allow SFTZ companies to engage in borrowing and lending to offshore subsidiaries and engage in cross-border RMB sweeping, a process that links intra-group mainland and overseas cash pools and permits movement of funds between them. This will allow businesses to more easily manage their cash and give them easier access to international finance.

Here again, implementing regulations are still being worked out but in an interesting development, Roche China and Dover Corporation are preparing to execute the first automated two-way cash sweep arrangements in China. Their banks, Citibank and HSBC respectively, have taken the bold position, citing the PBOC *Opinion*, that pre-approvals are no longer required. If these arrangements are not scotched by the PBOC, it will lead the way for multinational manufacturing and trading businesses that have significant operations and cash pools inside and outside of China to streamline their treasury operations.

In the meantime, there is no clear timetable for the other headline reforms announced in the PBOC *Opinion* so companies seeking relaxation of government controls on capital account RMB convertibility, interest rates, and the ability to trade on overseas securities markets will simply need to wait.

Streamlined Incorporation

One of the first concrete set of changes implemented in the SFTZ is also proving to be among the most popular. For the majority of businesses, officials have done away with the pre-existing approval and permit system and replaced it with a registration-based system which is faster, simpler and more convenient. Investors are finding that obtaining a business license in the SFTZ normally requires only 4 days instead of several months.

Within the SFTZ, minimum requirements on registered capital have been abolished, along with requirements on the percentage and timing of the first instalment of capital, minimum cash contributions and deadlines for the full payment of capital. These are now left for investors to determine.

SFTZ officials have also simplified the tedious annual inspection system and replaced it with electronic filings and an online registry which is more convenient, less intrusive and provides greater transparency.

The only complaint being made about these new arrangements is that their uniqueness will soon be a thing of the past. On December 28, 2013, China's legislature passed a law extending these changes throughout the country effective March 1, 2014 though full implementation may require several months.

What's Next?

The SFTZ undoubtedly represents an important milestone in China's efforts to liberalize its economy and, if it proves successful, should pave the way for both the next wave of foreign direct investment into the country and overdue reforms in China's hidebound financial sector. Expanding the role played by foreign banks, credit bureaus, healthcare providers and telecom companies within China's economy could have an especially transformative impact on its future development.

But first, China's legislators must look past entrenched domestic interests and press on with the implementing regulations needed to put the SFTZ's promising new policies into practice. The SFTZ General Plan outlines many exciting financial reforms and market entry opportunities for a diverse range of investors whose current skepticism will be overcome once concrete procedures and regulations finally materialize.

Until then, the only head starts offered in the SFTZ will be for overseas investors in the telecommunications and healthcare sectors. Foreign banks are also allowed to establish wholly foreign-owned and joint venture branches in the SFTZ, but with operational guidelines still pending, presumably the main opportunity for them is to secure eligibility to enjoy future reforms. In terms of sheer numbers, the main group of beneficiaries will be investors in sectors that are already open to foreign competition (eg: manufacturing, logistics and distribution). They are free to set up anywhere in the country but many will lured to the SFTZ by enhanced treasury capabilities, streamlined incorporation and customs procedures and other benefits.

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