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Will New China Free Trade Zones Attract Foreign Investors?

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Following the lead set by Shanghai's free trade zone, the State Council of the People's Republic of China approved at the end of 2014 the establishment of new FTZs in Tianjin, Fujian and Guangdong and the expansion of the Shanghai FTZ. After four months' preparation, these new FTZs were finally declared open in April this year. Coinciding with the opening, we have also seen the issuance of an updated negative list for foreign investment, a revised national security review rule and overall plans and administrative regulations for each FTZ. These regulations generally follow the model of the Shanghai FTZ with a couple of modifications to adapt for local characteristics.

Location of the New FTZs

The new FTZs extend the People's Republic of China's existing bonded zones and new development areas and are located in the coastal regions of Northern and Southern China.

- **The Tianjin FTZ** includes areas around Tianjin port, Tianjin airport and the Binhai New Area, covering a total geographical area of 119.9 square kilometers.
- **The Guangdong FTZ** spreads across Nansha Development Zone of Guangzhou, Qianhai Shekou area of Shenzhen and Hengqin New Area of Zhuhai, covering an area of 116.2 square kilometers.
- **The Fujian FTZ** covers a total area of 118.04 square kilometer, including areas in Pingtan County, Xiamen City and Fuzhou City.
- **The expanded Shanghai FTZ** covers an additional area of 91.94 square kilometers in Lujiazui Financial District, Jinqiao Development Zone and Zhangjiang Hi-Tech Park, making the whole Shanghai FTZ now an area of 120.72 square kilometers.

Benefits and Local Characteristics

Many of the key favorable policies available to foreign investors in the Shanghai FTZ have also been adopted in the FTZs in Tianjin, Fujian and Guangzhou and these include for example:

A simplified procedure for setting up foreign-invested enterprises
The Shanghai FTZ has since its launch in 2013 adopted a "negative list" approach to simplify the approval procedure for FIEs. This approach, with certain modifications, is now available in all the FTZs. Please see "An updated negative list approach" below for detailed analysis.

Customs check

Following the Shanghai FTZ model, customs check procedures will be significantly simplified in the new FTZs. The "first entering and then declaring" policy means customs checks will now take place after goods enter an FTZ rather than before, reducing the cost of customs clearance in terms of both time and money.

Liberalisation of the financial sector
Each FTZ will launch pilot programs to further facilitate cross-border RMB payment, relax settlement of capital accounts, promote the internationalization of the RMB and explore innovative financial products and services.

In addition, the PRC government also intends to develop different features for each new FTZ, according to its geographic advantage.

- **The Tianjin FTZ** is positioned to develop the economic integration of the region encompassing Beijing, Tianjin and Hebei Province, with shipping, financial leasing, high-end manufacturing will be the likely focus of the Tianjin FTZ.
- **The Guangdong FTZ** will enhance cooperation with Hong Kong and Macau and beyond — through to Southeast Africa and Europe. Key features of the Guangdong FTZ will include customs clearance and the finance industry.
- **The Fujian FTZ** will serve as a connection point on the cross-strait economy and trade with Taiwan. The Fujian FTZ will focus on producer services and high-end service sector.

An Updated Negative List Approach

As noted above the common benefit available from all FTZs will be an updated negative list approach for the approval of foreign-invested projects.

The Shanghai FTZ established a "negative list" approach for approval of foreign-invested projects in the zone. Foreign investment in an industrial sector not on the negative list does not require government approval but instead, a filing procedure needs to be completed prior to company incorporation. This approach, with a number of modifications, will be expanded to the newly established FTZs in Tianjin, Guangdong and Fujian from May 8, 2015, with an updated negative list. This modified regime and the 2015 negative list will also replace the current one in the Shanghai FTZ and thus apply in all four FTZs in China.

Compared with the Shanghai FTZ negative list released in 2014, the number of sectors and restrictive measures in the 2015 negative list has been largely reduced. More than 60 restrictive measures are to be removed, including those in the sectors of mining, agriculture, real estate, construction, value added telecommunication, direct sale, distribution of audio-and-video products, among others. However, most of these changes merely mirror the relaxation brought by the 2015 version of the Foreign Investment

Industrial Guidance Catalogue which was released earlier this year and entered into effect on the April 10, 2015.

Nevertheless, the 2015 negative list does contain a number of amendments offering relaxed policies to foreign investors which are only available in the FTZs, for example:

- The cap on foreign equity held in a petrol station chain (where the same foreign investor sets up over 30 outlets and sells different types and brands of refined oil from a number of suppliers) is now removed and thus 100 percent foreign ownership is allowed.
- The equity cap on foreign investment in processing certain types of edible oils is also removed.

In addition, the 2015 negative list also reflects a couple of notable clarifications and changes to the current approach:

- The negative list approach does not apply to foreign investors' acquisition of domestic Chinese companies (foreign M&A transactions), foreign investors' strategic investments in listed companies in China and foreign investors making capital contribution using equity held in Chinese companies. Instead, the existing approval procedure will still need to be followed.
- The existing arrangements in respect of filing procedure applicable to the Shanghai FTZ require prefiling with the approval authority before company incorporation. This procedure will be changed under the 2015 negative list approach — so that foreign investors may complete filing within 30 days after incorporation. This will greatly facilitate the company incorporation process for foreign investors.

A Broader National Security Review Regime

Another key reform in the FTZs is a modified national security review regime to be implemented exclusively in the zones.

Under the current framework across the country, foreign M&A transactions may be subject to national security review if the acquisition involves the military sector or constitutes acquisition of actual control in a company in the key agricultural, energy, infrastructure, transport, technology and equipment sectors. If a transaction is determined to pose a significant national security concern, the investors may be required to abandon the transaction or to implement changes to address such concerns.

According to the circular of the State Council on Distributing the Trial Measures on National Security Review of Foreign Investment in the Pilot Free Trade Zones (Circular 24), a modified national security review system having a much broader coverage than the current regime will be exclusively implemented in the FTZs in Tianjin, Guangdong, Fujian and Shanghai from May 8, 2015.

Expanded Scope of Review

The modified national security review regime in the FTZs will not only cover foreign M&A transactions but all the other forms of foreign investment, including (among other things) greenfield investment, variable interest entities arrangement, arrangements involving share nominees, offshore transactions, investment in the form of trust or leasing, re-investment by FIEs, subscription for convertible bonds.

Industry-wise, additional sectors are covered by the modified regime, including the acquisition of actual control by foreign investors in a company active in the undefined “key” cultural industry or “key” information technology products and service sector.

Additional Considerations of Security Review

Under the current national regime, the impact of a transaction needs to be assessed in a number of respects such as, for example, for any effect on basic social order or national economic stability. Two more factors are to be added to the modified regime in FTZs — whether a transaction has any impact on national cyber security, or on cultural security and public morality. Unfortunately, Circular 24 does not elaborate on these factors. In the absence of detailed guidance, it could be a challenge for foreign investors to assess whether their envisaged transactions may affect any of these factors and how to prepare information satisfactory to the reviewers.

Observations

Over the 19 months since the Shanghai FTZ was launched, a number of pilot reforms relating to foreign investment have been implemented. Some of the measures have already been expanded outside the zone and apply on a national basis, such as the foreign exchange reform to liberalize capital account settlement for FIEs.

The establishment of the new FTZs in Tianjin, Guangdong and Fujian can be seen as the latest step taken by the Chinese government to expand its experimental platform to a wider scope of places, with the aim to facilitate trade and investment. The new FTZs are also used as the testing ground for certain reform measures proposed under the draft Foreign Investment Law which was released for public comment in January 2015.

However, as there has been a continuous perception among some foreign investors that despite the various reforms launched in the Shanghai FTZ, the opening-up policies actually available are not as significant as expected. Whether the new FTZs will make any difference and offer more attractive opportunities to foreign investors remains to be seen. While the updated negative list approach will simplify an FIE’s incorporation process, the list itself is still too long to satisfy the hopes of many foreign investors. The national security review regime, with much broader coverage, also imposes greater uncertainty over foreign investment projects. The actual benefits that each new FTZ may offer to foreign investors may well depend on detailed local policies to be released in the near future.

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