HAN KUN LAW OFFICES

Legal Commentary

CHINA PRACTICE • GLOBAL VISION

September 6, 2013

Foreign Direct Investment Law

A General Overview on Proposed Rules in China (Shanghai) Free Trade Zone

Kelvin GAO | Shu WANG | Lynn TENG

On August 22, 2013, the State Council of the People's Republic of China officially approved the establishment of the China (Shanghai) Free Trade Zone (the "FTZ").[1] Meanwhile, in order to facilitate the smooth implementation of the reform measures in the FTZ, the Standing Committee of the National People's Congress issued the *Decision on Authorizing the State Council to Temporarily Adjust the Administrative Examination and Approval of Relevant Laws in the China (Shanghai) Free Trade Zone* (the "Decision") on August 30, 2013, which officially authorizes the State Council to suspend several examination and approvals items with respect to foreign invested enterprises (the "FIEs") as provided under the *PRC Law on Wholly Foreign-owned Enterprises*, the *PRC Law on Sino-foreign Equity Joint Ventures* and the *PRC Law on Sino-foreign Contractual Joint Ventures*.

Although the "General Plan of the China (Shanghai) Free Trade Zone" has yet to be promulgated (excluding the Decision above), we set out below a summary of the proposed rules and regulations to be adopted in the FTZ based on a selection of publicly available press releases for your reference. Please kindly note that this article is only a summary illustrating the relevant rules and regulations which might be implemented in the FTZ. The policies to be ultimately adopted in the FTZ shall be subject to the laws and regulations to be officially stipulated.

Based on the information currently available to the public, the new rules to be implemented in the FTZ will generally consist of the following aspects:

[1] It is reported that the FTZ contains four existing customs surveillance areas (i.e., Shanghai Waigaoqiao Bonded Zone, Shanghai Waigaoqiao Bonded Logistics Park, Yangshan Port Bonded Zone and Pudong Airport Comprehensive Bonded Zone).

Strengthen Financial System Reform and Innovation

The core innovation policy of the FTZ will be reform of the financial system. By categorizing and summarizing the relevant news reports, we are able to make the following conclusions in regard to financial reform in the FTZ:

(a) to liberalize the interest rates in the financial market and to no longer impose restrictions on the interest rates of deposits and loans, which will be completely determined by the market;

(b) provided that the risk is under control, to realize the free convertibility of Renminbi capital account and Renminbi cross-border pilot programs; to explore the internationally oriented reform pilot programs of foreign exchange administration; and to establish a foreign exchange administration system which will adapt to the FTZ;

(c) to allow foreign invested banks to set up subsidiaries and branches as well as to establish Sino-foreign joint venture banks with domestic banks, which may be no longer subject to the relevant approval procedures and requirements as stated under the existing PRC regulatory regime. In addition, to permit such foreign invested banks to conduct various Renminbiretail or wholesale banking business activities, including, among others, receiving deposits, corporate financing, trade financing, financial activities, precious metal trading and security trading;

(d) to allow the establishment of restricted license banks[2](which is preliminarily estimated to be the banks holding certain Renminbi business licenses) where the relevant conditions are satisfied;

(e) to allow the establishment of foreign invested payment institutions, in which case, foreign investors may apply for and obtain a Payment Business Permit from the People's Bank by referring to the *Administrative Measures on Payment by Non-financial Institutions*;

(f) to allow certain Chinesebanks to carry out off-shore business activities;[3]

(g) to encourage the business of financial leasing and granting tax support;

(h) to generally allow overseas enterprises to participate in commodity futures trading and allow overseas futures exchanges to designate or establish warehouses for commodity futures; and

(i) to grant tax preferences toqualified enterprises set up in the FTZ.

---

2 A "Restricted License Bank" is designed to make certain companies (i.e., small loan companies) which have a consolidated foundation but whose business scale is not so big as banks to be qualified to apply to become a restricted license bank (such banks may receive deposits in a certain amount and without depositing term limitations) or a deposit taking company. Such companies may receive deposits from local residents or carry out the business of wholesale and investment banking.

3 Offshore Business" refers to the financial activities of banks receiving funds from non-residents and providing services for non-residents.

For your convenient reference, we have set out in Appendix I attached hereto abrief comparison between the new rules which may be implemented in the financial field of the FTZ and the existing rules.

Simplify Certain Approval Procedures for Foreign Investments

In contrast to the existing approval system regarding onshore investments by foreign investors, the FTZ will adopt an administration model called "Negative List Administration". This "Negative List Administration" will be "permitted as long as the relevant laws and regulations have no explicit prohibitions". Specifically, within the FTZ, except for those key industries which are explicitly restricted/prohibited from foreign investment, foreign investments in other industries will not be subject to any approval and only filing is necessary. Therefore, the FTZ will implement an administrative model of "approval + filing" in regard to foreign investment access. We have listed below the approval items which may be suspended in the FTZ:

#	Suspended Approval Item	Main Content	Existing Rules
1.	Examination and approval on foreign investment projects conducted by the National Development and Reform Commission (the "NDRC") or its local counterparts	In the FTZ, based on the principle of "same treatment on Domestic and Foreign investment projects", only projects (domestic and foreign) which contain a fixed assets investment will be required to make filings with the NDRC or its local counterparts, and some administrative approval items will be suspended	Various foreign investment projects (including the establishment and alteration of FIEs and foreign merger & acquisitions) shall be subject to the project approval of the NDRC or its local counterparts[4]
2.	Approval on the establishment, alteration and termination of an FIE	According to the Decision, the following approval items regarding FIEs (including wholly foreign owned enterprises ("WFOEs"), Sino-foreign equity joint ventures ("EJVs") or Sino-foreign contractual joint ventures ("CJVs") will be replaced by filing:[5] • the establishment, division, merger, alteration, and determination and extension of the operation term of the WFOEs; • the establishment, extension of duration and dissolution of EJVs; • the establishment of and major changes to the agreement, contract or articles of association of the CJVs, transfer of rights and obligations under the CJVs' contract, entrusted operation and	Establishment, alteration and termination of an FIE shall be subject to the approval of the competent approval authorities

4 In practice, under certain circumstances, some foreign investment projects do not need to apply for project approval from the NDRC or its local counterparts.

5 The Decision will come into effect on October 1, 2013. We understand that the State Council will then adjust and promulgate a series of regulations regarding the establishment, alteration and termination of FIEs based on the principles established by the Decision.

#	Suspended Approval Item	Main Content	Existing Rules
		extension of duration	
3.	Approval on outbound investment	Outbound investment by domestic enterprises will be just subject to a filing requirement	When conductingoutbound investments, a domestic enterprise should firstly obtain the approval from the NDRC or its local counterparts and the competent PRC approval authorities. Such enterprise will then need to obtain a foreign exchange registration certificate of its outbound direct investment issued by the competent foreign exchange authority. Upon obtaining all of the above-mentioned approvals and certificates, such enterprise may carry out the procedure of remittance of funds in the appointed foreign exchange banks

ExpandAreas for Foreign Investment and Lower Threshold for Market Access

As previously mentioned, after the implementation of the "Negative List", any foreign investment project in the FTZ which is beyond such list may not be subject to the relevant existing restrictions on market access for foreign investment.

According to published information, we noted that the access threshold or restrictions on the qualifications, shareholding, business scope, etc. for foreign investment may be lowered or removed in the following areas:

#	Industry	Existing Rules	Proposed Rules in FTZ
1.	Shipping	According to the relevant provisions stipulated in the *Administrative Rules on Foreign Investment in the International Shipping Industry*, upon the approval of the Ministry of Transportation and the Ministry of Commerce, foreign investors may make investments in the international shipping industry through the following forms: • Establishment of EJVs or CJVs to operate in the business of international shipping, international shipping agencies, international shipping management, international shipping cargo handling, international shipping container stations and yards; • Establishment of EJVs, CJVs or WFOEs to operate in the business of international shipping goods storage; • Establishment of EJVs, CJVs or WFOEs to provide daily business services for ships operated or owned by the investors	Unless otherwise provided in the “Negative List”, foreign investors may freely make investments in such areas without being subject to the relevant approvals
2.	Credit Survey Firm	According to the *Catalogue for the Guidance of Foreign Investment Industries* (the “Catalogue”), the operation of credit survey and rating services companies falls into the “restricted” category for foreign investment	
3.	Performance Brokerage	According to the Catalogue, the operation of performance brokerage companies falls into “restricted” category for foreign investment, which should be majority controlled by the Chinese parties	
4.	Entertainment Venue	According to the Catalogue, the operation of entertainment venues falls into the “restricted” category for foreign investment, which should be limited to the form of EJVs or CJVs	
5.	Education and Training	According to the Catalogue, although the operation of higher education institutions belongs to the “encouraged” category for foreign investment, it should be limited to the form of EJVs or CJVs; Ordinary high-school educational institutions falls into the “restricted” category for foreign investment which should limited to the form of CJVs; The operation of compulsory education institutions, special area education institutions such as military, police, political and party schools fall into the “prohibited” category for foreign investment. In practice, most foreign investors make domestic investments through the establishment of Sino-foreign cooperative education institutions, running a Sino-foreign cooperative school project or vocational training project, or through the structure of a Viable Interest Entity	

6.	Trade and Auction of Cultural Relics	According to the relevant provisions of the current "Protection Laws on Cultural Relics", the establishment of foreign invested cultural relic stores or auction enterprises is generally prohibited	Qualified foreign investors will be allowed to set up FIEs to be engaged in the business of auctioning cultural relics in the FTZ, and qualification application submitted by such FIEs, and the examination and verification on the auction subjects will be merged into the existing administrative system
7.	Value-added Telecommunications Services	According to the relevant provisions of the *Administrative Rules on Foreign invested Tele-enterprises*, contribution percentages made by foreign investors in a foreign investment telecommunications enterprise which operates value-added telecommunications services (including wireless paging businesses within the basic telecommunications) shall not exceed 50% and no foreign investment is allowed in the area of internet information services	Provided that the safety of internet information is ensured, foreign investors are permitted to set up WFOEs or foreign investors controlled enterprises to operate part of value-added telecommunications services in specific forms
8.	Job Intermediary Agency	According to the *Interim Provisions Concerning the Management of Chinese-foreign Joint Job Intermediary Agencies*, a Sino-foreign job intermediary agency shall have a registered capital of no less than US$300,000 of which, the shareholding percentage of foreign investors shall be no less than 25% and no more than 49%, while the shareholding percentage of Chinese investors shall be no less than 51%	For any joint venture job intermediary agency established in the FTZ, the minimum registered capital shall be US$125,000, and the shareholding percentage of foreign investors shall not exceed 70% (previously, only Hong Kong and Macao service providers could enjoy such policy)
9.	Outbound Tourism	According to the *Interim Measures for the Supervision and Administration of the Pilot Operation of the Outbound Tourism Business by Sino-foreign Joint Venture Travel Agencies*, the quantity of Sino-foreign joint venture travel agencies participating in the pilot programs of the outbound tourism business is under strict control.	Any Sino-foreign joint venture travel agency in the FTZ which fulfills the relevant requirements may participate in the outbound (Taiwan excluded) tourism business

10.	Construction Project	According to the *Rules for the Administration of Foreign-funded Construction Engineering Design Enterprises*, foreign investors and foreign service providers of a foreign-funded construction engineering design enterprise shall be an enterprise, a certified architect or an certified engineer that are engaged in construction engineering design in their respective countries According to the *Rules for the Administration of Foreign-funded Construction Enterprises*, a construction enterprise in the form of a WFOE is only allowed to contract, within its scope of qualifications, a joint construction project in which foreign investment occupies no less than 50%, and a Sino-foreign joint construction project in which foreign investment occupies less than 50% but which cannot be independently implemented by any Chinese construction enterprise due to technical difficulties and has been approved by the provincial construction governmental authorities	Requirements for investors may be revoked when a foreign-funded construction engineering design enterprise (engineering investigations excluded) first applies for qualifications. When contracting a joint construction project, a construction enterprise in the form of a WFOE may be no longer subject to the restrictions on the investment ratio of the Chinese and foreign parties (previously, only Hong Kong and Macao service providers could enjoy such policy) The above mentioned policies only apply to enterprises registered in the FTZ when they provide construction project services within Shanghai

Appendix I General Comparison between the New FTZ Rules and Existing Rules in the Financial Field

#	FTZ's Proposed New Rules	Existing Rules	Han Kun Notes
1.	Liberalize the interest rates in the financial market of the FTZ and implement marketization pricing on the price of financial institutions' assets	According to the *Notice on Further Promoting the Reform of Interest Rate Marketization* issued by the People's Bank, as of July 20, 2013, the controls over the interest rates of financial institution loans will be completely released, and the financial institutions will reasonably determine the interest rates of loans based on the supply and demand of the market	Based on the existing policy, the "cap on deposit interest rates" still exists and there may be future breakthroughs in the FTZ
2.	Allow foreign invested banks to set up subsidiaries or branches and establish Sino-foreign investment banks with domestic banks	According to the *PRC Administrative Regulations on Foreign Investment Banks* and its implementing rules, it is generally allowed to set up foreign invested banks and Sino-foreign invested banks in China provided that certain requirements stipulated in these regulations and rules are satisfied, which include, among others, the minimum amount of registered capital for these banks (RMB1 billion or in a freely convertible currency equivalent to that amount) and satisfying the operation qualifications, financial conditions, and investment experiences within China of the investors	We understand that if the establishment of foreign invested banks and Sino-foreign invested banks is explicitly excluded from the "Negative List", then their establishment and alteration may be no longer subject to the pre-conditions and approval requirements stipulated in the *PRC Administrative Regulations on Foreign Investment Banks* and its implementation rules as well as the relevant laws and regulations
3.	Free convertibility of Renminbi capital accounts and Renminbi cross-border pilot programs	Currently, account convertibility has been realized conditionally in Mainland China. However, the convertibility of Renminbi under capital accounts has yet to be realized. Similarly, the State Council has made its official decision dated April 8, 2009 to set up pilot programs regarding the settlement of Renminbi for cross border trade in Shanghai, Guangzhou, Shenzhen, Zhuhai and Dongguan Therefore, current Renminbi cross-border settlements under trade items are considered common. There is also a limited practice of Renminbi cross-border settlements under part of capital accounts, but generally speaking, China has not realized Renminbi cross-border settlements under the capital accounts	Once the free convertibility of Renminbi under capital accounts is realized, it will greatly facilitate the capital exchange for foreign investors, which will further encourage foreign investors to make more investments in China
4.	Allow the establishment of restricted license banks	Currently there are no regulations on the establishment of restricted license banks in China, nor there is any restricted license bank established in China	Using the experience of Hong Kong as a reference, the "Restricted License Bank" is designed to make those companies (i.e., small loan companies) which have a consolidated foundation but whose business

#	FTZ's Proposed New Rules	Existing Rules	Han Kun Notes
			scale is not so big as banks to be qualified to apply to become a restricted license bank (such banks may receive deposits in a certain amount and without deposit term limitations) or a deposit taking company; so that such companies may receive deposits from local residents or carry out the business of wholesale and investment banking. There has been some discussion and exploration regarding this aspect in China, but currently no substantial reform has occurred.
5.	Allow the establishment of foreign invested payment institutions	Although the *Administrative Measures for the Payment by Non-financial Institutions* has not explicitly prohibited or restricted foreign investment in the payment industry, since these Administrative Measures were issued, only two WFOEs, (i.e., Edenred China and Shanghai Sodexhopass) have obtained permits to operate in the business of the "issuance and acceptance of prepaid cards", while the other two main business activities within the payment field (i.e., payments through networks and bankcard acquisitions) are still not permitted for FIEs to operate in. Therefore, the current scope of the payment business open to FIEs is still very limited	Provided that the payment business is explicitly excluded from the "Negative List", the relevant approvals will no longer be required and any FIE which fulfills the relevant requirements may directly make filings to operate in the relevant payment business
6.	Allow certain domestic banks to carry out off-shore business activities	The pilot banks, China Merchants Bank, Shenzhen Development Bank, Shanghai Pudong Development Bank and Bank of Communications have had some practical experience in the area of offshore business, whose main operation scope includes foreign exchange deposits and loans, international settlements, issuance of transferable deposit certificates with large amounts, and foreign exchange guarantees.	Since the offshore business itself is still under exploration and development, the FTZ will mainly summarize the existing practical experiences and highlight the policy requirements in order to promote domestic banks to carry out off-shore business activities
7.	Encourage the business of financial leasing and granting tax support; no requirement on the minimum amount of registered capital for financial leasing companies to set up single plane or single ship subsidiaries; permit financial leasing companies to	Currently, there is still no systematic legal supervision on Chinese financial leasing companies which are non-financial institutions, and this contributes to a difficulty for such financial leasing companies to enjoy tax preferences. In addition, the financial leasing business is still in the start-up phase, thus the relevant taxes and financial support have yet to be put in place, which is one of the most important factors impeding the	According to the relevant reports, the State Administration of Taxation raised its conservative opinions regarding tax support for the financial leasing business. Therefore, it is doubtful whether such policy may exist in the final plan

#	FTZ's Proposed New Rules	Existing Rules	Han Kun Notes
	concurrently operate in the business of commercial factoring which is related to its main business	development of the financial leasing business According to the *Notice on the Relevant Issues on the Establishment of Project Companies within the Bonded Area by the Financial Leasing Companies to Operate the Business of Financial Leasing* issued by the China Banking Regulatory Commission (the "CBRC"), those financial leasing companies which are under the supervision of the CBRC may set up project subsidiaries in the form of single plane or single ship companies, but only within the bonded area, while financial leasing companies which are under the supervision of the Ministry of Commerce are also allowed to operate a project subsidiary within a bonded area. In practice, despite how there is no regulatory requirement, there is still a requirement on the minimum amount of registered capital for such single plane or single ship company, ranging from RMB100,000 to RMB300,000 According to the *Notice on Work related to the Pilot Project of Commercial Factoring* issued by the Ministry of Commerce, investors shall set up an independent company to operate in the business of commercial factoring and no mixed operation is allowed. One of the commercial factoring company shall not conduct the financial activities such as receiving deposits and issuing loans, nor shall it be specialized in or be authorized to operate in the collection business. From a legal perspective, financial leasing companies are at present not allowed to concurrently operate in the business of commercial factoring	
8.	Allow overseas enterprises to participate in commodity futures trading and allow overseas futures exchanges to appoint or establish transaction warehouses for commodity futures	According to the *Administrative Regulations on Futures Transactions*, only qualified overseas institutions may participate in futures transactions of specific commodities. Currently, Qualified Foreign Institutional Investors may only be involved in a very limited scope of future transactions such as the transactions of crude oil futures and stock index futures According to the *Notice on Further Strengthening the Supervision on the Physical Delivery of Commodity Futures* issued by the China Securities Regulatory Commission (the "CSRC") in 2008, it is prohibited for overseas futures exchanges and other overseas	According to the relevant report, the CSRC raised its conservative opinions on this policy. Therefore, it is doubtful whether such policy may exist in the final plan

#	FTZ's Proposed New Rules	Existing Rules	Han Kun Notes
		institutions to appoint or establish transaction warehouses for domestic commodity futures or conduct other activities related to the delivery of commodity futures before the issuance of the relevant laws and regulations on the openness of China's futures market. At present, there have been no transaction warehouses for commodity futures set up by overseas futures exchanges	
9.	Project enterprises which carry out overseas equity investments in the FTZ will be granted tax preferences, i.e., the enterprise income tax ("EIT") rate for such enterprises and the proceeds received from their off-shore business activities will be 15%	According to the *Enterprises Income Tax Law*, except for certain enterprises (small low-profit enterprises with an EIT rate of 20% and high-tech enterprises with an EIT rate of 15%), the applicable EIT rate shall be 25%	

Important Announcement

This Legal Commentary has been prepared for clients and professional associates of Han Kun Law Offices. Whilst every effort has been made to ensure accuracy, no responsibility can be accepted for errors and omissions, however caused. The information contained in this publication should not be relied on as legal advice and should not be regarded as a substitute for detailed advice in individual cases.

If you have any questions regarding this publication, please contact **Kelvin Gao, (+86-21-6080-0920; kelvin.gao@hankunlaw.com) or Shu Wang, (+8610-8525-5526; shu.wang@hankunlaw.com)** .