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Navigating the Shanghai Free Trade Zone

In 1978, the Third Party Plenum of the 11th Central Committee marked the beginning of China's "Reform and Opening Up" policy, spearheaded by Deng Xiaoping to develop the then unknown fishing village of Shenzhen into China's most successful Special Economic Zone. 35 years later, the government's approach is bolder, with the launch of the first Pilot Free Trade Zone in China's biggest commercial hub - Shanghai. In the few months since its launch, there are still many policy grey areas - a possibly intentional move to encourage competition among investors, especially in the newly liberalised financial sector. With many of the world's top financial institutions rushing to submit proposals for their plans, new opportunities could make this pilot China's biggest economic success story, which we can help you navigate.

Stefan Kracht

In this Issue:

Shanghai PFTZ: the Facts

Let us answer your questions about the new Shanghai Pilot Free Trade Zone (PFTZ)

What's new for foreign investors?

Foreign-Invested Enterprises (FIEs) enjoy the same treatment as Chinese companies throughout the pre-establishment period of their business. They can set up without approval of the Ministry of Commerce, as long the industry is not on the Negative List.

What is the basic filing and registration process for FIEs in the Shanghai PFTZ?

The application process to begin operating in the PFTZ is surprisingly simple, especially for China standards: the applicant must file a form with only the Shanghai PFTZ Administrative Commission to obtain a business license, which can now be processed in only four days, reduced from the previous 29. Following this, the FIE must register with local agencies for a license to operate, similar to the FIE set-up in the rest of the country. Under the "license before certificate" registration system, companies may begin operating even before the license to operate is obtained, a brand new policy of the PFTZ.

What is the Negative List?

In a departure from the usual extensively long list of restrictions, the Shanghai PFTZ Administrative Committee opted for the use of a so-called "Negative List", which identifies specific sectors and industries that foreign companies may *not* engage in, leaving the rest open for investment (in theory). According to the Shanghai PFTZ official website, "for areas falling outside the Negative List, pre-approval will no longer be required for foreign investment projects [...] and establishment of foreign investment enterprises; instead filing (i.e. reporting) requirements will apply."

The List is made up of 18 classes, each further divided into categories and sub-categories, culminating in a grand total of 190 industries that are either restricted or fully prohibited. The largest class is manufacturing, which includes categories such as pharmaceutical and transportation equipment manufacturing. There is a general expectation that the List will be updated and shortened in the coming year.

What about foreign vs. local businesses?

The restrictions for ownership shares have been relaxed, meaning that any foreign investor can own part of a Chinese business within the Zone. Moreover, all enterprises will be treated equally in their business activities, a break from the preferential treatment of Chinese companies in the rest of the country. International stock exchange platforms can be established and foreign and Chinese-foreign JV banks can set up, in a move to develop the financial sector within the Shanghai PFTZ.

What does this mean for the RMB?

One of the goals of the Shanghai PFTZ is to create a convertible RMB for China's capital account, meaning that the RMB can be used for financial investments, including purchasing of stocks internationally. Currently, the RMB is only exchangeable for the current account (tourism and trade, e.g.). The aim is to have a fully convertible RMB within five years, a major step for China, which it has gradually

worked towards implementing for some time now. This will be one of the most important outcomes of the PFTZ.

What is China's goal with the PFTZ?

The rhetoric put forth by the Overall Framework Plan of the Shanghai PFTZ includes very uncharacteristic words for China such as "deepening reform", "encouraging innovation", and "opening of sectors". China has slowly moved towards opening up its economy and the Shanghai PFTZ can be seen as an experimental model that can be replicated throughout the country if it proves to be successful.

I thought the Waigaoqiao FTZ was set up in 1990. What's the big deal then?

The new Shanghai PFTZ not only integrates the Waigaoqiao FTZ but also is considered an upgrade of it, with the opening up of cargo trade and service industries. As a bonded zone, it has special arrangements for customs and import and export duties. When freight shipments enter the zone as 'bonded', they can be further processed, stored, or exhibited and later either imported into China after paying duties or shipped on internationally.

For more information on setting up your business in the Shanghai PFTZ, please email us at contact@fiducia-china.com

How Fiducia Can Help

Confused about the Shanghai PFTZ? Let us help you to:

- assess opportunities in the PFTZ for your business model
- devise an optimal structure from a business, legal and tax perspective
- set up legal entities in- or outside the Shanghai PFTZ
- outsource accounting to keep your organisation lean
- recruit key staff for your growth strategy

Email us at contact@fiducia-china.com for more information on how the Shanghai PFTZ can work for you.

What's in it for you?

When the Chinese government first announced the Pilot FTZ in Shanghai, there was much excitement as many were keen to find out what kind of benefits the new rules would bring to their industries. The initial euphoria passed quickly, leaving most regular businesses disillusioned. From what has been published so far, it seems that only certain specialized industries have reason to actually get excited.

Foreign companies in the zone, for example, are now allowed to manufacture and sell gaming consoles (Microsoft was one of the very first companies to set-up a subsidiary there for this purpose), set-up wholly foreign owned shipping management companies or medical insurance companies. Politically 'sensitive' websites are no longer banned, making websites such as Facebook, Twitter, and The New York Times accessible from within the Zone. Additionally, with the expected liberalization of the RMB in the zone it is an interesting option for banks and other financial institutions.

But what are the potential benefits for the many industrial companies that make up the largest share of foreign investment in China? China Focus has collected and evaluated several scenarios on how to make use of the Shanghai PFTZ.

Scenario A: Service centre for international technology companies

Setting up an after-sales centre to cut red tape at the border

Many foreign technology companies are experiencing continued growth in their business with China and Asia. Very often however local presence is limited to a sales organization with constrained after-sales service capabilities. After being active in the region for many years, the installed base of machines is likely to reach a threshold which makes it profitable to offer extended after-sales services. The new PFTZ presents the opportunity to build up a warehouse for critical spare parts outside of the Chinese customs territory. This is interesting because it saves tariffs and import taxes for parts that are later used in other Asian countries. For spare parts to be used in China, this is also advantageous because it avoids any strain on the Chinese company's liquidity that otherwise would result from import VAT prepayments on the spare parts. This is especially true for higher value parts.

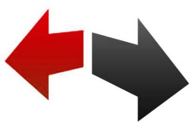
Previously, companies might have looked at Hong Kong or Singapore for the establishment of such a centralized spare-parts warehouse. In the Shanghai PFTZ the rules for customs clearance will be vastly improved with the adoption of an electronic supervision system, a single window for dealing with customs and CIQ issues and other measures to cut red tape at the borders. Once these new rules and procedures are fully implemented, the Shanghai PFTZ will be a competitive alternative for companies that are looking for a location for their Asia after-sales service hub.

Scenario B: Regional Headquarters

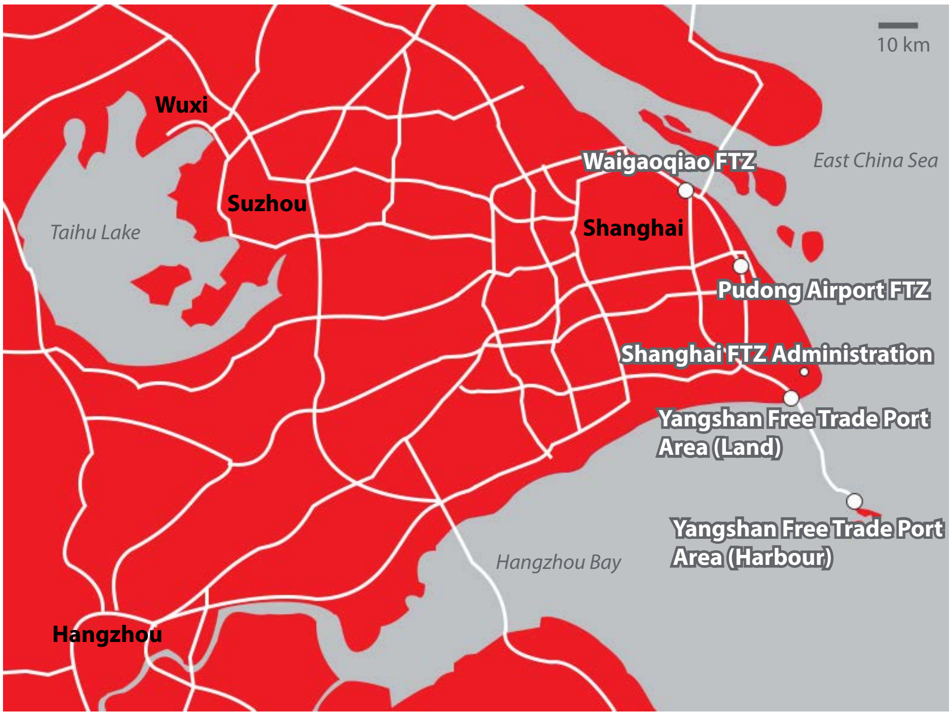
Setting up a management and holding company to control subsidiaries in China and Asia

With new regulations in the PFTZ, Shanghai tries to add further pull to its efforts to attract Regional Headquarters (RHQ) of MNCs that will manage several legal entities in and outside China. They are highly attractive for China because it means the MNC will relocate many overhead functions to the country which will result in the creation of high level jobs, the growth of an international workforce and the spurring of investment and development. Capital requirements for establishing a company within the Zone have been substantially relaxed, making it a more competitive location.

So far however, Shanghai lacks attractiveness as a location for RHQs that manage subsidiaries all across Asia when compared to alternative locations such as Hong Kong or Singapore. Especially in terms of financing options, liquidity pooling and foreign exchange risk management, as well as the strict regulation and non-convertibility of the RMB kept MNCs from choosing Shanghai over the others in the past. According to the plans for the PFTZ, these disadvantages might be leveled out soon. The draft rules of the zone also foresee easing the administrative requirements for overseas investment, which make it interesting for MNCs and big domestic companies as well.



The Shanghai Pilot Free Trade Zone



In contrast to what most people think, the PFTZ is not one continuous zone but is comprised of four previously existing zones, integrated under one umbrella administration.

Scenario C: Regional distribution hubs

Setting up an Asia distribution centre to simplify logistics and customs procedures

For Western companies that are looking for a location to set up a distribution centre in Asia, the Shanghai PFTZ offers some distinct advantages, too. It is particularly attractive for companies that need an advanced logistics infrastructure due to a high number of daily shipments, complex consolidation of incoming shipments or with higher value goods. Especially the simplified and faster customs clearance procedures are beneficial, since duties only apply to those goods that are eventually shipped to customers in China.

Additionally, the Shanghai PFTZ offers the opportunity to set up a showroom to showcase the capabilities of machinery, for example. Such a showroom can be used as a year-round location to attend to customers and also as a base to temporarily store machinery to be exhibited at various different industry trade shows in the region. By being located outside of the Chinese customs territory, all this is possible without having to go through time-consuming and costly import and export procedures every time, while simultaneously also avoiding duty and VAT payments.

Despite the many advantages that the Shanghai PFTZ can bring to companies, there are also some downsides that we would like to point out:

- The price for commercial properties is being driven up due to limited supply in the Zone. Warehouse rents in the former Waigaoqiao FTZ, for example, were already among the highest in Shanghai. Since the Shanghai PFTZ was announced prices are estimated to have gone up by another 20%.
- Due to the remote location, commuting times of 1.5 hours each way are common for many employees working in the Zone. As public transport connections are weak many companies rent their own shuttle buses. Finding the best talent under these conditions can be challenging and the fixed departure times of the buses make flexible working hours impossible.
- If companies registered in the zone wish to set-up a downtown office they can only do so with additional registration procedures, because they are required to formally register a branch.

Only time will tell how these challenges will be overcome and policies will be executed. Fiducia will keep you updated on any changes in the Shanghai PFTZ throughout the year.

What's New for Company Set-up

- Foreign Investors are not required to pay up registered capital for their FIE in the PFTZ. Moreover, they are not required to hold a minimum amount of registered capital, which is at least RMB 30,000 outside the Zone.
- The very detailed annual inspections required in the rest of China are not necessary in the PFTZ. Instead companies must only file an annual return, though this will be open to the public.
- The application to set up a FIE within the PFTZ can be filed online if it is not on the Negative List.
- Government approval for a foreign investment is not required to begin operating.

A Tale of Two Zones - Shanghai vs. Qianhai

	China (Shanghai) Pilot Free Trade Zone	Qianhai Shenzhen-Hong Kong Modern Service Industry Cooperation Zone
Inauguration	29 September 2013	10 January 2011
Goal	A pilot model that signifies the opening-up of China's economy with potential for replication nationwide.	A modern services innovation zone to further cooperation between Shenzhen, HK and Guangdong.
Target Industries	1. Financial services 2. Shipping services 3. Business services 4. Professional services 5. Cultural 6. Social services	1. Financial 2. Modern logistics 3. IT service 4. Applied scientific service 5. Professional service 6. Public service
Investment Controls	▶Negative List ▶Substantial loosening of restrictions for FIEs	▶Pre-approval process ▶Encouraging of industries through preferential policies
Challenges	Policies have lackluster since the launch of the Shanghai PFTZ. While more changes are expected, it is unclear how long it will take and how groundbreaking they will be. Similar to Qianhai, the execution has been vague, in typical Chinese style.	Even after 3 years, it is unclear what the direction for Qianhai is. Moreover, the expected level of close cooperation with Hong Kong has not been achieved to this day, partially due to the weak policies that were put in place.
Comparison	China's aim is to turn Shanghai into an international financial, logistics and trading hub, while simultaneously and cautiously testing the opening up of economic policies that can give China an edge in the global playing field. Qianhai, in comparison, was created to integrate the stand-alone yet highly successful Hong Kong into the Pearl River Delta Region and to cultivate innovation and talent. While some of the policies overlap especially in RMB foreign exchange and the financial field, the core target industries and regional focuses are different between the two, which will be the determining factor in which Zone is right for you.	

Hong Kong's Upper Hand

▶Hong Kong's personal income tax rate of 15% means talent and global headquarters are likely to remain in Hong Kong over China.

▶Hong Kong's sound rule of law is up to international standards and ensures a level playing field and protection of rights.

▶Hong Kong has one border, the Shanghai PFTZ has multiple, making it more challenging to implement policies.

▶While Hong Kong is long established, it is still unclear how the rest of Shanghai and China will benefit from the PFTZ.

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