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China Adds 3 New FTZs and Introduces New National Security Review Procedures for Foreign Investments in FTZs

New and Existing FTZs

Having experimented with the Shanghai Free Trade Zone (**SFTZ**) for more than a year, in December 2014, China's Premier Li Keqiang approved three new Free Trade Zones (**FTZs**) in Guangdong, Fujian and Tianjin, which were officially launched on 21 April 2015. With a total of four FTZs in China, the government has set different objectives for each based on geographic location:[1]

- Shanghai will focus on finance and services as a global financial centre;
- The Guangdong FTZ will focus on economic integration with Hong Kong and Macau and serve as a hub for a government initiative - the 21st Century Maritime Silk Road which is intended to connect China with Southeast Asia, Africa and Europe;
- The Fujian FTZ will focus on developing economic ties with Taiwan and high-end service and producer services sectors; and
- The Tianjin FTZ will focus on serving Beijing and Hebei and coordinate with South Korea based on an anticipated free trade agreement, while focusing on development in emerging industries, finance and high-end service sectors.

1 The pilot measures for capital account liberalisation for SFTZ will not be immediately extended to other FTZs.

The rationale behind China's Free Trade Zones is to allow the Chinese Government to experiment with reform policies on a localised basis before extending them to other parts of the country as it integrates China further into the world's economy. Each FTZ will be able to develop its own profile, although the four zones will compete for foreign investment which will be regulated by a new negative list applicable only in the four FTZs. The Government is additionally implementing a new national security review procedure of foreign investments in the new FTZs.

Shanghai Pilot FTZ

The Shanghai pilot FTZ was launched in September 2013 covering just 28 square kilometres. It has since been expanded and now covers some 120 square kilometres including the Lujiazui financial district, the Jinqiao Export Processing Zone and the Zhangjiang tech district in addition to the initial three areas of Waigaoqiao, Yangshan and Pudong International Airport.[2] According to a director of the steering committee responsible for planning the zone's development, the aim is for the Shanghai FTZ to be instrumental in China's continued integration into the global economy and to drive the "One Belt, One Road" initiative and the development of the Yangtze River economic belt. According to the zone's administration, 73,900 enterprises are based in the enlarged FTZ, of which some 22% are foreign-funded.[3]

2 China (Shanghai) Pilot Free Trade Zone. "City's free trade zone bigger and better". 28 April 2015.
3 Ibid.

Guangdong FTZ

From Hong Kong's perspective, the Guangdong FTZ is likely to offer the most opportunities. Covering 116 square kilometres, the Guangdong FTZ comprises parts of Guangzhou's Nansha New Area, Qianhai and Shekou in Shenzhen, and Hengqin in Zhuhai. The FTZ opens up the transport, finance and travel sectors in particular to Hong Kong companies and investors with the relaxation of a number of investment restrictions.

Financial sector liberalisation measures introduced in the Guangdong FTZ include the following:

- Qualified institutions registered in Hong Kong can establish financial leasing companies in the FTZ;
- Qualified insurance intermediary institutions and companies that are based in Hong Kong can establish branches in the FTZ;
- Qualified foreign financial institutions can establish foreign-owned banks and Sino-foreign banking JVs in the FTZ;
- Qualified investors from Hong Kong operating non-financial institutions in the FTZ can provide third party payment services;
- Foreign lenders can lend RMB funds to enterprises and financial institutions in the FTZ;
- Non-banking financial institutions in the FTZ can conduct cross-border settlements in RMB;
- Commercial banks are encouraged to establish institutions in the FTZ to conduct offshore foreign currency activities; and
- A Hong Kong-based parent company can issue RMB-denominated bonds in China if it has a subsidiary in the FTZ.

The new FTZ also paves the way for Hong Kong service providers to expand further into China. New measures introduced include the following:

- Five Hong Kong invested travel agencies can offer overseas group travel services (except to Taiwan);
- Hong Kong service providers can establish wholly foreign-owned international shipping enterprises within the FTZ;
- Hong Kong investors can provide high-end medical services and launch pilot schemes for exchanging patients; and
- Hong Kong service providers can establish intermediary service institutions for self-funded overseas study in the FTZ.

The Negative List 2015

When the SFTZ was opened in September 2013, a negative list was put in place specifying the areas that would be off-limits to foreign investors. A new negative list (the **FTZ List**), published on 20 April 2015, applies to foreign investment in all four FTZs from 8 May 2015. The government intends to apply the list uniformly, which suggests that the four FTZs will operate under the same rules and policies. For industries that are not included in the FTZ List, foreign investors will be treated the same as domestic investors.

Under the FTZ List, 122 areas within 40 industries will be prohibited or restricted for foreign investment; this is a reduction of 17 areas compared to the old SFTZ negative list which had 139 areas. This marks the second occasion when the SFTZ negative list has been trimmed. Many of the changes in the FTZ List reflect changes made in the 2015 version of China's Foreign Investment Catalogue which governs foreign investment in the rest of China, and categorises industrial sectors as encouraged, restricted or prohibited for the purposes of foreign investment. The latest version of the Foreign Investment Catalogue came into effect on 10 April 2015 and considerably reduced the number of sectors in which foreign investment is restricted or prohibited. The new FTZ List has however lifted restrictions on foreign investment in certain sectors which are still subject to restrictions in the rest of China under the 2015 Foreign Investment Catalogue. For example, foreign investment in the construction and operation of villas and golf courses is permitted under the new list for the FTZs, but remains prohibited in the rest of China under the Foreign Investment Catalogue.

Examples of sectors in which foreign investment remains prohibited under the FTZ List include: non-ferrous metal mining, radio and television programme production, air traffic control systems and postal services. Sectors in which foreign investment is permitted only via a joint venture with a Chinese company include oil and natural gas exploration and development, general purpose airplane design, manufacture and maintenance, and rare earths smelting. Moreover, the fact that certain areas have been removed from the FTZ List does not necessarily mean that they are open to foreign investment; for example, while weapons-related industries have been removed in the new FTZ List, they remain off-limits for foreign investors since they are also off-limits for most private domestic Chinese enterprises.

China's National Security Review for Foreign Investment in FTZs

The Chinese government is also extending its national security review process to foreign investments in the four FTZs from May 2015. This comes as the government drafts a new Foreign Investment Law implementing an enhanced national security review procedure entitling the government to conduct a national security review of any foreign investment which may damage China's national security. When implemented, the new law will significantly expand the government's power to conduct national security reviews which under the current framework apply only to foreign acquisitions of control over Chinese companies operating in certain "specified sectors", or their assets.

National security reviews of foreign investment in the FTZs will be conducted by a committee made up of representatives from the National Development Reform Commission, MOFCOM, and other relevant agencies which will participate on an *ad hoc* basis. A more stringent review will be conducted of a foreign company or a joint venture which acquires a controlling stake or acquires decisive voting rights that could affect the invested entity's structure and operations. Hong Kong, Macau and Taiwanese investors are regarded as foreign investors for the purposes of the national security review procedures and foreign investments include convertible bonds, reinvestments and outright purchases. Similar to the existing national security review regime for M&As, the new review regime requires a national security review of foreign investments in the following industries:

- Defence related industries;
- Key agricultural products;
- Key energy and natural resources;
- Key infrastructure;
- Key transportation services;
- Culture;
- Key information technology; and
- Key equipment manufacturing enterprises.

Foreign investment in financial areas will be subject to a different type of national security review. When conducting the review, factors to be considered by the joint committee are:

- National security;
- Economic stability;
- Social order;
- Cultural security and social morality;
- Internet security; and
- R&D of key technology related to national defence.

The new review procedures impose a duty on the FTZs' local governments to inform foreign investors whether they are obliged to undergo the review, and to stop their business application procedures until a decision/notice is issued by the joint committee.

A foreign investment will be prohibited if the joint committee considers that it may have a substantial negative impact on national security. However, if a negative impact could be resolved by additional commitments, the committee will request the investors to amend their business plan and make a decision after the provision of written undertakings.

China's adoption of new security review procedures on foreign investments are in line with national security review procedures adopted in other countries, such as the Committee on Foreign Investments in the United States or the End-User Committee in the Bureau of Industry & Security at the US Department of Commerce which controls American companies' exports.

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