In recent years, FTZs have been important laboratories for legal innovation in China. In the area of foreign investment, as of May 2015, the FTZs were the first to experiment with eliminating government approvals as a pre-condition for establishing foreign-invested enterprises ("FIEs") in industry sectors where foreign investment is categorized as “encouraged” or “permitted”. This approach was subsequently rolled out nationwide in October 2016. Similarly, in the area of foreign exchange, as of February 2015, the Shanghai FTZ had allowed Chinese companies to borrow money overseas on the strength of their balance sheet, where previously such borrowing was effectively subject to case-by-case approval by the State Administration of Foreign Exchange ("SAFE"), and it was generally understood that such approval was only available to large State-owned enterprises. This Shanghai FTZ innovation became national policy in January 2017.

With plans to add seven new FTZs in Sichuan, Henan, Zhejiang, Hubei, Liaoning, Chongqing, and Shaanxi to the existing four FTZs in Shanghai, Guangdong, Fujian, and Tianjin, it is clear that the FTZ experiment is set to continue. With each FTZ also adopting a specific industry focus, it is likely that innovations for specific industries will similarly focus on specific FTZs. This article will describe reforms currently being tested in the FTZs in the areas of foreign exchange, foreign investment, outbound investment, tax benefits, and commercial arbitration. It will also summarize and compare the industry focus of each of the FTZs in China.

I. Reforms Being Tested in the FTZs

Set forth below is a summary of significant policies that have been recently adopted by the FTZs and which are worth keeping an eye on. This is not intended to be an exhaustive list, and the pace of new reforms seems to be quickening in some cases. However, this hopefully gives a useful overview of some of the more notable policies, especially those which might affect foreign companies doing business with China.

1. Foreign Exchange

   i. Foreign exchange settlement through NRA Accounts across all FTZs
Non-Resident Accounts ("NRA Accounts") are foreign exchange accounts maintained in China by foreign institutions. For many purposes, such NRA Accounts are treated as "offshore" accounts, foreign currency deposited in NRA Accounts was generally not allowed to be converted into RMB without applying to SAFE on a case-by-case basis.[1] However, starting from January 2017, it became possible to convert foreign currency in an FTZ NRA Account into RMB. [2] While there are limitations on the use of such RMB (if such funds are to be used in China, normal SAFE rules regulating cross-border transactions will apply), the policy of allowing the conversion of currency in the first place may signal that SAFE is experimenting with some of the issues around the increasing convertibility of the RMB and looking for insight into the ways that offshore RMB is being used by commercial parties.

ii. FT Accounts with special benefits in Shanghai FTZ

Enterprises registered in Shanghai FTZ and foreign institutions may open Free Trade Accounts (an "FT Account") with qualified banks in the Shanghai FTZ.[3] An FT Account is a special account capable of receiving both RMB and foreign currencies on a separate accounting basis, with its master account denominated in RMB and subsidiary accounts denominated in various kinds of foreign currencies. FT Accounts, which are generally treated as "offshore" accounts, are entitled to preferential treatment in terms of cross-border financing and exchange settlement. Among other things, although foreign exchange settlement through non-FT Accounts is required to undergo review by banks for the authenticity of the underlying transactions (and sometimes by SAFE if the amount involved exceeds certain limits), the balance of an FT Account can be converted between RMB and foreign currencies at the discretion of the account holder. This would be instrumental for Chinese enterprises making oversea investments. Besides, in calculating the exchange rate for converting funds in an FT Account, where desirable, the account holder may use the offshore RMB market exchange rates (CNH), rather than the onshore RMB reference exchange rates (CNY) established by the People’s Bank of China.

2. Foreign Investment

i. Finance leasing

All of the published plans for the FTZs (the "FTZ Plans") have expressed their intent to encourage the finance leasing industry. According to the FTZ Plans and their ancillary regulations, benefits enjoyed by finance leasing enterprises within FTZs will include the following:

- qualified finance leasing companies can collect rent in foreign currencies within the FTZs;
- for finance leasing enterprises registered in customs special supervision area within FTZs (equivalent to bonded area in FTZs) importing certain
large-size equipment (such as aircrafts, vessels, ocean engineering structures, etc.), they may go through customs formalities with the customs where they are registered but subsequently import such equipment through other customs;[4]

- qualified financial leasing companies can set up specialized subsidiaries in the FTZs; compared with project subsidiaries (which are single-project based and have to be dissolved upon completion of the relevant financial leasing projects), specialized subsidiaries are industry-based and can operate for a longer period of time all financial leasing projects in the same industry.

ii. Value-added telecom

Earlier reforms in the FTZs allowed 100% foreign-owned businesses to secure licenses (an “EDI License”) for “online data processing and transaction processing” effectively a reference to e-commerce—and, in theory, this was subsequently rolled out nationwide. (In reality, experience shows that it is still easier to secure an EDI License in the Shanghai FTZ.) More recently, the Shanghai FTZ has allowed foreign-investment to exceed 50% in other types of value-added telecom on a pilot basis. These include information service (for APP stores only), store-and-forward business, call center, domestic multi-party communication services, Internet access services (access services for Internet users), and domestic Internet virtual private network services. The Shanghai FTZ[5] has further adopted a simplified procedures for applications of value-added telecommunication licenses. In particular, the statutory timeline for applications in the Shanghai FTZ is now 60 days, which is much shorter than the 180-day norm outside of the Shanghai FTZ.

iii. The 2017 version of FTZ Negative List

The FTZs have continued to narrow the negative list of industries that require government approvals for foreign investment. Recently, the 2017 version of FTZ Negative List[6] (the “FTZ Negative List”) has eliminated a number of business sectors, including accounting and auditing service, which were left out of the 2017 version of the nation-wide Catalogue on Industry Guidelines for Foreign Investment[7] (the “Foreign Investment Catalogue”). In addition, it is worth noting that:

- the investment in business premises for Internet access services have been removed from FTZ Negative list, whereas the Foreign Investment Catalogue still prohibits foreign investment in this specific business;
- the FTZ Negative list has no limitation on the design and manufacture of helicopters of not less than three tons, whereas the Foreign Investment Catalogue requires a Chinese party to own a controlling stake; and
- the FTZ Negative List allows 100% foreign ownership for performance brokerage agencies/talent agencies where the agency services will be
provided in the province or municipality in which the applicable FTZ is established, whereas the Foreign Investment Catalogue requires a Chinese party to own a controlling shareholding percentage.

Notwithstanding these openings, financial services (including banking, securities, futures, and insurance), telecommunication business, and Internet services continue to appear on the FTZ Negative List.

3. **Outbound Investment**

The FTZs were important pioneers in China’s experiments with allowing outbound investment by Chinese companies. However, given the stringent new controls put on capital outflows by SAFE last November, it is unclear whether the FTZs currently offer any meaningful benefits to Chinese companies seeking to expatriate funds for investment abroad. That being said, the FTZs continue to adopt policies that would otherwise support outbound investments. For example, capital gains tax arising from a Shanghai FTZ company contributing capital in-kind to an offshore affiliate may be eligible for installment payment over five years. The latest FTZ Plans and relevant policies indicate that Shanghai, Guangdong, Fujian, and Tianjin FTZs are developing further tax credit schemes tailored for outbound investment.

4. **Tax Benefits**

FTZs have recently adopted policies creating the following tax benefits.

%i. Payment of Enterprise Income Tax in installments

For enterprise income tax resulting from increase in value of an FTZ company’s interest in a portfolio company that arises out of non-cash restructuring of such portfolio company, the FTZ company may be eligible to defer such taxation by paying it out over a five-year period.

%ii. Reduced Enterprise Income Tax rate in certain regions for specific industries

If an enterprise is registered in the following sub-regions within the FTZs, it will be eligible to pay enterprise income tax at a reduced rate of 15% if its primary business—accounting for more than 70% of its total revenue—falls within an encouraged industry identified in the relevant investment catalogues for such sub-regions of FTZs:

- Hengqin New Area of Guangdong Province (广东横琴新区) - Guangdong FTZ
- Pingtan Comprehensive Experimental Area of Fujian Province (福建平潭综合实验区) - Fujian FTZ
- Qianhai Shenzhen-Hong Kong Modern Service Industry Cooperation Zone (深圳前海深港现代服务业合作区) - Guangdong FTZ
Of particular note, the following industries would be treated as "encouraged":

- high and new technology industries, such as development of certain software, smart products, Internet, and cloud computing;
- healthcare industries, such as the development and manufacture of certain new drugs, biological products, and medical device; and
- culture innovation industries, such as the research and development of animation, games, and digital products.

iii. Duty Free Import

Unless otherwise specifically provided by relevant laws and regulation, machinery, and equipment imported by manufacturing enterprises or manufacturing services enterprises in the FTZs for self-use are duty-free.

5. Commercial Arbitration

An opinion issued by the Supreme People’s Court around the end of 2016 (the "SPC Opinion") provides interesting judicial support to the FTZs.

i. Foreign Arbitration between Two FTZ Companies

In general, parties to a contract governed by PRC law are not allowed to submit any dispute relating to such contract to arbitration outside of the PRC if there is no “foreign element” involved in such dispute. To constitute a “foreign element,” one of the parties must be a foreign party (i.e. for a company, it must be incorporated outside of China) or an important underlying element of the dispute must have occurred outside of the PRC. In the past, this would have precluded two wholly foreign-owned enterprises ("WFOEs") established in China from arbitrating a dispute using a foreign arbitral organization.

However, the SPC Opinion carves an interesting exception out from this general rule. Pursuant to the SPC Opinion, two WFOEs, if they were formed in an FTZ, may now submit their dispute to a foreign arbitral organization. This follows on a previous Shanghai court case between Siemens International Trade (Shanghai) Co., Ltd. and Shanghai Gold Landmark Co., Ltd. where the Shanghai First Intermediate Court ruled that the agreement between these two WFOEs had a “foreign element” because (i) the parties of the agreement had “foreign element” insofar as they were both WFOEs established in the Shanghai FTZ; and (ii) the performance of the agreement was “foreign-related” as the dispute involved the operation of special customs supervision measures in FTZs.

In addition, the SPC Opinion appears to have extended this principle to disputes between two FIEs registered in the FTZs if they have agreed to submit their disputes to foreign-seated arbitration. However, to the extent that the SPC Opinion still seems to admit the possibility that an FIE disputant can argue that
a dispute “lacks a foreign element” at the commencement of proceedings (even if the disputants had previously agreed to such arbitration in their contract), there remains substantial uncertainty as to the utility of this innovation.[12]

ii. Ad-hoc Arbitration

Compared with arbitration under the auspices of an arbitral institute, ad-hoc arbitration does not require a specific arbitral organization to administer the arbitration and parties are free to choose any arbitration location, arbitration rules, and arbitrators that they agree on. Key advantages of ad-hoc arbitration include flexible procedures, as well as efficiencies in time and cost. A number of jurisdictions, such as the United Kingdom and Hong Kong, allow ad hoc arbitration primarily for these reasons.

Ad-hoc arbitration is not explicitly permitted by Chinese law, and ad-hoc arbitration awards have been explicitly rejected by courts in Beijing[13] and Jiangsu Province[14]. Moreover, the current Arbitration Law of the People’s Republic of China provides that an arbitration agreement can be held invalid for failure to select a specific arbitral institution to administer the arbitration.

The SPC Opinion upends this rule for the FTZs and would permit parties to agree to ad-hoc arbitration. Following the SPC Opinion, the Hengqin sub-region in Guangdong FTZ has issued implementing rules for ad hoc arbitration[15].

II. FTZ Specialization

With the creation of seven new FTZs, an effort has been made to give each FTZ a specific industry focus. Although detailed implementing rules have yet to be issued, these industry focuses are as described below.

Comparison of FTZs re industry focus
<table>
<thead>
<tr>
<th>Year</th>
<th>FTZs</th>
<th>Industry Focus</th>
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| **2013**   | Shanghai   | • International and globalization  
                • Financial innovation                                                   |
| (Phase I)  |            |                                                                                  |
| **2015**   | Guangdong  | • Cooperation between Canton and Hong Kong/Macau  
                • Preferential policy to Hong Kong/Macau investors  
                • Regional based development focus: Pearl River Delta               |
| (Phase II) | Fujian     | • Cooperation between Fujian and Taiwan  
                • Preferential policy to Taiwan investors                               |
|            | Tianjin    | • Regional based development focus: Beijing/Tianjin/Hebei region  
                • Leasing industry                                                     |
| **2017**   | Sichuan    | • Regional based development focus: western area  
                • Cooperation with countries along “one belt one road” re: streamlined standards in terms of customs, certification, quarantine and inspection, etc.  
                • Land use rights related innovation                                   |
| (Phase III)| Henan      | • Logistics and transportation industry                                          |
|            | Zhejiang   | • Staple commodities trade, with key focus on petroleum products               |
|            | Hubei      | • regional based development: Yangtze Economic Zone                            |
|            | Liaoning   | • Cross border regional development: northeast Asia region  
                • Cooperation between Asia and Europe  
                • Reform of state-owned enterprises                                      |
Chongqing

- Regional based development focus: western area
- Cooperation with countries along “one belt one road” re: streamlined standards in terms of customs, certification, quarantine and inspection, etc.
- Regional based development: Yangtze River Economic Zone

Shaanxi

- Regional based development focus: western area
- Cooperation with countries along “one belt one road” in terms of agriculture, education, culture, tourism, etc.

Given past patterns of using the FTZs as a test lab for innovation, it is probably worth keeping a close eye on different FTZs for different types of reforms. For example, the Shanghai FTZ will likely continue to be an important innovator in connection with foreign investment rules and the financial industry. Sichuan may be an important place to keep an eye on for real estate reforms. And Guangdong and Fujian may see further preferential policies for Hong Kong, Macau, and Taiwan companies.

* O’Melveny recognizes legal consultant Wuxiao Liang for his valuable contribution in researching and drafting this article.


[3] FT Account opened by enterprises registered in Shanghai is also marked as “FTE” while FT Account opened by foreign institutions is marked as “FTN”.

[4] For comparison, finance leasing enterprises registered in customs special supervision areas outside of FTZs are generally required to complete customs formalities with and accept cargo through the “customs in charge”, which should be the customs where the enterprises are registered, or with the other customs
upon the approval of the “customs in charge”.

[5] The Administrative Measures on Pilot Scheme for Foreign-funded Value-added Telecommunications Businesses in China (Shanghai) Pilot Free Trade Zone (《中国（上海）自由贸易试验区外商投资经营增值电信业务试点管理办法》) issued on and effective as of April 15, 2014.


[12] The SPC Opinion seems to suggest that, if a disputant fails to raise a defense of “lack of foreign element” at the outset of proceedings (similar to an argument of lack of jurisdiction in a U.S. proceeding), it will lose its right to claim this later in proceedings.

The Opinion of Beijing High People’s Court on Issues Relating to the Hearing of Civil and Commercial Judicial Review Cases (《江苏省高级人民法院关于审理民商事仲裁司法审查案件若干问题的意见》) issued on and effective as of April 24, 2007.


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