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New Rules Regulating the Latest Reform of the Foreign Investment Entry System in China--Interpretation of the Innovative Foreign Investment Entry System of China (Shanghai) Pilot Free Trade Zone

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China (Shanghai) Pilot Free Trade Zone (hereinafter referred to as the "Pilot Zone") was formally established on 29 September 2013. This innovative shift, altering the course of foreign investment in China attracts a high level of public interest, while the administrative mechanism of the negative list creates a new precedent in the Chinese administrative system. This article, based on existing regulations and systems in the Pilot Zone, attempts to interpret the innovation in foreign investment entry system in the aspects of procedures, substantiality and regulation.

Introduction to the Innovation Relating to the Entering Procedures of Foreign Investment in the Pilot Zone

The investment procedures generally require the establishment of the foreign-invested enterprise and approval of the investment project. These stages are regulated respectively by the competent commerce authority and the project approving authority. In addition, if a specific industry regulation is involved, a corresponding examination and approval by a competent regulation authority shall be obtained.

Generally speaking, in recent years, the regulation over the entry of foreign investment has been gradually liberalized. Nationally, In the nationwide, according to the Circular of the National Development and Reform Commission on Properly Delegating the Authority to Approve Foreign Investment Projects (Fa Gai Wai Zi [2010] No.914), the State Council has, to a large extent, delegated its authority to regulate foreign investment projects. Projects involving a total investment (including the registered capital increase) of less than USD300 million under the encouraged and permitted categories in the Catalogue for the Guidance of Foreign Investment Industries, which were originally subject to the

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approval of the State Council, are now subject to the approval of the development and reform commission at the provincial level. However, those that are subject to the approval of the relevant departments of the State Council as prescribed in the Catalogue of Investment Projects Approved by the Government, and excepted. The regulation of the entry of local foreign investment reflects this process. For example, the relevant provisions of the Reform Plan of Guangdong Province for Administration System of Enterprises Investment, Guangdong Province, besides further delegation of the authority of examination and approval, similarly require a change from the approval system to the filing system for foreign invested projects, where the total investment is below USD300 million. This is the case under the encouraged and permitted categories, except for those that require approval of the competent authorities at the state level. According to relevant provisions of the Opinion on Implementation of Combined Handling for Enterprise Investment Projects in Guangdong Province, where one authority is required to examine and approve several items in the same approval phase, the approval authority shall establish internal leading handling offices, optimize internal approval procedures, integrate internal divisions and working procedures, strengthen the linkage effects of internal institutions and achieve one window for external affairs and combine the handling procedures.

In contrast to the progressive liberalization of national and local regulation over foreign investment entry, the establishment of the Pilot Zone constitutes a significant leap in establishing open systems. It is for this reason that the change is sometimes deemed as a reform: in addition to greatly simplifying governmental administration procedures in accordance with the relevant provisions of the Administrative Measures of China (Shanghai) Pilot Free Trade Zone, the Administrative Measures of China (Shanghai) Pilot Free Trade Zone for Filing of Foreign-invested Enterprises and the Administrative Measures of China (Shanghai) Pilot Free Trade Zone for Filing of Foreign Investment Projects, the Pilot Zone also introduces the negative list system into the administration of foreign investment entry. The existence of the negative list system means that, in regions not covered by the list, there is a general presumption that the examination and approval of investment project, contracts, Articles of Association will be regulated by the approval system rather than the filing system. This will not be the case in relation to specific domestic investment projects which have been excepted, and thus reserved by the State Council to approve. Prior to this reform, the administrative procedures governing the competent commerce authority and the competent project approving authority have required the direct filing of foreign investment, which has become a major form in the Pilot Zone. In addition, the time, cost and formalities for foreign investment have been greatly reduced and simplified. In order to further facilitate the approval procedures, "one-window handling mechanism" has been adopted for the enter procedure of foreign investment in the Pilot Zone. According to Article 28 of the Administrative Measures of China (Shanghai) Pilot Free Trade Zone: "The administration for industry and commerce in the Pilot Free Trade Zone, in concert with taxation agency, quality supervision agency and the Management Committee, shall establish the "one-form application and one-window handling" working mechanism for the approval (filing) of foreign investment projects and establishment (change) of enterprises. The administration for industry and commerce shall uniformly receive application documents submitted by applicants and send relevant instruments to applicants." The Pilot Zone has made explicit stipulations in respect of time limit of approval that, where foreign investment solely involves establishment or change of enterprises, the filing authority shall complete filing within one working day upon the completion of online application by such foreign-invested enterprises and send certificates of filing to the foreign-invested enterprises and relevant departments. Where project approval is involved, the project filing authority shall, within ten working days upon the receipt of the application documents, issue opinions on the filing of foreign-invested projects in the Pilot Zone to the filing applicants.

Approval and Filing of Foreign-invested Projects under the Negative List Administration Mechanism

One of the core advances relating to foreign investment entry system in the Pilot Zone is the adoption of the negative list administration system. The negative list administration mode (hereinafter referred to as the "Negative List"); has been explicitly adopted, as stated in the Special Administrative Measures for Entry of Foreign Investment in China (Shanghai) Pilot Free Trade Zone (2013). The Negative list system dictates that the government has listed specific industries and fields which are excluded,, while the rest will be permitted through filing. The establishment of negative list system has simplified the approval procedures of foreign investment, destroyed the original four levels of classification of investment projects, and expanded the scope of foreign investment. The implementation of the system also represents the determination of the government to alter its role as a supervisor and regulator.

- Adjustment of the Negative List

  When comparing the Catalogue for the Guidance of Foreign Investment Industries (Revised in 2011) (hereinafter referred to as the "Guidance Catalogue") with the Negative List, foreign investors should pay attention to: firstly, with respect to special administrative measures for items under the prohibited category, the addition of some contents to the Negative List which are not included in the Guidance Catalogue. On the one hand, this addition reflects the cautiousness adopted by the government regarding the initial stage of the Pilot Zone, while on the other hand, it offers a reminder to potential foreign investors who intend to invest in the Pilot Zone to assume that the prohibited fields under the Pilot Zone are the same or narrower than the items under the prohibited category set by the Guidance Catalogue. Secondly, some items in the restricted category under the Guidance Catalogue have been deleted in the Negative List, and thus items that are restricted in other regions of Mainland China may be qualify for entry simply by filing in the Pilot Zone. Thirdly, the Negative List has expanded or reduced the applicable range of the items under the restricted category in the Guidance Catalogue, by detailed explanation on relevant items in the original Guidance Catalogue, in respect of specific administrative measures on restricted items. For example this has occurred in relation to the requirements on the registered capital of companies, business scale and the proportion of shareholding by foreigners.

- Major Concerns under the Negative List Administration Mode

  - Explanation of the Negative List

    The principal question associated with the Negative List is that "those not covered by the Negative List are subject to filing". However, if the project appears in the Negative List, it is subject to special restrictions. Does this mean that unlisted projects may be filed directly? For example, it is stated in the special administrative measures under the Negative List that:

"Investment in printing of publications is restricted (Chinese shareholders shall own a majority shares), and the registered capital shall be no less than CNY10 million". Should this be interpreted to mean that the foreign-invested projects on printing of publications, with a registered capital of less than CNY10 million are not included in the Negative List and can proceed through the filing procedures? By contrast, the measure may be interpreted to mean that all foreign-invested projects on printing of publications are included in the Negative List and the registered capital of such projects shall be no less than CNY10 million. The General view is that of the second interpretation. However, according to Article 2 of the Administrative Measures of China (Shanghai) Pilot Free Trade Zone for Filing of Foreign Investment Projects, the project filing administration scope of the Pilot Zone covers foreign-invested projects beyond those subject to the special administrative measures of foreign investment entry in the Pilot Zone. Therefore, the first interpretation seems to make sense too. Since projects listed in the special administrative measures are projects with registered capital of no less than CNY10 million, should those with registered capital of less than such amount be excluded from the Negative List? It is clear that special attention is needed in respect of the interpretation of the Negative List in the future application.

- Difference between categories of the Negative List and categories of the Guidance Catalogue

This problem stems from the fact that the categorization in the Negative List is not exactly the same as that in the Guidance Catalogue. For example, item B09 under the mining industry in the Negative List states that the "mining of precious metals (gold, silver, platinum group)" is restricted; while in the category of mining industry in the Guidance Catalogue, the restricted activity is the "exploration and mining of precious metals (gold, silver and platinum group)". In terms of the category of mining industry, it appears that the exploration of precious metals (gold, silver and platinum group) does not fall within the scope of the Negative List. However, in M747, in relation to the category of geographical exploration under the Negative List, the provision to restrict the exploration of precious metals (gold, silver and platinum group) is explicitly preserved. Furthermore, F511 and F521 under the Negative List have distinguished wholesale and retail. Therefore, the restrictive conditions for distribution of cotton are not consistent: it is required in the category F521 of retail that "Chinese shareholders shall own a majority share of chain stores with more than 30 branch stores with different categories and brands of commodities from multiple suppliers," while this is not required in the category F511 of wholesale. However, in the Guidance Catalogue, this requirement is uniformly placed on both categories of wholesale and retail. Therefore, foreign investors should not assume that the form of categorization used in the Negative List is the same as that used in the Guidance Catalogue. Instead, investors should develop a comprehensive understanding of the categorizations and the differences between the two, should they arise. A failure to adopt this approach, may lead to an incomplete understanding of the Negative List, which may in turn lead to a failure to perform the relevant approval procedures.

Regulation and Risk Prevention in respect of Foreign Investment in the Pilot Zone

The simplification of approval procedures for foreign investment and the expansion of the scope of foreign investment by the Negative List system results in more freedom for foreign investment. However, the "freedom" of the Pilot Zone does not signify the weakening of administration, but rather, represents a transformation of governmental function. The purpose of the establishment of the Pilot Zone is not only for opening-up foreign investment. It also embodies the active exploration of the administrative approval system, based on a thirst for reform. However, in lifting restrictions in relation to entry of foreign investment and expanding the scope of foreign investment, there still remains the issue of how to ensure effective regulation and control risk.

The risks of the Pilot Zone are controlled at both micro and macro levels: on the macro level, the Pilot Zone adheres closely to the policies and guidance of "opening-up in the front line while regulation in the second line", and strictly limits the reform trials to the 28.78 square kilometers Pilot Zone. The application of any new policies shall be effective solely in the Pilot Zone, which renders policy risks controllable within the space. On the micro level, the following actions have been taken in the Pilot Zone:

- Creating an Open and Transparent Investment Environment

  An open and transparent investment environment is the foundation for regulation and risk control in the Pilot Zone. The functioning of The Pilot Zone is premised on a smooth communication among regulators, between regulators and enterprises, and enterprises and the public. The Pilot Zone legislation requires that various policies and systems, laws, rules and regulations can be openly and transparently accessed by the public, that regulation information involving enterprises is issued on a true and timely basis and that information sources of departments such as industry and commerce, customs, taxation and finance can be efficiently and comprehensively shared, so as to provide strong supports for the optimization of administration procedures, provision of convenient service and strengthening of interim and post regulation. Aside from general information to be conventionally disclosed, according to Article 29 of the Administrative Measures of China (Shanghai) Pilot Free Trade Zone, "the law enforcement inspection in the Pilot Free Trade Zone shall be disclosed to the public on a timely basis in accordance with laws. Where food and drug security, public sanitary, environmental protection and safety production is concerned, the handling progress shall also be disclosed and necessary warning and preventative suggestions shall be released." Enterprises have been granted great freedom in the Pilot Zone and in respect of information disclosure, as long as the information disclosure complies with the filing conditions, foreign-invested enterprises are only required to make sure that the filing information is consistent with that provided by the registration authority and disclose in a timely manner the change of company filing and annual reports.

- Change of Government from Approver to a Regulator

The change of regulation and administration mode of the Pilot Zone stands as a guarantee of the effective regulation and risk control of the Pilot Zone. Advances in the system such as the establishment of the Negative List system and replacement of the approval system with filing system, as well as the changes in details such as replacement of the annual inspection system with the annual reporting and disclosure system are demonstrations of adjustments in the regulation and mechanisms employed by the administrative departments, which will result in the progressive evolution of the relationship between the administrative departments and the enterprises, extending from the relationship between approver and the applicant to the regulator and the regulated. The development of these roles has contributed to an enthusiasm and eagerness to self-manage enterprises, and has placed more burdensome regulations and requirements on administrative departments. Furthermore, the altering of the foreign investment entry system in the Pilot Zone can be seen as an experimental model and a beneficial attempt.

- Linkage Mechanisms: Incentives for Good Credibility and Penalty for Dishonesty

A reasonable incentive and penalty mechanism underlies the regulation and risk management of the Pilot Zone. According to Article 13 of the Administrative Measures of China (Shanghai) Pilot Free Trade Zone for Filing of Foreign-invested Enterprises, "the Filing Organization shall regularly inspect undertaking items of an investor (or foreign-invested enterprise). If the actual situation of such investor (or foreign-invested enterprise) is not consistent with the content undertaken, the Filing Organization shall give a written notice ordering such investor (or foreign-invested enterprise) to make corrections and, within a specified time limit, make a rectification. in the event of serious case, the Filing Organization shall cancel the filing, record such cancellation information in the credit archieves of foreign investors, include the enterprise in the directory of enterprises which have made a false statement, and notify relevant departments of the same and announce the disposal result. At present, provisions with respect to incentives and penalty are still excessively broad and the articles lack detailed guidance. Therefore, it is unclear how to identify and implement the incentives and penalties.

Compared with the conventional externalized regulation, the linkage mechanism of incentives for good credibility and penalty for dishonesty constitutes a type of internalized regulation, which does not exclude disqualified enterprises by setting up strict entry restrictions or restricting the activities of enterprises with powerful government regulations, but instead, encourages enterprises to voluntarily abide by the relevant systems and standards of the Pilot Zone by increasing the cost of violation and setting forth reasonable incentive measures. It is expected that this form of regulation may assist in further developing the innovative quality which defines the Pilot Zone system.

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