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Is Japan Falling Behind China?– Financial Free Trade Zone

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New Financial Free Trade Zone in Shanghai

In September 2013, China officially unveiled bold plans for a new financial free trade zone in Shanghai (see our attached concept paper *"*Four Areas for Near-Term Action to Make Shanghai a Global Financial Center*"* prepared for the 2013 China-U.S. Symposium) toward making Shanghai a "world class financial center."

Is Japan Falling Behind (Again)?

In the past, Japan has implemented numerous special zone initiatives as part of broad economic growth strategies. As recently as mid-October 2013, Prime Minister Abe announced renewed efforts for special zones to spur growth and investment.

However, despite past Japanese efforts with special zones and general financial reform, Hong Kong and Singapore have — through bold market liberalization, lower tax rates and aggressive business incentives — overtaken Tokyo as financial centers. Will Shanghai be the next Asian center to overtake Tokyo?

As the *Economist* magazine notes regarding the tokku (special zones) ". . . if Mr. Abe's tokku are to succeed, they will need to be bold. The country is already littered with special economic zones. The first group, almost a thousand, was chosen by the government of Junichiro Koizumi, Japan's reforming prime minister between 2001-2006. Most failed — chiefly because central-government bureaucrats rejected many ideas for deregulation for fear of offending vested interests." (Aug. 10, 2013 "Abenomics Zoning Out")

Now is a Rare Opportunity for Japanese Success

Despite great hopes in China, as our Shanghai concept paper shows, there are numerous Chinese obstacles for real reform. However, with the momentum of Abenomics reform, major corporate tax cuts, government pension fund asset reallocation and fundamental market liberalization, the Japanese special zones have a rare opportunity to help Japan realize its efforts to strengthen its position as a truly global financial center.

The Need for Policy Focus

Japan is at a very different developmental stage than China and any new "special zone" initiatives should be designed with this in mind. In the financial area this means that legislative, regulatory and tax policy reforms should be designed to meet the future needs of Japanese investors and financial intermediaries.

Emphasis should be placed on policies that enhance the productivity of Japanese savings capital and investor education and knowledge. This is particularly true in view of Japan's demographic challenges and the need to ensure that pension assets are invested in a manner than will ensure that pension obligations will be fully met. Japanese policymakers have yet to address pension underfunding in a realistic manner and with a view to ensuring the greatest productivity for these accumulated financial assets.

With respect to financial markets, reforms should focus less on supporting outmoded financial instruments business models in the banking, insurance and securities trading sectors and more on ensuring that Japan's financial markets remain globally competitive and "first in class." Consolidation in Japan's financial services markets is inevitable and needs to be recognized and accepted by the Diet and bureaucracy. Policies advocated by industry representatives that continue to support failing business models will only end up costing Japanese citizens, taxpayers and pensioners more.

Focus on Investors, Not Vested Interest in Financial Services

In the past, Japan's "iron triangle" in the financial services area has consisted of financial intermediaries, the Japanese regulatory bureaucracy (FSA, SESC and MOF) and the Diet. Many commentators note the role and input of investors (both retail and institutional) was largely ignored and investor advocacy groups were excluded or patronized in the policy dialogue.

This “market input excluding” approach continues to a lesser degree today and it needs to change as Japanese financial markets attempt to address increasing growing financial challenges and compete globally. Going forward, it is critical that investor input is received and acted upon in designing “special zones” for financial services and, in that connection, policies should be adopted that support the development and growth of investor advocacy groups (even if they consume a disproportionate amount of bureaucratic resources).

Japan Can Do This

Whatever economists may say about the “realism” of Abenomics, for younger Japanese, Abenomics represents the first real hope for a brighter future offered by policymakers during their lifetime. That is the sense “on the street” in Tokyo and many other cities. Japan needs to capitalize on the optimism in the future and design financial policies to serve the interests of the next generation. Japan can do this, and our Symposium needs to lead the dialogue as to how that dream of younger Japanese can be achieved.

Attachment

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Four Areas for Near Term Action to Make Shanghai a Global Financial Center for Asset Management

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A great deal has been written about the initiative of China's State Council to make Shanghai an "international finance center" by 2020 that was announced in March 2009. On August 22, 2013, another milestone in this initiative was passed with State Council's approval for the establishment in Shanghai of a Free Trade Zone ("SFTZ").

While the decision to allow Shanghai to proceed with the SFTZ was welcomed in many sectors, descriptions of the planned SFTZ did little to address the uncertainty that remains about making Shanghai a "world class financial center" within the foreseeable future (much less by 2020). Indeed, although press commentary about the State Council's decision focused in part on the proposed financial reforms in the SFTZ, there was little official confirmation of the details of the reforms or the many rumors and commentary that attended the announcement.

This brief concept paper considers the SFTZ from the perspective of facilitating the development in Shanghai of a world class financial center. We consider how the yet to be written rules for the SFTZ could be drafted to advance the goal of speeding up the process of making Shanghai an international financial center.

Shanghai's Progress as a "Second New York"

There is little doubt that Shanghai is already a global level trade and commercial port on par with any United States port city including New York. For many years Shanghai has been the world's busiest port by cargo tonnage and also by container volume[2] and it remains the dominant hub of commercial activity in the Yangtze basin (although China now boasts 6 of the top 10 ports in the world). However, as a financial center, it lags behind Shenzhen and Hong Kong in China, Singapore, Seoul and Tokyo in Asia, New York, Chicago and Boston in the United States, and London, Zurich, Geneva and Frankfurt in Europe. Despite Shanghai's size and many advantages over its competitors in Asia, without creative and strong commitment from the Chinese Government, at this

[1] The authors wish to express their appreciation to Christopher Chen of the Beijing office of Bingham, McCutchen LLP in the preparation of this concept paper.

[2] http://en.wikipedia.org/wiki/World's_busiest_port.

juncture it seems very unlikely that Shanghai will become the "New York of Asia" within the next several decades.

The "Assessment of Shanghai's Plan to Become an International Financial Center by 2020"[3] prepared by the American Chamber of Commerce in Shanghai ("ACCS Report") in June 2012 provides a detailed summary of the challenges that Shanghai faces to becoming an international financial center. Among the challenges listed in the ACCS Report that might be addressed by the new SFTZ are: (i) limited use of the RMB in global transactions and continuing restrictions on RMB convertibility; (ii) the relatively few Chinese financial institutions based in Shanghai, (iii) Shanghai's under-developed services industry; and (iv) the inadequate "soft infrastructure" needed to attract global level talent. Little has changed in this regard since the ACCS Report was released, but the proposed SFTZ could change that.

Proposal 1: Use the SFTZ to Facilitate Internationalization of the RMB.

According to press reports, Shanghai's free trade zone may emphasize financial reform (which is a prerequisite to a fully functioning international financial center), including interest-rate liberalization and full convertibility of RMB, within the SFTZ. It has also been suggested that the SFTZ will allow unrestricted participation by foreign enterprises in a manner similar to that which currently exists only in Hong Kong (and to a limited extent in Shenzhen). Such liberalizations, if carried out to the fullest extent possible, could radically transform China's financial economy in a manner that could put Shanghai on the global financial map by 2020.

One problem with the SFTZ proposal is that geographically it does not include the existing financial market infrastructure areas in Pudong and Puxi.[4] This concern might be addressed by allowing so-called "back office" functions of asset managers and other financial intermediaries that are handled (settled and cleared) through facilities located in the SFTZ to qualify for the benefits of the SFTZ even where the trades that created them take place within Shanghai's existing financial development areas. Such an approach would encourage development of "regional back office" facilities for major international financial intermediaries within the SFTZ thereby spurring job growth for Shanghai's increasingly well-educated and internationalized college graduates.

Shanghai's status as a major center of trade also makes it an attractive place to develop debt and commodity trading centers as well as facilities for physical settlement of commodity trades. Shanghai already has a developing commodities trading business and providing tax and other incentives to commodities brokers,

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[3] http://www.amcham-shanghai.org/ftpuploadfiles/Publications/Achieving2020/Achieving-2020_Report.pdf (the "ACCS Assessment")

[4] A map showing the geographical boundaries of the Shanghai SFTZ can be found at http://www.slideshare.net/datasul/shanghai-waigaoqiao-free-trade-zone.

derivatives traders and asset managers to set up in the SFTZ could facilitate development of this sector of the financial economy of Shanghai. In particular, encouraging the creation within the SFTZ areas of commodity storage and delivery facilities to support regional commodities physical settlement and transshipments has great potential to inject energy into Shanghai's financial center.

Perhaps equally important would be for the SFTZ to encourage the location within its area of electronic, trade processing, data archiving and other IT infrastructure related to: (a) a nationwide bond trading and exchange market that incorporates a streamlined trading system and regulatory framework for inter-bank and exchange (including repo-financed) bond markets; (b) global around-the-clock derivatives trading facilities, and (c) multi-currency trading and clearing platforms. Co-location (with low trading latency) of these facilities in a specific area of the FTC would enhance the chances for development of a "financial hub" similar to Wall Street within Shanghai even where the "front office" facilities were located in Shanghai's existing financial centers in downtown Pudong and Puxi. Such facilities would also dramatically increase the desirability of RMB settlement of international trade and financial transactions.

In order to spur the development of a financial market in the SFTZ, the SFTZ's implementing rules should also allow for entity level tax exemptions (or rebates) on commodity, lending, securities trading and derivatives trading transactions that are conducted by businesses located within the SFTZ. In addition, providing a withholding tax exemption on all extensions of credit and debt instruments would be a core element of encouraging debt origination and trading amongst entities located within (and regulated under the rules applicable in) the SFTZ.[5] These concessions could be time limited but should last for at least a 20 year period in order for the financial center to develop a strong base. In addition, the regulations should make clear to what extend trading operations outside the SFTZ (i.e., in downtown Shanghai) can benefit from such tax benefits.[6]

Proposal 2: Use the SFTZ to Attract the Regional Headquarters for Global Investment Banks and "Economic Headquarters" for Chinese Financial Institutions.

At this time most of China's major financial institutions are headquartered in Beijing even when the greater volume of the financial activity is in Shanghai. The ACCS Report notes that "it is a least a modest disadvantage [to Shanghai's development as a financial center] that China's largest financial institutions are based in Beijing"[7]

[5] The ACCS Report notes that: "Corporate and personal taxes play an important role in determining the cost structure and overall profitability of financial firms. The ability of truly global business to be conducted in any of several locations means that these cost differences can have a serious effect on the growth of different financial centers. ….. The obvious point is that excessively high levels of taxation of financial firms or of their employees will make a financial center unattractive."

[6] Ambiguity in implementing regulations has led to confusion about the requirements for and scope of benefit coverage in other SFTZ and fiscal concessionary regimes in China that should be avoided with the SFTZ.

[7] ACCS Report at 29.

explaining that these financial institutions are amongst the most important customers of the global investment banks that drive the activity and prominence of global financial centers.

Shanghai might consider using the SFTZ (through the application of tax incentives, additional infrastructure development, etc.) to attract regional and China headquarters for global financial institutions and asset managers and to provide an "Economic Headquarters" to Chinese financial institutions much as the Tokyo "headquarters" is a second headquarters for Kansai based banks in Japan. Also, in order for Shanghai to become an international financial center substantial commitment must be shown by Chinese financial intermediaries to activity in the SFTZ, through repositioning financial "back office," settlement, clearing and similar activities within the borders of the SFTZ.

Currently, Hong Kong is China's leading financial center, ranking in many surveys in the top 5 financial centers globally.[8] A major challenge for Shanghai is how to lure away from Hong Kong global financial firms that have, over the past two decades, made Hong Kong their "Asia Hub." This will not be easy as Hong Kong is well-known for its competitiveness (especially vis-a-vis Singapore) and will not easily give up the mantle of Asia's leading financial center.

Here again, the SFTZ provides an opportunity for Shanghai to "leap frog" Hong Kong and increase its attractiveness globally. Shanghai should focus on developing first the markets in which it has the greatest competitive advantage. Targets might include commodities trading markets, financial derivatives markets and asset and money management markets. All three of these markets have recently been driven by technological change and innovation and in this regard Shanghai's SFTZ could incentivize the use of cutting edge trading technologies and infrastructure to attract Chinese and global traders and asset managers. Because of membership and cost issues affecting Hong Kong's exchanges, they could have a hard time keeping up with Shanghai if it were to aggressively develop these markets and facilities.

With respect to asset management, Shanghai again has a unique (and historic) opportunity to capitalize on capital aggregation and propensity towards savings by China's middle and affluent classes located within the Yangtze basin. The development in Shanghai of a vibrant asset management infrastructure and market to handle this wealth aggregation is Shanghai's best near-term opportunity to create an international financial center as much of this wealth will necessarily need to be diversified and invested in global markets. SFTZ planners should make fostering the development of a strong asset management industry a primary focus of the new SFTZ.

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[8] See http://en.wikipedia.org/wiki/Financial_centre for a summary of the recent results of some of these surveys.

Proposal 3: Use the SFTZ as a Rationale to Simplify the Shanghai QDLP Program Procedures.

Since 2008 Shanghai has promoted foreign capitalized private equity businesses. Following the promulgation of various regional rules and policies regarding the private equity businesses (e.g. simplified tax returns, provision of financial support, etc.) issued by various governmental authorities at the municipal level, after several years Shanghai issued a comprehensive regional rule on foreign invested private equity activities entitled Implementation Rules on Promoting a Pilot Program of Foreign Invested Equity Investment Enterprises[9] (the "Pilot Rules"). Through the Pilot Rules and program, Shanghai intended to alleviate some traditional foreign investment obstacles (e.g., time consuming government approvals, foreign exchange issues, etc.)[10] and create more opportunities for foreign investment in Shanghai.

Issues with the Private Rules to Be Addressed in the SFTZ Initiative

The Pilot Rules state that if a private equity fund is established under the Pilot Rules it will be entitled to the favorable treatments of the Pilot Rules thereunder ("RMB Fund"). Moreover, the portfolio of the RMB Fund can retain its original nature (i.e. pure domestic company or foreign invested company) provided that (1) the amount committed by the foreign capitalized asset manager (as the general partner) is less than 5% of the total capital raised by RMB Fund; (2) limited partners of the RMB Fund are domestic individuals or legal entities; (3) the capital (except for capital committed by the assets manager) is raised onshore. Because accumulation of capital in no longer a problem in China (although capital diversification opportunities remain constrained), if experienced and knowledgeable assets managers can be attracted to work in Shanghai, the success and rapid development of the private equity investment business in Shanghai is reasonably foreseeable and Shanghai's advancement as an international capital market would be considerably enhanced.

However, because the Pilot Rules are regional rules, the effectiveness and controlling status of these rules has been challenged in practice from time to time in some other areas in China. In one reply issued by the national level National Development and Reform Committee ("NDRC") it was stated that an RMB Fund still must be subject to

[9] Issued jointly by Shanghai Financial Service Office, Shanghai Commerce Commission and Shanghai Administrative Industrial and Commerce Bureau on 24 December 2010 and effective as of 23 January 2011.

[10] In a traditional foreign investment transaction, some extra governmental approvals (e.g. the approval of commerce authorities regarding the transaction, the approval of foreign exchange authorities regarding foreign exchange settlement) will be necessary and some industrial restrictions (e.g. telecommunications restrictions) will be imposed. The industrial restriction will limit the selection of portfolios and the extra governmental approvals will definitely lengthen the whole pre-closing period, which are major negative factors for private equity investment businesses and the development of the asset management market in Shanghai. These issues should also be addressed as part of the SFTZ regulatory initiatives.

foreign investment rules and policies.[11] The NDRC's comment has to a certain extent created uncertainty to the implementation of the Pilot Rules.

The creation and integration of the existing asset management market in Shanghai into the SFTZ is an opportunity to integrate the Pilot Rules into the overall national rules for the governance and development of Shanghai's asset management industry. One of the main contributions of the Pilot Rules is providing a much simpler way of structuring foreign exchange settlement for the RMB Fund. Compared with the settlement on a case by case basis in traditional foreign investment transactions, the Pilot Rules allows a RMB Fund to settle foreign exchange in a lump sum and then invest in the portfolio directly in RMB. This big step forward does not signal the end of the foreign exchange authorities' supervision, but it does provide flexibility and efficiency to the whole investment process, particularly the closing. These innovations in the Pilot Rules should be extended in the creation of national rules for the SFTZ.

Use the SFTZ Initiative to Advance the QDLP Program in Shanghai

Following the Pilot Rules on RMB Funds, Shanghai has commenced the countdown to the introduction of a "qualified domestic limited partner" ("QDLP") scheme, which would allow foreign hedge funds to raise RMB capital in China to make investments in overseas securities from 2013.[12] Under the QDLP scheme, qualifying foreign hedge funds need to be registered with the local authorities before they can convert RMB (which is principally raised from mainland high-net-worth individuals) into foreign currencies for securities investments abroad.

Some media reports have suggested that at least six licenses for QDLP have been granted, but no official confirmation has been issued.[13] An official with the Pudong Financial Services Bureau has stated, however, that "the QDLP program will be launched sooner rather than later, and the city officials are very active in pushing ahead with major liberalization, including the QDLP".[14] If true, this is very positive for the development of an asset management industry in China because when the QDLP rule comes into effect, the implementation of such rule will be less challengeable because the whole investment will be made offshore and thus no PRC laws and

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[11] In an April 2012 reply issued by national NDRC in response to Shanghai NDRC's request to clarify the applicability of the Foreign Investment Catalogue to a Blackstone RMB Fund (which is established under the Pilot Rules), the NDRC states that the Blackstone RMB Fund and similarly structured RMB funds shall be administered by foreign investment rules and policies and the Foreign Investment Catalogue is applicable to the portfolio investments of such funds.

[12] The detailed rules of QDLP pilot program have yet to be made publically available. Though the QDLP rule will be a regional regulation, it is not clear that whether a QDLP will be subject to the Securities Investment Fund Law effective as of 1 June 2013. If so, QDLP will be subject to the supervision of China Securities Regulatory Commission. In any event, integration of the QDLP with the liberalization principles of the SFTZ should be a priority.

[13] Rumors have circulated in the Shanghai market for several months that a number of QDLPs have been approved and are currently operating. This rumor was confirmed in the press on September 16 when the Dow Jones Equities News that six QDLP (including Oaktree Capital, Och-Ziff Capital Management, Winton Capital Management, Man Group, Citadel and Canyon Partners) have been authorized to raise up to $50 million each . Still, no official confirmation has been issued.

[14] See "Foreign Hedge Funds set to get Yuan Fundraising Toehold", available at: http://www.scmp.com/business/money/markets-investing/article/1193285/foreign-hedge-funds-set-get-yuan-fundraising.

regulations will apply (except for certain outbound investment procedure and fund formation rules).

The liberalization of investment by Chinese investors in foreign markets will mark a major evolution in China's financial markets. It is entirely consistent with the idea of the creation of a world class financial market that this liberalization occur in Shanghai as part of the SFTZ implementation. Although initiation of a free trade zone may appear an odd approach to financial liberalization, the timing to tackle both objectives together is almost ideal. The sooner that such financial liberalization can be achieved, the better it will be for enhancing Shanghai's international reputation in financial circles.

Proposal 4: Address the Expatriate Tax Problem.

The plan for the SFTZ needs to recognize that, in order to compete with existing centers like Hong Kong (much less London and New York), Shanghai will also need to encourage much greater participation by expatriate professionals.[15] The ACCS Report makes this point diplomatically, but it is certainly the "elephant in the room" in terms of developing a competitive financial market in Shanghai.

Today, world-class financial executives and investment professionals are almost non-existent in the Shanghai financial community, and the most obvious reason for this is that it is very unattractive to be based in Shanghai from a personal taxation point of view. Talented financial professionals seek to make money and keep a reasonable amount of that money for themselves. Even with an SFTZ providing tax concessions for businesses, Shanghai's mandatory 45% individual income tax rate (compared to 15% in Hong Kong, 25% in Singapore and 35% in New York) will almost certainly limit Shanghai's ability to compete for global financial professionals. The SFTZ could address this problem by providing relief (or rebates) of tax for expatriate professionals that work within the SFTZ for specified periods in respect of specified activities.

The Road Ahead

Shanghai has a "long march" ahead of it to become an "international financial center" comparable to Hong Kong and Singapore, much less London and New York especially since all of these financial centers also continue to grow. Since the 2009 announcement of the plan to make Shanghai an international financial center by 2020, both Hong Kong and Shenzhen have significantly outpaced Shanghai in the race to the top. Indeed, it can be argued that this particular goal for Shanghai has receded rather than advanced in over the 5 years since its announcement.

[15] See ACCS Report at 6.

The State Council's recent decision to create a SFTZ provides an opportunity to reinvigorate the effort to make Shanghai a "global financial center" if not a "second New York." Using the SFTZ initiative as a milestone in Shanghai's march to the top is not only logical, it may be essential if Shanghai is to catch up in the near term. As they say, "死马当活马医[16] (nothing is impossible)."

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[16] Literally "Try to save a dead horse as if it is alive."