A PRACTICAL GUIDE TO THE NEW FREE-TRADE AGREEMENT BETWEEN SWITZERLAND AND CHINA

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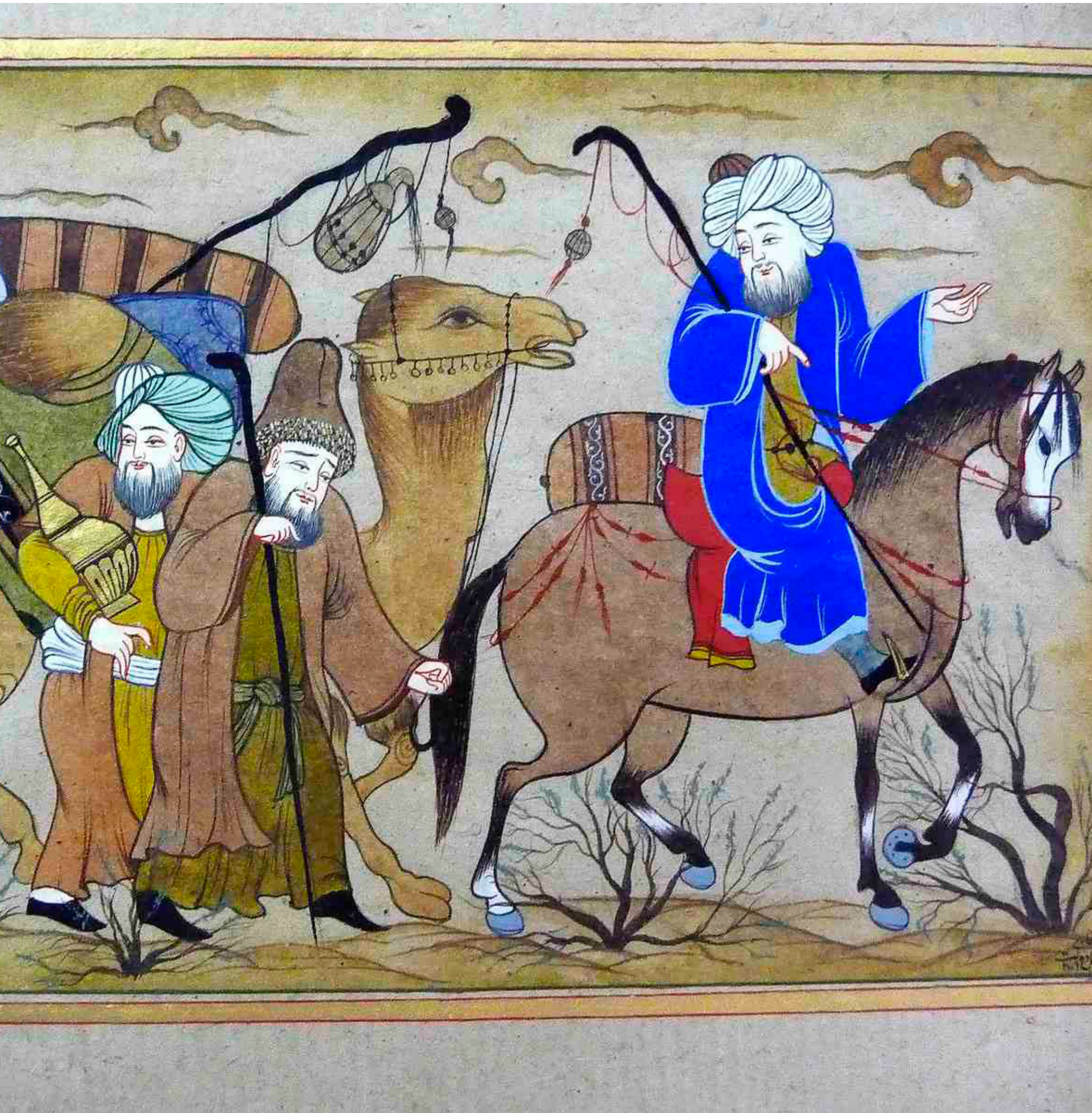

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I. Introduction

After two and a half years of negotiations, Switzerland and China signed a Free Trade Agreement ("the FTA") on 6 July 2013 – a milestone in bilateral relations between the two countries. The FTA grants tariff reductions on a very wide range of products: while Switzerland agreed to remove tariffs on up to 99.7% of goods imported from China, China promised tariff reductions on 96.5% of Swiss imports. The FTA is set to enter into force on the first day of the third month after the receipt of the last notification confirming that the agreement has been ratified by China or Switzerland. In Switzerland, the approval procedure by the parliament is expected to be completed in spring 2014, which leads to an expected entry into force by mid to end 2014.

This publication aims to give a comprehensive overview over the content of the FTA. It highlights the practical implications of the new trade regime on future business between China and Switzerland as well as a number of concrete challenges still lying ahead. Where appropriate, Wenfei comments on the new regime based on its 20 years of experience in Sino-Swiss legal and strategic advice.

II. Overview of the FTA's content

1. Rules of origin

In order for a product to benefit from the reduced tariff rates according to the FTA, it must meet the rules of origin as set out in the agreement, i.e. it must originate from either Switzerland or China, respectively. A product can meet the rules of origin under two headings:

a. Wholly obtained or produced products

A product is deemed originating from a country if it is wholly obtained in such country in accordance with article 3.3 of the FTA. This applies, among other examples, to natural substances, agricultural products or fishing products originating from national territory and to goods manufactured entirely from such products inside national borders.

b. Substantial transformation

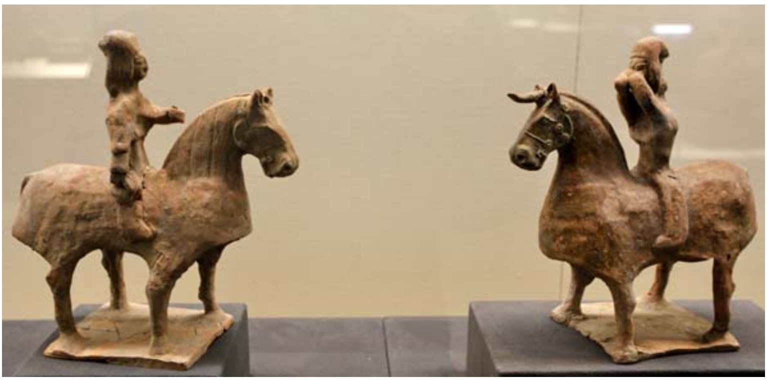
A product made up of materials of foreign origin meets the rules of origin if it has undergone substantial transformation in Switzerland or China in accordance with article 3.4 FTA and Annex II to the FTA. Substantial transformation can occur in three ways: the product undergoes a transformation substantial enough to (a) push the value of non-originating components below a certain percentage of the overall ex-works price of the product, (b) to cause a change in tariff classification, or (c) the product undergoes a specified manufacturing process set out in Annex II. Annex II lists all products according to their tariff classification and, for each category, specifies whether the product needs to satisfy the either first, second or third definition of substantial transformation or a combination of them.

Examples:

(a) According to Annex II, clocks and watches meet the condition of substantial transformation if their "Value of Non-Originating Material" does not exceed 40%, i.e. if the value of components not originating from Switzerland or China, respectively, does not exceed 40% of the total ex-works price of the watch ("VMN 40%").

(b) A relevant change in tariff classification occurs if the transformation process leads to a change in, depending on the product, either the chapter, the heading, or the sub-heading of the Harmonized Commodity Description and Coding System ("HS"). For example, roast iron pyrites (HS code 2601.20) are deemed substantially transformed according to Annex II if they are turned into high speed steel wires (HS code 7229.90).

(c) Silver meets the substantial transformation criterion if a change in the HS heading occurs or, alternatively, if it undergoes "electrolytic, thermal or chemical separation or fusion of precious metals of heading 71.06, 71.08 or 71.10" or "alloying of precious metals of heading 71.06, 71.08 or 71.10 with each other or with base metals".



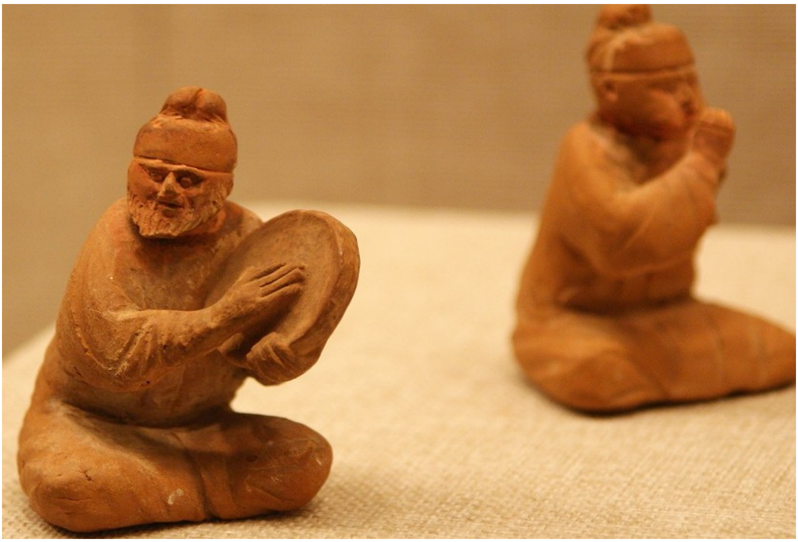
2. Tariff reductions

The applicable reductions in customs duties between the two Parties are set out in Annex I, Appendix 1 and 2, to the FTA.

Appendix 1 contains the schedule of concessions granted by China to Switzerland. It lists all products according to their HS classification and, for each item, specifies the base rate and the preferential tariff rate after the entry into force of the agreement. According to article 2.4 FTA, the base rate is defined as the most-favoured nation ("MFN") import customs duty rate applied on 1 January 2010, or a subsequently reduced rate if applicable. The preferential tariff rate is set out in the schedule for each year following the entry into force of the FTA as a percentage of the base rate. **Whereas duties on some products are eliminated from day one, duties on the majority of products will be reduced step-by-step on a yearly basis mostly within 5 or 10, at times within 12 or 15 years. While some of those tariff rates are gradually reduced to zero, others are only partially reduced.** For example, wrist watches with automatic winding and a precious metal case are gradually reduced from a base rate of 11% to a preferential rate of 4.4% over 10 years.

Appendix 2, which contains the schedule of concessions granted by Switzerland to China, also lists the MFN base rate for each item together with the preferential rate applicable after the entry into force of the FTA. As opposed to exports from Switzerland to China, imports into Switzerland are not subject to any transition periods: all tariff reductions occur from day one after the entry into force. The majority of import duties are reduced to zero.

According to article 2.8 FTA, both Parties will review the scope of the tariff reductions two years after entry into force of the agreement in a Joint Committee and continue to conduct biennial reviews thereafter. The Joint Committee is also mentioned in the other chapters of the FTA and, via several specific sub-committees, is tasked with monitoring and reviewing various aspects of the FTA framework over time. The impact this review mechanism will have in practice is not entirely clear at this time: is the Joint Committee merely going to monitor the correct implementation of the FTA or is it an actual tool to renegotiate certain terms, such as tariff rates or transition periods? The Swiss view is that the mechanism will effectively enable an ongoing adaptation of the FTA should new circumstances arise in the future. For example, the Swiss government may request fair treatment if, at some stage, the European Union and China conclude a free trade agreement with significantly more favourable terms.



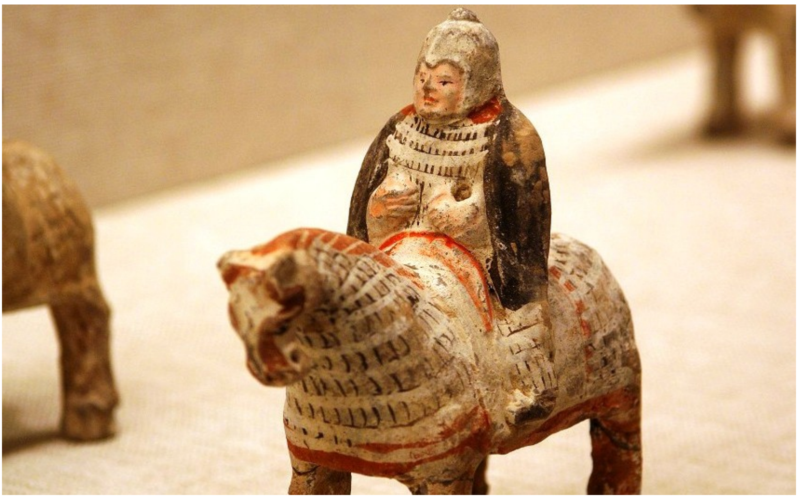
3. Trade in services

Chapter 8 of the FTA deals with trade in services, a domain that is of particular interest from a Swiss point of view given the paramount role of the service sector in Switzerland.

The provisions on trade in services are based on the structure of the General Agreement on Trade in Services of the World Trade Organization ("GATS"), to which China acceded in 2001. Just like the GATS, the FTA defines four modes of service supply: cross-border service supply, service supply within a Party's national territory to nationals of the other Party, commercial presence within the other Party's national territory, and service supply through the presence of natural persons on the other Party's national territory (article 8.2 FTA). Furthermore, like in the GATS, the terms and conditions of the market access granted by each Party is set out in a positive list, the so called Schedule of Specific Commitments ("Schedule"; article 8.17 FTA and Annex VII, Appendix 1 and 2). The Schedule also contains the terms under which foreign service suppliers may be treated less favourably than a Party's own service suppliers (*cf.* article 8.5 on national treatment).

A comparison of China's commitments made under the FTA with those currently made under GATS and the Catalogue for the Guidance of Foreign Investment Industries reveals that the former are largely consistent with the latter. For example, the construction, distribution, IT, business consulting or advertising or sectors, which are of particular interest to many potential Swiss investors, see no improvements compared to the GATS framework.

Similarly, banks and insurance companies will have to be patient as the FTA brings no immediate benefits. The GATS schedule as well as the FTA provide for the following regime: While Swiss non-life insurers are permitted to set-up Wholly Foreign Owned Entities ("WFOE"), life insurers are permitted to participate in Joint Ventures ("JV") with up to 50% ownership under the FTA as well as the GATS. Cross-border service is restricted except for reinsurance or insurance of large-scale commercial risks. Banks and other financial service providers are not restricted when it comes to foreign currency business in China, however, they may only serve enterprises with regard to local currency business. Except for the transfer of financial data and certain advisory services, cross-border supply is not allowed. For insurance providers as well as banks, the conditions for obtaining a license to conduct business in China and the permitted scope of business are consistent with the GATS framework (*cf.* Annex VII, Appendix 1, sect. II(7) A and B).

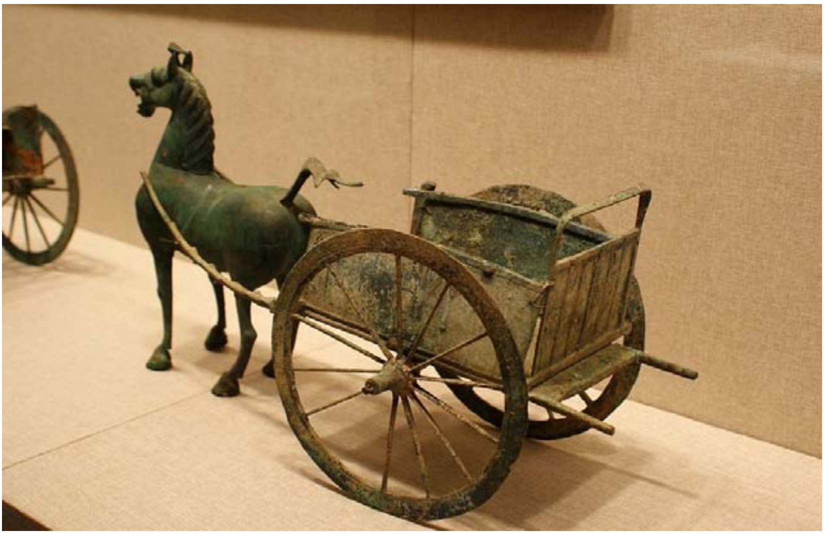


With regard to the securities sector, the FTA brings about certain benefits as opposed to the GATS schedule: Swiss securities institutions are permitted to establish JVs with up to 49% foreign ownership to launch funds and to engage in underwriting A shares and in underwriting and trading B and H shares as well as government and corporate debts. The general rule according to the latest Chinese Catalogue for the Guidance of Foreign Investment Industries is a maximum foreign ownership of 1/3, whereas the newly established Shanghai Free Trade Zone offers the same conditions as the FTA. JVs which meet the regulatory requirements, upon approval, are permitted "to gradually engage in securities brokerage, proprietary trading and asset management". Furthermore, Swiss service suppliers may provide services to Chinese Qualified Institutional Investors ("QDII"), such as securities trading, portfolio management, and custody for overseas assets – a privilege not granted under the GATS framework (*cf.* Appendix 1, sect. II(7)B).

While at this stage many of the rules applicable to foreign banks, insurers and securities institutions in the Shanghai Free Trade Zone are not entirely clear yet, the Chinese government has promised major liberalizations for the financial sector in the Free Trade Zone. The situation there remains highly dynamic and should be watched closely. In the medium-term, it is likely that within the geographical confines of the Free Trade Zone financial institutions will have significantly more options than under the FTA.

The most conspicuous difference to the GATS commitments relates to contractual service suppliers, such as installers and maintainers, architects and engineers, who are to be granted a stay permit of up to six months or one year according to the FTA Schedule (*cf.* Annex VII, Appendix 1, limitations on market access: sect. II(4)(c) and (d)). Certain benefits are also granted in the area of environmental services (waste water treatment, solid waste disposal, emission and noise control services), where WFOEs are permitted while the GATS schedule only allows for JVs with foreign majority ownership. Certain real estate services are also open for WFOEs (*cf.* Appendix 1, sect. II(1)D).

With regard to the Most-Favoured-Nation Treatment ("MFN"), i.e. the undertaking that each Party shall accord to services and service suppliers of the other Party treatment no less favourable than the treatment it accords to any third party, both sides reserve the same exemptions as in the GATS (*cf.* article 8.3 and Annex VIII). For Switzerland, these are most notably the areas in which bilateral agreements with the EU are in force.



4. Intellectual property

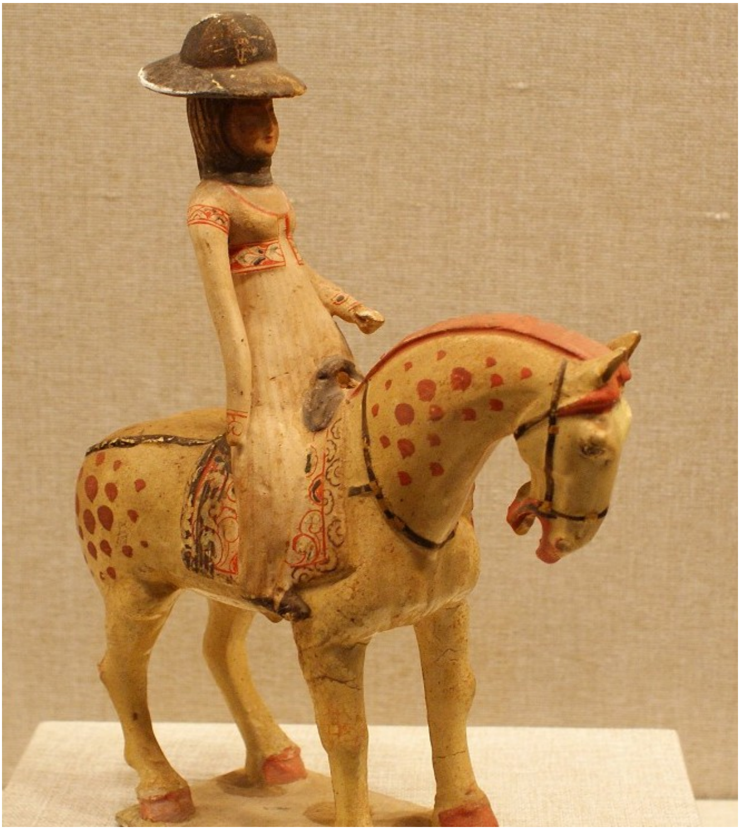
Section I of this Chapter includes provisions of a general nature, including a definition of intellectual property ("IP"), a general commitment to the protection of IP rights and to the existing international agreements to which both countries have adhered, as well as basic rules of information exchange. Section II defines the scope and use of IP rights, including copyright, trademarks, patents, genetic resources and traditional knowledge, plant variety protection, undisclosed information, industrial designs and geographical indications. Section III and IV, respectively, concern the acquisition and enforcement of IP rights.

Most of the provisions in this Chapter 11 are based directly or indirectly on the WTO Agreement on Trade Related Aspects of Intellectual Property Rights ("TRIPS") or on other international treaties of which both countries are member states. **Certain provisions go beyond or further specify the protection offered by TRIPS or other treaties.** However, this does not mean that they go beyond the protection currently granted by PRC legislation. For instance, in the area of copyrights, the existing protection under the WIPO Performances and Phonogram Treaty is extended to videograms (i.e. videotapes or DVDs), but these are already protected under article 29 of the PRC Copyright Law. With regard to trademarks, the FTA explicitly grants protection to acoustic marks, which are covered by article 8 of the new RPC Trademark Law, scheduled to go into force on 1 May 2014. Furthermore, the procedures outlined in article 11.16 FTA concerning the seizure of goods suspected to infringe on IP rights by customs authorities already exist in PRC law.

However, there are a few cases where the FTA appears to go further than current Chinese law and thus has a positive value:

- According to Chinese law, an applicant for confiscation of goods by customs may be required to provide a security of at least the value of the goods (irrespective of whether this may deter applicants from taking action). In contrast, the FTA stipulates that the amount of the security shall "not unreasonably deter" recourse to such enforcement procedures. To put this into perspective, it must however be noted that the TRIPS also contains the same qualification, which has done nothing to change realities on the ground.
- According to the FTA, customs may hand over or send samples of seized goods to the applicant. This option is not mentioned by Chinese law.
- Regarding enforcement, the FTA provides that the amount of damages caused by a violation of IP rights shall be determined in consideration of actual damages or a fair license fee. The possibility of using fair license fees for the calculation of damages is mentioned in the PRC patent and trademark laws, but not in the Copyright Law of the PRC.
- As to provisional measures and injunctions, the parties to the FTA must ensure that their judicial authorities may order prompt and effective provisional measures to prevent infringement to IP rights from occurring, including *ex parte* measures, where any delay is likely to cause irreparable damage to the right holder. Here the wording of the FTA is strong and rather detailed in comparison with the more general rules of property preservation of the PRC Civil Procedure Law. At the same time, it is unlikely that this will have an effect on the handling of such applications by People's Courts in practice.

- Regarding geographical indications, the FTA allows for a comprehensive protection of indications of source, country names and flags with regard to all goods and services. Although PRC law strictly forbids the abusive registration of such geographical indications in trademarks, the legal framework is rather patchy and lacks strong deterrents.



III. Practical implications of the FTA

1. Trade volume

Empirical research conducted by the Swiss State Secretariat of Economic Affairs ("SECO") on the economic implications of free trade agreements concluded by Switzerland between 1998 and 2008 has shown that trade volume between the parties grows by an average of 10.5% per annum in the first four years following the conclusion of a free trade agreement. Swiss foreign direct investment on the free-trade partner's territory grows by an average 18% per annum in the same period.

Switzerland's most important exports to China are machinery, mechanical appliances, precisions instruments, chemical and pharmaceutical products, and watches. The bulk of China's exports to Switzerland is made up of data processing machines, electronic appliances, textiles and chemicals. While almost all of China's major export goods will benefit from an immediate elimination of all duties, the tariff rates on most of the major Swiss exports to China will be subject to transition periods of 5 to 10 years. As result, the effect of the FTA on Swiss export growth will most likely not be immediate, instead it is expected to take some time to be felt.

2. Foreign direct investment

While foreign direct investment ("FDI") between Switzerland and China has already surged throughout the past years, the Sino-Swiss FTA is expected to further compound this trend in the near future. The most notable stimulus to FDI flows is expected to occur in the production sector, which currently makes up the bulk of economic relations between China and Switzerland, as lowered trade barriers facilitate the movement of intermediate or final products between parent firms and their foreign affiliates in the two respective countries.

The provisions relating to investment promotion supplement the bilateral agreement between Switzerland and China on the promotion and mutual protection of investments ("BIT"), which came into force in April 2010. As the BIT remains in force unchanged, the provisions of the FTA are confined to investment promotion. Article 9.1 FTA holds that the two countries are committed to "promoting mutual cross-border investment and technology flows", but stops short of setting any clear and binding guidelines.

IV. Implementation planning

1. Approved exporter system

To qualify for preferential tariff treatment under the FTA, the exporter must submit either a Certificate of Origin issued by an authorized body of the exporting Party or a Declaration of Origin on the invoice or shipping note (i.e. a self-declaration) to the customs authorities of the importing Party.

A template of the Certificate of Origin for each Switzerland and China is contained in Annex III to the FTA (*cf.* article 3.15 FTA). In contrast, the Declaration of Origin is to be completed by the exporter itself in accordance with article 3.16 FTA and the sample text provided in Annex IV. A Declaration of Origin can only be affixed by an Approved Exporter, whose prior examination and approval is subject to the domestic rules and regulations of the exporting Party. Each Origin Declaration is valid for 12 months and must be retained for at least 3 years. Both Parties to the FTA must communicate to each other the names and registration numbers of all Approved Exporters along with the serial numbers of the Origin Declarations before 31 March of each year.

The approved exporter system brings great advantages to exporters in both countries. In order to benefit right from the start, exporters should get themselves informed and start the application procedure early. This is particularly true for exporters based in China, where such a system is implemented for the first time, so that some of the procedures are not yet clearly established in practice. In Switzerland, the exporter must fill out a form available for download on the website of the Swiss Customs

Administration and address a signed application to the Customs Directorate in the applicable District in accordance with the Federal Ordinance on the Issuance of Certificates of Origin (SR 946.32).

2. Value chain planning

The impact of the FTA goes beyond products exclusively manufactured in and traded between China and Switzerland. While the Swiss economy is deeply integrated with the European market, China notably forms a comprehensive free trade area with the Association of Southeast Asian Nations ("ASEAN"), which was implemented in January 2010 and makes up the largest free trade area globally in terms of population.

As a result, multinational companies operating in the European Union and/or ASEAN may potentially benefit from the Sino-Swiss FTA by making certain adjustments to their value chain. An intelligent modification of the supply chain, e.g. by establishing manufacturing facilities in Switzerland or China or optimizing supply sources in order to meet the rules of origin on substantial transformation, could lead to significant duty savings. The planning process should begin with an evaluation of current trade flows and customs expenditures and include a cost-benefit analysis pertaining to the FTA's coverage of the relevant products, the applicable timeline and extent of the tariff reductions, the amount of potential duty savings that can be achieved, as well as the prospective costs of the required supply chain modifications.

There are a number of potential set-ups allowing companies to optimize their benefits under the Sino-Swiss FTA in combination with other free trade frameworks entered into by China or Switzerland. A few illustrative examples involving the EU and ASEAN can be visualized as follows:

CH supplier	Reduced or 0% tariff →	CN producer	0% tariff →	ASEAN consumer
CN supplier	0% tariff →	CH producer	0% tariff →	EU consumer
EU supplier	0% tariff →	CH producer	Reduced or 0% tariff →	CN consumer
ASEAN supplier	0% tariff →	CN producer	0% tariff →	CH consumer

V. Practical issues

1. Non-tariff barriers and administrative hurdles

Chapter 6 of the FTA deals with technical barriers to trade. It reaffirms the WTO Agreement on Technical Barriers to Trade and the application of international technical standards. Chapter 6 also provides for intensified and continued cooperation on such issues, in particular by creating a sub-committee on technical barriers to trade which shall monitor the implementation of the measures and facilitate technical consultations. Furthermore, article 2.5 FTA incorporates article XI of the WTO General Agreement on Tariffs and Trade of 1994 ("GATT") into the free trade framework, which prohibits trade restrictions other than duties, taxes or charges, such as quantitative restrictions (trade quotas), licenses or other types of import and export restrictions.

Despite this comprehensive legal framework, past experience with other free trade agreements in China has shown that the implementation of smooth import and export procedures can be tricky in practice and that there is often a lack of clarity when it comes to Chinese customs requirements. Trading companies should be aware that administrative hurdles, slow processes and unexpected difficulties at the border are likely to persist also under the new FTA framework. Hence, carefully examining customs requirements, planning ahead and maintaining good relations with the authorities will continue to be of crucial importance when conducting trade with China.

A specific example that is likely to remain to be a cause for delays and a reason for planning ahead is the China Compulsory Certificate ("CCC"), a compulsory safety mark required for many products imported, manufactured or sold in the Chinese market. In frequent cases, it is unclear whether a product is exempted from the CCC, which can cause difficulties in obtaining customs clearance. The certification process involves several steps, including product tests, factory inspections and evaluations, and usually takes around 4-8 months to complete. The CCC certificate must be renewed annually. Similar issues arise in connection with some other compulsory certificates.

Another frequent cause for delays that is likely to persist even after the entry into force of the FTA are random and lengthy inspections or audits by customs authorities at the border.

2. Indirect shipment

Exports frequently undergo transit through third countries before they arrive at their country of destination. For geographical reasons, this is especially true for shipments out of Switzerland.

In article 3.13, the FTA points out that preferential tariff treatment shall only be granted to originating products which are transported directly between the Parties. Goods transported through the territories of non-parties may still be considered as being transported directly between the Parties, provided that: (a) they do not undergo operations other than unloading, reloading, or any operation confined to preserve them in good condition; and (b) they remain under customs control in those non-parties.

It is therefore important for exporters to pay attention that products do not undergo any further treatment, leave customs supervision or enter into trade or consumption in transit-countries before they are shipped to China or Switzerland, respectively. In certain cases, customs authorities at the port of entry may require documented confirmation by authorities of transit countries that the products have not been subject to any additional operations within their territory. On the positive side, past experience with FTAs has shown that customs authorities at the port of entry usually take it into account where transit through third countries is justified for geographical reasons.

3. Third party invoicing structure

Multinational companies usually operate supply chain structures which de-link the flow of goods from the flow of invoices, i.e. there is no single invoice that correlates with the movement of goods because a trading or administrative entity located outside the borders of the country of export, not the exporter itself, issues the invoice to the importing entity. The exporter, on the other hand, will invoice a different amount to the administrative entity. While some other FTAs mention this type of third party invoicing structure in a more or less accommodating manner, the Sino-Swiss FTA is silent on the issue.

This may lead to certain challenges in the country of import as authorities may deny the application of preferential treatments because of discrepancies in value between the Certificate of Origin and the invoices or because of difficulties in calculating the value added in the last invoicing country. Furthermore, it cannot be excluded that the lack of a pertaining rule in the FTA may lead authorities to conclude that preferential treatment can only be applied in cases where the invoice originates from the same entity or at least the same country as the shipment. Challenges may also arise in the country of export as authorities may not be willing to issue a Certificate of Origin until a copy of the invoice from the foreign third party is presented, which for supply chain management reasons (confidentiality, “price-masking”) may not yet exist at the time of exportation.

In summary, the fact that the FTA is silent on third party invoicing structures does not necessarily mean that they will not be feasible in practice, much less does it mean that the Parties to the FTA actually intended to exclude such supply chain structures from preferential treatment. Rather, it means once again that multinational companies will have to examine their supply chain practices in advance and, if necessary, initiate discussions with the customs authorities prior to conducting exports under the framework of the FTA.

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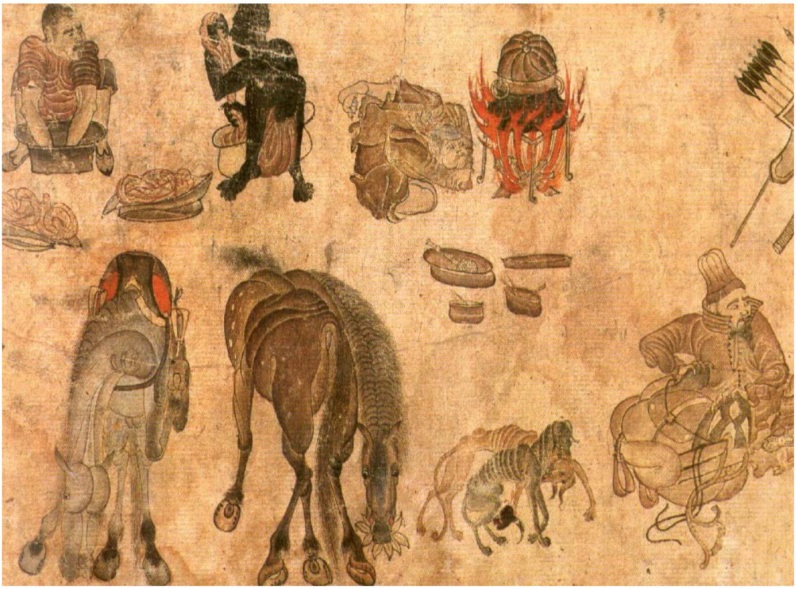

Wenfei Law is a Swiss law firm with duly registered offices in Zurich, Beijing and Shanghai. With our team of Western lawyers with Chinese expertise and Chinese lawyers with additional educational backgrounds in the West, we are truly local both in China and Europe.

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