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Subject China's Corporate Social Credit System

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I. Introduction

The Chinese government has beencollecting a massive amounts of individual and company data for a long time as part of its initiative to establish a comprehensive social credit system that encompasses all individuals, legal entities and government offices.The national Social Credit System 社会信用体系 (SCS) is operational and processing vast amounts of collected data in centralized facility as of the beginning of 2020.

It is worth noting that such a system is directed to individuals as well as to companies, government bodies and judicial authorities. This report, however, focuses only on China's *Corporate Social Credit System* (the "CSCS"). The CSCSis established based on the collaboration of various administrative bodies and aimsto increase and complete controlover all market participants. Data produced by differentmonitoring systems will be processedina data collection center managed by the central government, where an algorithm-based data analysis will apply.With the operation of the CSCS, the Chinese government intends to create a panoptical market, where market participants – more than ever – are permanently and comprehensively monitored and rated.

II. Historical background of the CSCS

In 2014, the State Council of China published its *Outline Plan for the Establishment of a Social Credit System*(the "Outline Plan"), setting out the goals and specific timeline for the Social Credit System (the "SCS").The CSCS is a category within the SCS concerning companies. Public credit records for companies have been under development ever since, allowing the general public to access the basic information of registered companies directly online.

In July 2019, the State Council promulgated the *Guiding Opinion on Accelerating the Constructionof the Social Credit System and the Construction ofa New Credit-based Monitoring System* (the "Guiding Opinion"). In September 2019, the National Development and Reform Commission (the "NDRC") issued a notice on*Promotion and Applying Market Actors' Public Credit Comprehensive Evaluation Results*(the "NDRC Notice").According to the NDRC Notice, about 33 million companies have been evaluated and rated and such results would be shared on provincial-level information sharing platforms.

It feels like again a big change on the ever-changing Chinese market – but is it really? The following report intends to shed light on the mechanics of the CSCS, analyzefactors that willaffect business operations in Chinaand lay out our recommendations for business operations facing the CSCS in China.

III.Panoptic Monitoring System and Joint-sanctions

a.) Data of Private Entities in China

The CSCS introduces a panoptic monitoring system to the Chinese market that in the future is said to monitor all areas of business. For private entities in China it is significant to be aware of the main areas that are subject to the CSCS and to know the main administrative and judicial bodies involved.

According to the Outline Plan, the following areas are in the main focus of the CSCS:

- Manufacturing, particularly for companies operating in the field of coalor other mining, dangerous chemicals, special equipment and civil explosives and so on;
- distribution, particularly for companies operating in the field of wholesale, retail, logistics, accommodation and food service;
- finance, whereby the focus lies on data related to customer protection against fraud, debt evasion, insider trading, fraudulent representation and disclosure, illegal fundraising, illegal foreign exchange transaction;
- taxation, whereby information related to transactions, assets and tax payment records will be exchanged amongst the administrative bodies to ensure a higher level of compliance;
- construction, particularly with a focus on the improvement of the market entry and exit rules and more consistent prosecution of violations of safety defaults:
- government procurement, in particular suppliers, experts, procurement agents and other actors.

The basic data relevant for the CSCS will be composed of information collected, received and published by various administrative and judicial bodies such as the Administration of Industry and Commerce (the "AIC"), the General Customs Office (the "GCO"), the State Taxation Bureau (the "STB"), the Environmental Protection Bureau (the EPB"), the State Trademark Office (the "STO) and the State Courts (the "SCT").

According to the Guiding Opinion, the information processed by the AIC, the GCO, the STB, the EPB, the STO and the SCT is shared between these and other authorities. The goal of such exchange of information is to create an official, comprehensive and public record that reflects each company in all-embracing way.

b.) CSCS Information Sources

A company'sratingis published on several different platforms and made visible to all participants on the Chinese market. There are several credit assessment platforms which implement the CSCS. Amongst others, the following are the most important company rating information platforms:

- *Credit China*（www.creditchina.gov.cn): Established in June 2015, it is a platform that publisheskey credit informationon individuals and on companies. Theplatform provides key information in the fields of tax envision, product safety and others. It also provides for a list of blacklisted entities.
- *National Enterprise Credit Information Publicity System* (www.gdgs.gov.cn): Is the official CSCS online platform.Compared to theCredit China platform, it features more detailed information on a company's CSCS records such as registration information of enterprises, results of government supervisions and inspections, administrative penalties and so on. Companies can be found by their name or their so-called Unified Social Credit Code. The platform lists companies with irregular business practices as well as blacklisted companies;
- *People's Bank of China Credit Center*: A platform that publishes all kinds of personal credit information, including small and micro entities;
- *National Construction Market Integrity Information Platform*: A platform that features credit information records of companies in the construction industry;
- *Credit Publicity Platform of Import and Export Business of Customs*: A platform built by the Custom Administration.

c.) Joint-sanction System

On May 30, 2016, the State Council issued the *Guiding Opinion on Establishing and Improving the System of Offering Joint Incentives to Acts in Good Faith and Imposing Joint Punishments against Acts in Bad Faith to Accelerate the Construction of Social Integrity* (the "Opinion on Joint-sanctions").

The Opinion on Joint-sanctions sets out a regulatory framework for incentives and punishmentsdependent on the CSCS records. Such joint measures follow the principle"one infringement, everywhere limited"– a problematic principle from a legal point of view. Consequently, a bad rating in one area may not only lead to a punishment in this very area but alsoto other sanctionsoutside factual context.

According to the Guiding Opinions, a bad rating or compliance-record leads to different sanctions,such as penalty fees, court orders or blacklisting. The sanction mechanism operates among different government departments. This means that sanctions are not only levied by one authority based on the rating it is directly responsible for, but also in response to negative ratings in other areas where a different administrative or judicial body is responsible. For example, a record as a distrusted taxpaying company may not only lead to tax-specific sanctions but also to deniedapprovals or restricted land use rights. Which in certain cases might even be a positive result from a public asset protection point of view; in other cases, however, it could appear to be too discriminatory.

Article 32 of the *Announcement of the State Administration of Taxation on Issuing the Measures for Tax Credit Administration for Trial Implementation,* provides for measures by other authorities such as restrictions to business operations, investments, financing measures, land use rights, import and export activities, staff entering or leaving China, new company registrations, tenders or biddings for projects ifa taxpayeris rated with the lowest possible D rating. This tax law provision dates back to the year 2014. With thejoint-sanction system simplifying and speeding-up communication between provincial and national governments and other administrative bodies, the CSCS will facilitate a more rigorous implementation of such sanctions.

Severe misconduct is sanctioned with blacklisting. Due to the joint-sanction system, a blacklisted company will face further sanctions, similar to the afore-mentioned example. Blacklisting and related sanctions will lead to reputation damage, increased difficulty in obtaining project approvals or permits, prevention from tax benefits and financial subsidies, downgrading of other of credit records, restriction from participation in government procurement and more frequent government inspections. In very serious cases, companies may even be restricted from engaging in business activities at all.

According to the *Memorandum of Understanding on Taking Joint Disciplinary Actions against Dishonest Persons Subject to Enforcement* (the “MoU”), jointly issued by a number of government and administrative bodies, the legal representative and other so-called key personnel of a listed company may also be held liable.

IV. Suggestions for Your Business in China

a.) For foreign invested enterprises (FIEs)

FIEsin their daily operationshave to pay attention to the factors which may affect their CSCS record. The following areas arecrucial for FIEs to avoid bad CSCS records:

- Litigations, breaches of contract, enforcement cases and labor arbitrations;
- customs offences;
- tax issues;
- infringements of IP-rights
- delayed bank loans;

- other non-compliant actions, e.g. regarding environmental standards.

It is worth noting that bad CSCS records of an FIE may have serious negative effect on the legal representative'sor other so-called key personnel's individual SCS record.The MoU, for instance, which was signed by 44 governmental bodies, proposes 55 disciplinary measures to impose comprehensive restrictions on companies (and persons holding important positions in the companies) who are subject to the enforcement. These measures include theexclusion of companies from establishing financial institutions, the ban of key personnel to take management positions in other companies, restrictionson taking business class flights or high-speed trainsand other disciplinary actions.

FIEs willing to improve their CSCS records should pay particular attention to the following points:

- Qualifications, permits and awarded patents and similar;
- awards from governmental bodies;
- good record on corporate social responsibilities, charities for public interests;
- growth of tax payment;
- ratings from regulatory departments;
- scoresof third-party ratingagencies.

FIEs should keep a close watch on their ratings and compliance recordsregarding the important areas as mentioned above and in other areas that are subject to the CSCS and might be significant for a FIE because of its scope of business. FIEs are further advised to not only observe their own CSCS records,but also keep an eye onrecords such as records of their key-personnel and business partners.

b.) For foreign investors

Foreign investors, who are involved in M&A projects in China, must be aware of the CSCS throughout their project.

CSCS information sources serve as a first access point for foreign investors to do research on companies of interest. This is a good starting point for a preliminary due diligence on a Chinese target company or potential business partner.

Based on the results collectedfrom such information platforms, red flagged areas of a potentialtarget or partner may be identified. However, foreign investors should be aware that the information displayed may not be complete and more in-depth research is certainlyrequired. Nevertheless, foreign investors may profit from the comprehensive CSCS data available to create a preliminary evaluation of potential targets and partners.

Furthermore, it is advisable forforeign investorsto include a warranty and indemnity clauseregarding a company's CSCS records and/or an obligation of the contractual partner tokeep their SCSC in due course as well as SCSC related information duties.

V. Credit restoration

According tothe*Guidance on Speeding up the Construction of a Social Credit System and Building a New Credit-Based Regulatory Mechanism*(the "Guidance")Companiesmay actively restore their credit when receivinga bad rating.

The Guidance indicates ways on how a company can restore an unfavourable CSCS record. Amongst others, the following measures may be taken:

- Making a credit commitment;
- requesting a rectification of the CSCS record;
- passing credit verification;
- receiving special training;
- submitting a credit report;
- and participating in charitable activities for public welfare.

After companies have completedcredit restorationmeasures, all departments in each region, in accordance with procedural rules, muststop publishing unfavourable company records and terminate the implementation of joint-sanctions.The State Councilfurther announced that bad CSCS records shall not be kept more than five years in accordance with existing laws and regulations. The State Councilfurther announced that it will speed up the establishment of acommunication mechanism toincrease the awareness of companies affected by a bad CSCS rating on how to restore a good record.

Although there is no comprehensive regulation on thereparation of a company's CSCS record, various local authorities and specific administrative bodies have published guidelines on credit restoration within their responsibility.

The STB, for example, on November 7, 2019, released *the Announcement on Matters Related to Tax Credit Restoration* which entered into force on January 1, 2020. According to this, corporate taxpayers can apply for tax credit restoration by correcting tax irregularities and making credit commitmentssince the beginning of this year.On July 1, 2019, the official online SCSC platform, the *National Enterprise Credit Information Publicity System*,issued a guideline on how to restore credit on its platform after companies have received administrative punishment. On a provincial level, different provincial governments,such asZhejiang, Jiangsu andSichuan,have issued measures to restore CSCS ratings already in 2018 and 2019.

VI. Conclusion

This contribution to the CSCS explained the basic mechanism of the new monitoring system for companies and, with a focus on FIEs and international investors, highlighted the factors that are of particular importance for business activities or investment projects in China under the regime of the new CSCS.

In conclusion, it should be noted that even after the introduction of the CSCS, those areas that have been known to the affected companies for several years will continue to cause intensive compliance efforts. These are in particular areas such as taxation, customs, intellectual property rights and environmental protection.

What is new is that various company ratings and compliance records will be brought together, processed and published as an overall picture of a company. The CSCS aims to increase the interconnectivityof the authorities and administrative bodies involved, resulting in a more vigorous distribution of sanctions and rewards.

Wenfei will keep a close eye on the further development of the CSCS and will inform in due course and with a strong link to practice.

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