

Client Alert

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Baker McKenzie FenXun
A Leading Chinese and
International Law Joint Platform



For further information, please contact:

Beijing

Zhi Bao
Partner
+86 10 5649 6066
baozhi@fenxunlaw.com

Vivian Wu
Senior Counsel
+86 10 6535 3860
vivian.wu@bakermckenziefenxun.com

Scott Silverman
Special Counsel
+86 10 6535 3969
scott.silverman@bakermckenzie.com

Hong Kong

Tracy Wut
Partner
+852 2846 1619
tracy.wut@bakermckenzie.com

Shanghai

Howard Wu
Partner
+86 21 6105 8538
howard.wu@bakermckenzie.com

Cherrie Shi
Partner
+86 21 6105 8511
cherrie.shi@bakermckenziefenxun.com

Zhenyu Ruan
Senior Counsel
+86 21 6105 8577
zhenyu.ruan@bakermckenziefenxun.com

Are you ready for China's Social Credit System?

Chinese government authorities have recently issued a series of policies and draft amendments to push forward the establishment of the Social Credit System (SCS). Multinational companies are particularly concerned at how the SCS could affect the business operation of their Chinese subsidiaries. The following are selected developments released by various key government authorities:

- July 9, 2019: the State Council issued the Guiding Opinion on Accelerating the Establishment of the Social Credit System and Building a Credit-based Monitoring System;
- July 10, 2019: the State Administration for Market Regulation issued an amended draft of the Measure for List of Entities and Individuals With Serious Illegal or Untrustworthy Conduct (amendment for public comments); and
- September 1, 2019: the National Development and Reform Commission (NDRC), the key regulator mandated by the State Council to lead the establishment of the credit record platform and coordinate with other relevant regulators in this regard, issued a notice regarding Furthering and Applying Market Actors' Public Credit Comprehensive Evaluation Result, which mentioned that around 33 million companies have been evaluated and rated and such results will be shared on provincial-level information sharing platforms.

This alert provides an overview of the SCS, its working mechanism and potential implications, as well as our general observations and recommendations.

1. Background

The proposal to establish a comprehensive SCS is not new. The State Council of China published the *Outline Plan for the Establishment of a Social Credit System* (the "**Outline Plan**") back in 2014. The Outline Plan envisages that a comprehensive SCS will be largely in place by the end of 2020. It clarifies that the goal of the SCS is to promote the integrity and credibility of the whole society by establishing a credit record infrastructure network in accordance with laws, regulations, standards and contracts. The Outline Plan states that due to the lack of a well-established SCS, various issues have recurred, such as serious production safety accidents, food safety accidents, commercial fraud, and tax evasion. The Outline Plan thus aims to establish the SCS legal and standardized systems, build the SCS infrastructure, and make the incentives and penalty systems fully functional by 2020.

Further, on May 30, 2016, the State Council issued the *Guiding Opinions of the State Council 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* ("**SC**





Guiding Opinions"), which lays out the general regulatory framework for the incentives and penalties in association with the SCS system.

In practice, some Chinese regulators, such as the market regulation administration, customs and tax bureaus, have already implemented their respective credit systems in the course of supervising the operation of business partners (including both domestic entities and foreign invested enterprises). Further, the National Credit Information Sharing Platform ("**Platform**") has been launched as the central database for the SCS since October 2015. The Platform is run by NDRC and the State Information Center and is expected to integrate all local and central-level government data sources across various regulators.

The Chinese government considers the SCS as an important step in the further development of the Chinese economy in an orderly manner. The Outline Plan makes it clear that the SCS is applicable to all sectors: government departments, business entities, social organizations and even the judiciary. With respect to business sectors, the SCS is to promote positive business conduct and penalize serious illegal and untrustworthy conducts by effective and efficient monitoring of companies. To this end, information technology will be deployed to collect and collate data from various Chinese regulators and courts.

To sum up, the SCS intends to establish an information sharing platform covering all the credit and rating information administered by various Chinese regulators. The SCS does not replace the credit and rating system administered by various Chinese regulators. Instead, it operates in parallel with those information systems and relies upon the credit and rating information shared by these regulators.

2. Joint Sanctions

A major concern triggered by the proposed establishment and implementation of the SCS is the "joint sanctions" — as embodied by the general principle of "misconduct somewhere, restrictions everywhere" (一处违法、处处受限). It means an offending company would not only receive sanctions from the government authority that is responsible for enforcement of its illegal or untrustworthy conducts, but should also expect restrictions and negative treatment from other government agencies. In other words, if a company is placed on a blacklist, it may suffer from various implications including without limitation to:

- name and shame;
- increased difficulty in obtaining project approvals and permits;
- exclusion from tax preferential treatment;
- exclusion from financial subsidies;
- credit rating being lowered;
- restrictions on government procurement and bidding activities; and
- being subject to more frequent government inspections, audits and supervision.



- in an extreme case, where a company refuses to perform a court judgment or administrative decision, or repeatedly commits an offence, it may be restricted from engaging in business operations.

It is important to note that a serious misconduct by a business may not only affect the company itself, but may also have implications to such company's senior management. If a business entity is placed on a blacklist and receives joint sanctions, the legal representative, manager and other senior management of such company may also be held liable. The personal SCS ratings and records of these individuals will also be affected due to the company's negative rating.

That said, it is worth noting that not every non-compliance would result in a company being blacklisted for joint sanctions under the SCS. According to the SC Guiding Opinions, joint sanctions would be imposed on key areas and serious illegal and untrustworthy conducts, including without limitation:

- conduct seriously jeopardizing people's life, health or safety, such as the serious illegal and untrustworthy conducts in the areas of food and drugs, environmental protection, construction quality, safety production, fire prevention, and compulsory product certification;
- conduct seriously disrupting market order or social order, such as bribery, tax evasion or fraud, malicious evasion of debts, contract fraud, operating without a license, production of fake products, unfair competition, and false advertisement;
- refusal to perform statutory obligations, which seriously affects judicial and administrative authorities' authoritative power; and
- refusal to perform national defense obligations.

Chinese regulators have issued and are still working on various rules to provide further guidance as to what serious illegal and untrustworthy conducts will lead to a company being blacklisted. Generally speaking, being placed on the blacklists is due to serious violation of laws and regulations and/or serious damage caused to society, public or consumers. If the illegal and untrustworthy conducts are not serious enough to be included in the blacklist, it may be covered by a monitoring list, which usually means more frequent government inspections, audits and supervision. Some published rules also contain more details on the procedures on companies being blacklisted as well as being removed from a blacklist.

Additionally, it is worth noting that various incentives will be offered to the companies covered by a "red (white) list (which have maintained good credit status and/or received awards for integrity. For example, green channels for processing tax matters, priority in customs clearance, and priority when applying for certain permits and licenses.

3. Working Mechanism

The implementation of joint sanctions is based on the Memoranda of Understanding ("**MoUs**") signed by various Chinese government authorities. Under the MoUs, the parties agree to recognize other government authorities' judgement on whether an entity should be listed on the black or red(white) list as the basis for sanctions or rewards for the matters subject to their



jurisdiction. Reportedly, so far more than 50 MoUs have been signed, covering a broad range of areas/industries, including without limitation tax, accounting, statistics, finance, government procurement, intellectual property, environmental protection, e-commerce, insurance, real estate, culture and tourism, scientific research, charitable donation, electronic authentication, food and drugs, trade, oil and gas, transportation and logistics, and electricity.

- When the SCS is fully in place, general information and credit data relating to a business will be gathered from different sources, analyzed, and published on a centralized platform, i.e., www.creditchina.gov.cn. The sources of data will likely include:
 - information collected by various government agencies (including information supplied by companies themselves during annual reporting);
 - real-time data (e.g. pollutant emission levels);
 - results of government supervisions and inspections;
 - data from partnering private companies (e.g. Alibaba); and
 - CCTV surveillance.
- A central database and information sharing platform, called "Internet + Monitoring" (互联网+监管), is currently being developed. Once launched, the platform will allow automatic integration and analysis of data collected from the various sources mentioned above. At this stage, it is unclear whether all data will be publicly available, or if certain data will only be accessible to the authorities.
- Reportedly, 14 localities have been designated as pilot locations to test-run the "Internet + Monitoring" platform. Shanghai, one of the pilot cities, will begin its trial in late September 2019. The platform is expected to officially launch in Shanghai by the end of the year. The effects of joint sanctions are expected to be more strongly felt once data is fully integrated and the "Internet + Monitoring" platform is officially launched.

4. Observations and Recommendations

The SCS aims to improve the effectiveness and efficiency of monitoring and supervising business operators. Once fully established and functional, SCS is expected to provide more transparency with respect to the compliance status of business operators and may also act as a deterrent against non-compliance.

On the other hand, it will be necessary to ensure the blacklisting and joint sanctions system is implemented with due process in place to minimize the adverse impact to bona fide business operators trying to conduct business in China in a compliant way. With the increase in data protection concerns in China, it remains to be tested as to what measures business operators and relevant management personnel could take to effectively protect confidential or sensitive data under the SCS.

Although the SCS is not fully established and functional yet, a clear message has been delivered that Chinese regulators are working together to make it



happen. We thus recommend companies consider taking the following actions to prepare and mitigate the potential risks associated with the SCS:

- conduct a health check on key regulatory and compliance risks and implement risk-mitigating measures as soon as feasible. The health check should focus on the top issues that have been subject to regulators' enforcement and may cause substantial damage to the consumers and the general public (e.g. food safety incidents, serious environmental pollution issues, bribery);
- regularly monitor credit records and credit ratings, and take a proactive approach to communicate with regulators if any negative entry has been made;
- check and monitor the credit records of potential and existing business partners to timely address any identified red-flag risks as needed; and
- closely follow up on the regulatory development in this regard (in particular the blacklisting rules issued by various regulators) and implement risk-mitigating measures accordingly.

www.bakermckenziefenxun.com
www.bakermckenzie.com
www.fenxunlaw.com

Baker McKenzie FenXun (FTZ)
Joint Operation Office
Unit 1601, Jin Mao Tower
88 Century Avenue, Pudong
Shanghai 200121, PRC

Tel: +86 21 6105 8558
Fax: +86 21 5047 0020