ON THE SUBJECT

SOCIAL CREDIT SYSTEM FOR FOREIGN-INVESTED ENTERPRISES IN CHINA: IMMINENT CHALLENGES?

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DR. NIKOLAUS VON JACBOS, DING HAN

INTRODUCTION

The comprehensive establishment of China's Social Credit System (SCS) has already started. In July 2019, the State Council again issued Guiding Opinions to accelerate the establishment of the SCS and a credit-based new regulation system. The SCS is scheduled to be fundamentally completed in 2020 and ideally fully implemented at the end of 2020, so having an adequate knowledge of SCS becomes more urgent than ever.

Besides the other two Chinese credit systems, which include credit system of the People's Bank of China and the non-governmental third-party credit system (similar to Schufa system in Germany), the SCS is meant to be the most comprehensive credit system operated by the Chinese central government. The SCS applies to all Chinese enterprises, social organizations and individuals.

This article will focus on Foreign-invested Enterprises (FIEs) in China, which have been hop-ing for a more transparent and fair competition environment in the Chinese market. However, although there are many potential benefits, complications and challenges could also lie in wait. How should FIEs understand the SCS-related policies in a thorough and right way and benefit from them? This article will shed some light on these points.

CHINA'S SOCIAL CREDIT SYSTEM

With the release of the "Outline Establishment Plan of the Social Credit System of China (2014-2020)" (hereafter referred as "the Plan") in June 2014, the comprehensive establishment of China's Social Credit System (SCS) announced its official start. The Plan aims to lift its credit system management up to the level needed for the current economic and social governance developments. According to the Plan, the design of SCS mainly focuses on four areas:

1. Government affairs
2. Commercial activities
3. Social activities
4. Justice system

The applicable subjects would be all enterprises, social organizations and individuals registered in China[1]. Supported by corresponding legal framework and technological tools, the establishment of China's SCS will be fundamentally completed by 2020. By then, with the help of a well-established credit evaluation system, the whole society will create a dynamic business culture with integrity, a sound credit-information system and a functional credit-based incentives-punishment mechanism[1]. To be more specific, social or market behaviours of an enterprise in China—either domestic or foreign-invested—would leave credit records in every related regulatory areas such as finance, tax or custom, which would be further collected and saved to the central information system. The enterprise would then get an overall evaluation on its social credit based on those credit records, and accordingly receive prospective incentives or punishments.

The Chinese government has invested much in digitalization and big data application. Besides the aforesaid central information system (not open to the public) used only by the government internally to stitch data together, there are also web portals built for the publicity of credit information and inquiries, including "Credit China," the most authoritative and comprehensive web portal operated at the state level by the central government; separate web portals operated by authorities in different regulatory areas such as customs or tax; and other local-level web portals. Moreover, a data sharing system between government departments is set up for exchanging credit information and tracing administrative decisions[2].

In addition, the establishment of SCS also involves third parties. The government can purchase services from qualified third parties and cooperate with them to enhance technical capacity, especially in relation to big data calculation, related application and the video monitoring system (to be more clear, the video monitoring system is not used to supervise enterprises' operational activities, but rather to monitor the service quality of government authorities and visualize statistics[3]). So far, the Chinese government has already started cooperation with Huawei, Alibaba, Tencent, Taiji Computer and VisionVera in the above-mentioned sectors[4, 5].

DUTIES AND CHALLENGES OF ENTERPRISES IN FRONT OF FULL IMPLEMENTATION OF SCS

The requirement of submission and publicity of enterprise information change

There will be no big change that enterprises will face regarding the information— such as the annual report or tax declaration—which shall be compulsorily submitted to relevant government departments. Instead, entrepreneurs are encouraged to voluntarily register their credit information related to qualification certificates, market operations, contract performance, social welfare, etc. on "Credit China" and other channels. The government also welcomes a voluntary submission of additional enterprise information about, for example, operation, logistics or production. All these data will also be saved in the central database and shared between government departments under relevant regulations and rules[2, 4, 6].

The scope of the enterprise information, which can be publicized by the Chinese government, is enlarged according to the requirement of SCS. However, the publicity of enterprise information is subject to more strict and standardized procedures[7]. The overall range of the enterprise information to go publicized is defined in the "Interim Regulation on Enterprise Information Disclosure" issued by the State Council in force from August 2014. According to the State Council, such information shall refer to the information generated from not only the production and operation activities of enterprises themselves, but also the duty performance of the government, including random inspections of governmental authorities[2, 4, 6]. As to any intended publication of sensitive data, the practice of including business secrets or personal privacy by the government will get special approval from the competent department at a higher level[6, 8].

Reports from third-party matters

Opinions of the masses, including industry associations as well as big data service providers, now also matter to enterprises. Credit reports issued by those qualified third-party organizations, as well as tip-offs and complaints from the public, will be taken into account in the comprehensive credit evaluation[4].

Adjusted regulatory approaches come into force

- **Pre-commitment of data authenticity**

A pre-commitment mechanism is proposed as a new regulatory approach for registration, application and approvals. Enterprises are encouraged to make a commitment of authenticity for the information they provide to the government or disclosed to the public through "Credit China" or other channels, which serves as the basis for the comprehensive credit evaluation and evaluation reports[4].

- **Credit-based targeted regulatory approach**

More targeted regulation approaches are used. Relying on the well-established credit-information system, as well as the results of comprehensive credit evaluation, the government divides their regulatory subjects into categories by credit ratings from central government and third parties. Enterprises in different categories would receive differentiated regulatory intensity, inspection frequency or regulatory approaches[4]. For example, China customs nowadays divides enterprises into three categories, from the lowest to the highest, Discredited Enterprise, General-credit Enterprise, Normal Authorized Economic Operator (Normal AEO) and Advanced AEO. The average inspection rate of imported and exported goods of Discredited Enterprises can reach over 80%

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(*e.g.*, 92.37% in 2018)—much higher than General-credit Enterprises. In contrast, the average inspection rate of Advanced AEOs is only below 20% of the General-credit Enterprises' rate (*e.g.*, 0.52% in 2018) [9,10].

- **Credit-based joint incentives-punishment mechanism**

A joint incentives-punishment mechanism is designed to encourage the good market behaviour of Enterprises, which increase their credit rating, further leading to more preferential treatments by authorities, while continuous bad market behaviours will decrease the credit rating, causing the enterprise the severe punishment measures when credit has been dropping to the certain level[11].

The slightest punishment for the breaching behaviour for the first time can be a notice or a private conversation invited by an authority for rectification within a specified period, and the downgrading of credit evaluation can be cancelled as long as the rectification meets the requirement. Severe punishment, designed for enterprises with continuous breaching behaviours, include the publicized enterprise blacklist of the corresponding areas, restricted activities, being banned from entering the industry or even being kicked out of the market forever[2, 4]. The legal representative, as well as other direct responsible persons of a non-creditworthy enterprise, would also get an adjusted lower rating in their individual credit evaluation, or even fall onto the individual blacklist, as well[2, 4, 11].

In contrast, enterprises with good credit will be granted more trust and priority by the government and the market. Benefits include, but are not limited to, better public image through positive reports by medias, priority in preferential policies such as a better financing and subsidizing condition, priority in convenient services provided by the government, priority in market entries, less strict reviews and easier approvals, and priority in bidding government projects. For example, authorities will accept and process applications of enterprises keeping good credit over three years even without full application materials. These trusted enterprises only need to hand in the complete application materials afterward within a specified period[4, 11].

Extra cares needed for management team and third parties

Enterprises are now encouraged to undertake more cares when dealing with its own management team and third parties.

Under the new credit-based joint incentives-punishment mechanism, serious breaching behaviours by an enterprise can bring negative impact on the individual credit record of its legal representative and direct responsible persons. Once the enterprise is put on an enterprise blacklist, the legal representative and responsible persons of such enterprise will be prohibited from being in charge of any other enterprises immediately for three years [4,6,11]. This may cause much inconvenience for such related other enterprises, since they have to change their registration information, project application materials and all documents in relation with the current legal representative or responsible persons. Such facts urge enterprises to think more over before they hire management for the enterprise or appoint a legal representative and check carefully on their credit condition.

What's more, the government encourages enterprises to take credit records on public web portal, reports from qualified third parties and comprehensive credit ratings as important factors when they choose their own suppliers, cooperative partners and other associated parties[1].

Challenges hidden in the shadow for Foreign-invested Enterprises (FIEs)

With a relatively better internal governance and compliance practice, FIEs are expected to have less compliance problems and much quicker responses on information-reporting issues than domestic enterprises. However, due to a different culture and less understanding on local rules, FIEs face more challenges than domestic ones in certain areas.

- **Digestion on SCS-related guiding rules**

Although many of the government departments and local governments already issued SCS-related implementation guidelines, they are scattered in different documents—still lacking a clear and unified picture for enterprises—to follow as a whole. In addition, some wordings of guidelines are, to some extent, general and vague and requiring of proper interpretation or further detailed guidelines to be fully understandable and executable by FIEs. As a result, FIEs in particular may not be able to digest the guidelines well due to the language barrier. These can lead to problems with their compliance practices or failure to secure the best interests for themselves.

Therefore, it is suggested that FIEs will more actively and frequently communicate with relevant authorities. Besides the benefit of receiving better understanding on guidelines, FIEs can also establish a good relationship with the authorities and might therefore get more practical guidance on daily handling of compliance matters against the background of SCS. One more important thing: FIEs should make it clear to themselves, before submitting any data to the government or disclosing to the public, the range of their sensitive data and to what extent they would like to disclose the company information. In this way, they can keep a clear mind when discussing or complaining with relevant authorities whether certain sensitive information should not be made public.

- **Blacklist vs. unreliable entity list**

The blacklist under SCS is easily confused with the unreliable entity list to be issued by the Chinese government. The blacklist of SCS is a list of Chinese enterprises, including FIEs, organizations and individuals from different sectors, who are recognized as seriously discredited entities by the government due to the breaching behaviours within the commercial or economic sphere. Whereas the unreliable entity list was initiated by the Chinese government against the background of US-China trade war, especially after Huawei was listed in the US blacklist[13]. It records foreign enterprises, organizations, legal persons and individuals who damage seriously the legitimate rights and interests of Chinese enterprises out of non-commercial purposes by not following market rules, departing from the spirit of the contract or imposing business blockades or supply cut-offs on Chinese enterprises[14].

To avoid being listed in the unreliable entity list, the enterprises with foreign background will be careful about the content in a public speech—in particular the political-related opinions.

STILL A LONG WAY TO GO

Although bearing an ambitious goal, the SCS is still far from its full establishment.

First, we do not know yet if SCS is compatible with the already existing credit system of People's Bank of China and third-party credit systems[15] without conflicting with each other in credit evaluation and reporting. We will see if China will further integrate them into one in the near future.

Secondly, with such a huge framework and so many departments involved, it remains a big question whether in reality China can manage to build a specific, effective and unified working mechanism for each involved department and realize the coordination or synergistic effect successfully between all involved departments[15].

Finally, yet importantly, in the supporting framework legal documents and its following implementation guidelines, the more clear definitions of many scopes needed for regulation, such as the scope of submitted information subject to the publicity, are needed to fill the gap between obscure legal documents and a clear action plan that Enterprise can simply follow without difficulties[15].

Overall, China's SCS still has a quite long way to go from its fundamental establishment in 2020 to its full establishment.

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AUTHORS

For more information, please contact your regular McDermott lawyer, or:

DR. NIKOLAUS VON JACOBS
PARTNER
njacobs@mwe.com
Tel +44 89 12712230

DING HAN
FOREIGN COUNSEL
dhan@mwe.com
Tel +49 49 89127122

For more information about McDermott Will & Emery visit mwe.com

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