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Llinks Corporate and M&A Bulletin
December 2019

A Future Based on Creditworthiness
——Review of China's Corporate Social Credit System and Corporate Compliance

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"China has newly introduced its corporate social credit system (the "CSCS")", "the CSCS is mainly targeting European and American companies in China" and "the 2020 deadline is near and there is not much time left for foreign companies in China", since the second half of 2020, headquarters and local offices of multinational companies operating in China have received many alert emails so headlined. Some consulting agencies held several seminars on the CSCS topic, which were quite popular among the concerned companies despite the costly tickets. Setting aside the hyperboles in these agencies market campaigns, the authors believes the CSCS' profound influence on companies business operation in China.

I. A brief introduction of CSCS

As is known to all, the Chinese government is transforming its regulatory framework from paternal ex-ante supervision to ex-post supervision that emphasizes self-discipline of market participants and heightened regulatory penalties. For foreign invested companies, China's market entry regulation is also transforming from hard restrictions such as industry

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catalogues, joint venture and shareholding percentage requirements, to overall market opening plus negative list. The CSCS is an important part of such market regulation transformation.

Contrary to the abovementioned agencies' claims the brand-new CSCS, China began to design and implement the CSCS since 2012. Since State Council's publication of *Plan for Establishing a Social Credit System (2014 – 2020)*, China issued a large number of laws, regulations and policies at the state level in relation to the establishment of the CSCS, and different government departments and governments at various local levels also followed by issuing their own ancillary policies. From 2014 to 2018, laws, regulations and standards of the CSCS were successively promulgated, and a credit system covering the whole society based on the sharing of credit information resources has been gradually established. During the period from 2019 to 2020, as a system of rewarding compliance and punishing non-compliance, the CSCS will be fully established and implemented.

The CSCS is a comprehensive system governing all industries and from all perspectives. The CSCS covers almost all areas and aspects of business operations of a company, such as environment protection, taxation, foreign exchange, customs, advertising, antitrust, product quality, and so on. The CSCS sets forth rating requirements that enterprises must abide by, provides clear credit rating parameters and rating methods, as well as the legal consequences corresponding to different credit ratings, and lays down a reward mechanism for compliance and punishment for violations.

II. How does the CSCS work

1. Definition of rating requirements by Government

As the first step, the government defines and publishes rating parameters and methodology. The authorities define the requirements in different areas that companies must comply with. A failure in compliance will lead to a low rating or a non-compliance record. Between 2013 and 2019, Chinese government published approximately 350 regulations, laws and policies at national level to define the details of the CSCS, including the formulation of rating requirements. Currently there are over 30 different CSCSs and over 300 specific rating requirements. The rating requirements mainly include scale ratings and compliance records. For example, regarding taxation credit rating, the rate requirements and methods are provided in *Taxation Credit Administrative Measures* (tentative), *Taxation Credit Rating Parameters and Methodology* (tentative) and *Material Taxation Violation Untrustworthiness Publication Measures*.

2. Monitoring of companies' behavior

After establishing the CSCS, with the rating systems and the use of technologies, the authorities collect information on companies' activities and monitor their behavior. For example, "National Big Data Public Service Platform on Enterprise Credit" comprehensively evaluates corporate credit by collecting and analyzing big data on various aspects, such as corporate finance, management, technology, social responsibility, institutional norms and value concept.

The government collects data on companies from the following three sources.

The first is to collect the data submitted by companies themselves. Companies transfer data required by laws and regulations to the central data base of the CSCS. For example, companies must submit their "annual filing" report to the State Administration for Market Regulation (SAMR) in due time each year.

The second is to collect data gathered during government inspections and investigations. The State Council published *Random Inspection to Regulate In-process and Ex Post Supervision* in 2015. It indicates that the authorities are proactively implementing an inspection mechanism called "double randomness, one publicity" (双随机，一公开), which randomly selected officials to conduct random inspections on companies. The inspection and investigation are disclosed promptly. The authorities can obtain a large amount of corporate data during inspection.

The third way is to utilize web-based, digital inspection on company performance (big data, artificial intelligence and Internet of Things etc.). Government authorities are testing new ways of receiving reliable information on companies' behavior, such as the real time monitoring on companies' emission of pollutants. In addition, government may also collect data from third-party database, for example, Alibaba.

3. Rating results and sanctions

After the definition of rating requirements and collection of corporate data, a rating for the company can be automatically generated in the CSCS system. The CSCS's credit rating mainly comprises of scaled ratings and compliance records. For example, the taxation credit rating is categorized into A, B, M, C, D; The environment credit rating is based on a score on a 0-100 scale, and is categorized into Environment Protection Trustworthy Enterprise, Environment Protection Ordinary Enterprise and Environment Protection Warned Enterprise. In some areas, scale ratings are not yet well developed. Nevertheless, non-compliance with laws and regulations in such areas will still be included in the company's compliance records. A company that materially violates laws and regulations will be put on a "heavily untrustworthiness list", and consequently will be subject to joint sanctions imposed by multiple government authorities.

Depending on companies' credit ratings, the government will exercise differentiated supervision on each company. Companies with good credit rating will be rewarded and face less government supervision, while companies with poor credit rating will face more stringent government oversight and sanctions. Non-compliance information is submitted to the database of CSCS and can either lower the companies' scale ratings or even cause the companies to be blacklisted. A reduced scale rating can adversely impact a company's ability to obtain preferential government treatment or lead to sanctions. Particularly, because inter-government joint sanction mechanisms have been implemented in many areas, records of "untrustworthiness" of a company in one area will be shared with government authorities in other areas. As a result, a company badly rated in one area may face sanctions in other areas. For example, if a company is blacklisted for non-compliance in taxation area, it can be sanctioned in the areas of government financial support, government procurement and financial credit as well.

III. Practice of CSCS

1. "Internet + Monitoring" System

Opinions of the State Council on Strengthening and standardizing the In-process and Ex-Post Supervision was published in September 2019. It indicated that "Internet + Monitoring" System is an important part of innovation and perfection for government supervision. The new national "Internet + Monitoring" system integrates company data from government and private companies. It is jointly developed and implemented by a consortium of technologically advanced companies (Huawei, Alibaba, Tencent, and so on). Currently, the data infrastructure of the CSCS mainly has the following design and functionalities. First, National Credit Information Sharing Platform integrates all local and central level government data sources from all government departments. Second, Credit China is the web portal of the National Credit Information Sharing Platform, which publishes key credit information on companies, including blacklisting information. Third, National Enterprise Credit Information Publicity System provides detailed information, including companies' CSCS records. Forth, Privately-run credit information platforms (Qichacha, Tianyancha and many others) provides company data. Fifth, Databases and ratings of third-party rating agencies (HIGGS Credit and Alibaba Credit) also evaluate the credit of the enterprises.

In the April of 2019, the Chinese government circulated a draft of coding requirements for administrative matters subject to "Internet + Monitoring". The Code of administrative catalogue includes eight digits. The first two digits are the area code (e.g. 00 for nationwide, and 31 for Shanghai). The following six digits are called the "primary code", which consists of a two-digit code for the authority in charge(e.g. 31 stands for the SAMR), and the remaining four digits for the administrative matter (e.g. 0003 stands for supervision on company registration with SAMR). For example, 00310003 stands for the Code "Registration, change cancellation Registration" in National government service platform.

The Subcode is a combination code with 14 digits. The first 8 digits are Code and the last six digits are called the "secondary code", which consists of a two-digit code for administrative action (e.g. 02 stands for administrative punishment and 06 for administrative inspection) and the following four digits for the subsets of such administrative action(e.g. 0001 stands for conduct of registration). Therefore, 00310003 020001 stands for administrative punishments by the SAMR on companies' violation of company registration requirements.

2. Examples for CSCS

(1) Customs

According to *Customs Enterprise Credit Administrative Measures*, the customs credit rating is categorized into three classes: Certified Enterprise, Ordinary Enterprise and Distrusted Enterprise. Certified Enterprise is subcategorized into Advance Certified Enterprise and Ordinary Certified Enterprise. The "Certified Enterprises" rating is achieved through a point deduction calculation. For each parameter, there are either two point-deduction values (pass or fail, corresponding to 0 point or -2 point respectively) or three values (pass, roughly pass or fail, corresponding to 0 point, -1 point and -2 point respectively).

An enterprise must meet the following conditions to be certified. First, the enterprise has no "fail" (-2 point) on any of the parameters. Second, the enterprise has no more than three "roughly pass" (-1 point) in each of "internal governance" or "trading security". Third, the enterprise has an overall score of 95 or more. General Administration of Customs also published other detailed evaluation parameters and standards for Advanced Certified Enterprise and Ordinary Certified Enterprise, and so on.

The "Ordinary Enterprise" rating applies to an enterprise that registers or files with the customs for the first time, or a certified enterprise that fails to meet Customs Enterprise Certification Standards but has not been categorized as a "Distrusted Enterprise" yet, or a Distrusted Enterprise that has not engaged in actions that would lead to the enterprise to be categorized as a "Distrusted Enterprise" for two consecutive years since its date of categorization as a "Distrusted Enterprise".

The "Distrusted Enterprise" rating applies to an enterprise that materially violate customs laws and regulations. A rating of "Distrusted Enterprise" will be listed in jointly sanctioned system. For example, according to foreign exchange regulations, an enterprise rated as "Distrusted Enterprise" cannot be listed by foreign exchange authorities as a Class A enterprise.

(2) Taxation

The taxation credit rating is categorized into five classes: A, B, M, C, D. A rating applies to an enterprise with an annual score of 90 or above. B rating represents an enterprise with an annual score between 70 and 90. M rating is for newly established enterprises or enterprises with no revenue in the year of evaluation and with an annual score of 70 or above. M rating cannot be given to an enterprise which is categorized as a "taxation distrusted company". C rating is for an enterprise with an annual score between 40 and 70. D rating is for an enterprise with an annual score lower than 40, or an enterprise that is directly categorized as D rating.

The taxation credit rating system consists of an annual score scheme and a direct rating scheme. The annual score is a net result after deduction from a base point. Where a taxpayer has complete information of current parameters and non-current parameters, the base point is 100; while for a taxpayer entity whose non-current parameters are incomplete, the base point is 90. Direct rating applies to a taxpayer entity which materially violates tax laws and regulations. Taxpayers will be administrated based on their respective credit rating. A major taxation violation will be published to the public via tax authorities' portal websites, as well as via mass media such as newspaper, broadcast, television and the Internet.

IV. Compliance Suggestions

As mentioned above, the CSCS is essentially a rating system, in which the government authorities set forth rating requirements, collect data from companies through supervision and inspection, and then compare the data collected against the rating requirements to reach a rating for companies. The companies are then sanctioned or rewarded based on the rating results. In addition, companies with poor scale rating results or severe non-compliance records may be blacklisted and jointly sanctioned. Therefore, with the development and implementation of the CSCS, it is imperative for all companies to get a thorough understanding of the CSCS for compliance purpose.

1. Internal adjustments

Enterprises must understand exactly what the CSCS requires to them. That is, an enterprise must know precisely which ratings apply to its business operations in China, at the national, provincial or local levels. Then, the enterprise must assess its standing in the CSCS, in order to identify compliance gaps and future risks for negative rating results. The enterprise shall weigh its options for adjustments necessary to narrow the gaps, considering cost-benefit comparison, other adjustment options and effects.

2. Continuously track the CSCS

Still in evolvement, the CSCS is continuing to adjust, expand and improve itself. Therefore, it is advisable for enterprises to stay on top of further developments. The monitor can be two-fold: First, enterprises shall closely track the government's changes to ratings and rating requirements. Second, enterprises shall monitor it business operations so as to meet the rating requirements which are still evolving.

3. Exchange with government authorities

Enterprises should directly consult with government authorities the unclear issues of the CSCS. Inquiries and statements must be made in a detailed, concrete and technically precise manner, with correct references to the relevant market documents and concrete regulatory stipulations. The exchange with government authorities can focus on two parts. First, enterprises can ask government authorities to explain vague requirements and their application in specific business operation context. Second, after conducting internal adjustments and analysis, enterprises will identify the specific technical requirements of the CSCS which are practically infeasible for the enterprises to comply with. Enterprises may want to consider asking government authorities to modify such CSCS requirements.

In summary, the CSCS is not something out of thin air. It has been put in place and in use for years in many sectors, and most companies have been examined under the CSCS and have received their credit ratings and compliance records. While there is no need to be panic, companies must fully understand the CSCS systems and rating requirements that apply to them, and improve their compliance performance in the course of business operations. In a virtuous circle of creditworthiness, good ratings will endorse companies, and companies will benefit from the endorsement.

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