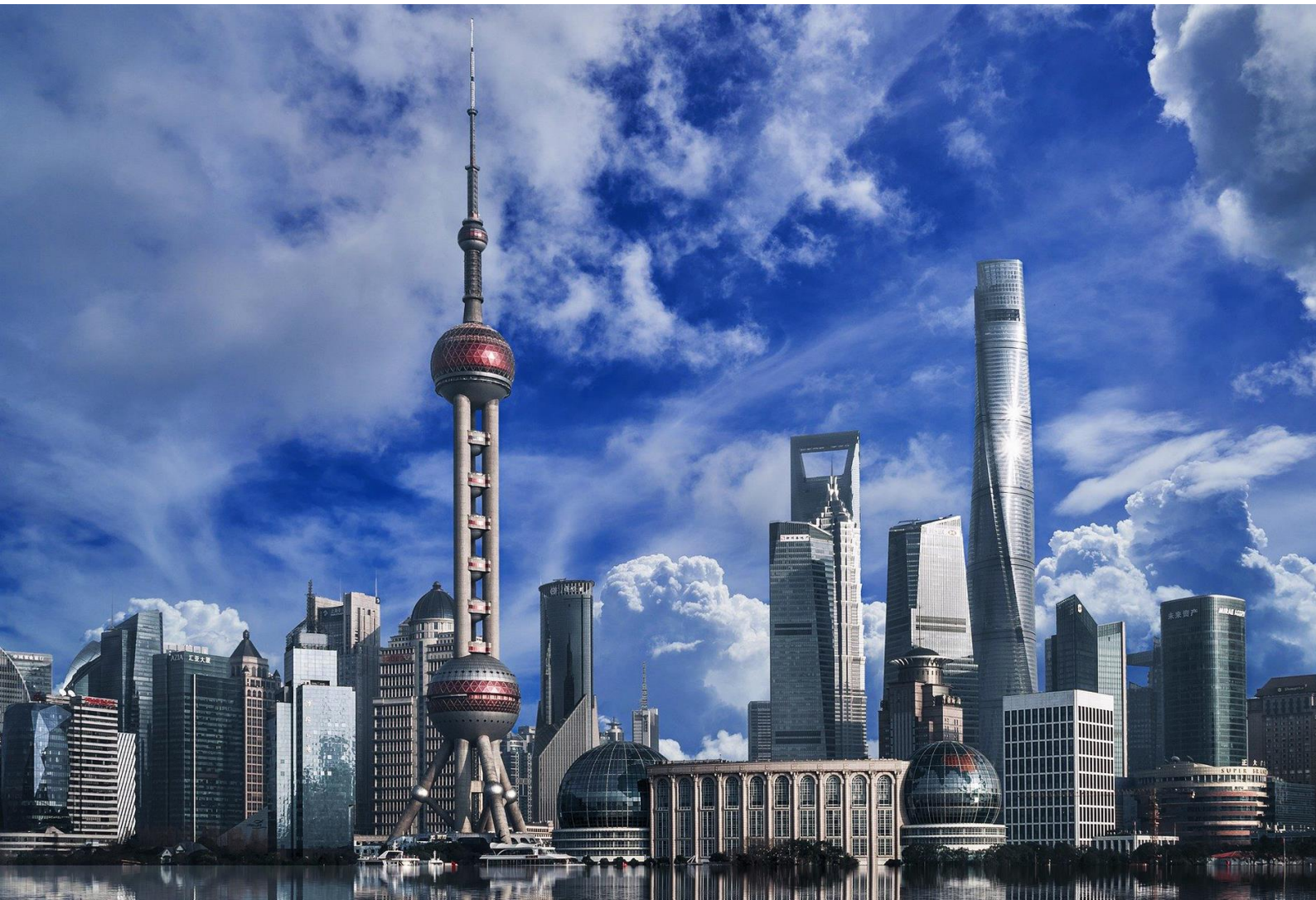


PSA BRIEF:

Understanding “Abnormal Operations” in China



Understanding China’s “Abnormal Operations” Designation

The failure of a registered company in China to meet information disclosure requirements may result in inclusion on the “List of Companies with Abnormal Operations.” The public nature of this list incentivizes companies to comply with disclosure requirements, while longer-term noncompliance results in inclusion on the Dishonest Entities List – which carries more severe penalties.

Inclusion on the abnormal operations list is not necessarily a serious issue of concern, and ought to be evaluated within the broader scope of a company’s profile.

List of Companies with Abnormal Operations

In 2014, new regulations outlining information disclosure requirements for Chinese companies created a List of Companies with Abnormal Operations (“the Abnormal Operations List”; 企业经营异常名录). The list includes companies that have failed to comply with information disclosure requirements.

There are four circumstances under which a company would be added to the list:

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| <p>1 Failure to publicize annual reports within the prescribed time frame;</p> | <p>3 Publicized information conceals facts or involves falsification;</p> |
| <p>2 Failure to publicize other required information within the prescribed time frame;</p> | <p>4 Failure to contact the company at its publicized registered address.</p> |

PSA conducts due diligence investigations into a large number of companies in China each month; all of these investigations include checks for inclusion on the abnormal operations list. In our experience, the first circumstance listed above (failure to publicize annual reports) is the most common reason for a company to be included on the list. In most cases, the company rectifies this issue and is removed from the list in due course. Only in a handful of cases have we found that a company has failed to rectify the issue for more than three years, causing it to be added to the blacklist described below.

Consequences of Inclusion on the List

The list of companies with abnormal operations is available online, and a Chinese-language database search will reveal whether a company is included on the list. According to the current policy, publicly disclosed records of a company’s current or past inclusion on the abnormal operation list will not be removed from official databases for a set period of time. Therefore, potential reputational damage associated with inclusion on the list is itself intended to incentivize companies to adhere to information disclosure regulations.

If a company updates its information or fulfills its legal obligations as required within three years of being included on an abnormal operations list, it may apply to be removed. However, if the authority

does not approve its application for withdrawal, the time limitation is still based on the initial date at which the company was included on the list. If a company remains on the list for more than three years, it will be added to the “List of Dishonest Entities Committing Serious Illegal Activities” (“the Dishonest Entities List; 严重违法失信企业名单”), which can essentially be considered a type of blacklist, and may be accessed online. When other regulatory bodies learn of a company’s inclusion on the blacklist, they have the discretion to impose wide-ranging penalties. Potential consequences may include the company’s legal representative being barred from serving as legal representative of another entity for a fixed period of time, the company’s business license being revoked, and the company being prohibited from participating in bids for government projects. Operations of companies that primarily serve as government contractors would be significantly impacted by inclusion on the Dishonest Entities List.

Amendments in September 2021 further stated that a company can apply for removal from the dishonest entities list only after it is proven that the enterprise has not committed any further violations of relevant legal obligations within five years from the date of being listed. Furthermore, companies on the list will be designated as a “key supervisory target” and will be subjected to an increased frequency of inspections as well as exempted from receiving relevant certificates and approvals for some administrative procedures.

Reasons for Inclusion on the List

The four circumstances under which a company may be included in the abnormal operations list are introduced above. However, not all circumstances carry the same level of risk. For example, failure to make timely information disclosures is not always indicative of serious operational issues within a company, especially in the case of small or newly-registered companies that may not be familiar with disclosure requirements. On the other hand, disclosures that involve falsification are potentially more serious. Therefore, careful attention should be paid to which category a company’s inclusion in the list falls under.

Is Abnormal Operations a Business Risk?

When considering whether to enter into a business relationship with a company registered in China, you may find that it is (or has been) included on the abnormal operations list. This finding alone should not end consideration of a business relationship; instead, it should be evaluated alongside other findings. It is often the case that direct communication with a company’s key principals results in a more robust understanding of the nature of a company. When asking companies’ principals about their inclusion on the abnormal operations list, PSA has found that some instances are more easily explained – small companies founded by one or two individuals that are simply focused on other aspects of business – while other instances may indicate a higher level of risk, such as falsification of publicized information.



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