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2006 Update to Granting Stock Options in China

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This memorandum is an overview of the legal and strategic issues related to granting stock options in China, including understanding Chinese cultural views of employment and compensation, structuring option grants to comply with applicable Chinese currency controls and securities law restrictions and the tax consequences of options to the optionee. The memorandum is applicable whether the company granting the options is a U.S., Cayman Islands or other non-Chinese entity. Implementing an equity-based compensation program for employees of a foreign subsidiary is a challenging, and often costly, undertaking. Because the use of options and other equity-based compensation has only recently started in China, its laws and regulations, to the extent applicable, do not specifically address certain issues and/or are ambiguous and often incompatible with U.S. grant making practice. To complicate the situation further, the China Securities Regulatory Commission (the "*CSRC*") has indicated that new regulations are forthcoming and, until final rules are issued, implementing any type of stock plan should be undertaken cautiously.[1]

Strategy

Before implementing a compensation scheme, a company must evaluate its likely effectiveness in incentivizing and retaining employees. A company should ask "What does my Chinese employee want?" Employees in China attach importance to feeling valued and having a sense of "belonging." As a result, Chinese companies must maintain a reputation for treating their employees well or risk unwanted attrition. In the current business climate in places like Beijing and Shanghai, where competition for key employees is fierce, competitive compensation packages determine a company's ability to recruit and retain employees. Options, to the extent they inspire loyalty and commitment and provide employees with a sense of ownership, are a potentially powerful compensation tool. A stock option, however, will not have any motivating effect to an employee who does not understand its value. Though educating employees may be one resolution to this issue, the cost and logistical burden of such undertaking may outweigh the potential benefit to the company. The current practice among U.S. companies in China is to limit grants to senior management and key employees (in particular, key employees who have worked in the U.S. and understand the value of options).

Securities Law Considerations

Shares issued in a "public offering of securities" approved by the CSRC may be held by a Chinese employee, but in practice such approval is unlikely to be given until the new regulations have been issued. Therefore, the holding of shares absent such approval may pose a regulatory risk to the company.[2] Companies undeterred by this risk have chosen to avoid having an employee hold shares by requiring that options be exercisable only by a cashless "sell-all" exercise method. In a cashless "sell-all" exercise, all of the shares acquired pursuant to the exercise of an option are immediately sold and the employee receives only the cash spread. This works in the case of a public company but not a private company (though a private company could at least grant stock options that are not exercisable until such a "sell-all" method is possible).

Currency Control Considerations

Use of a cashless exercise also facilitates compliance with China's foreign exchange controls. At present, Chinese employees may not remit funds in excess of approximately

1. The CSRC has indicated for some time now that new regulations are "forthcoming", so it is unclear if the issuance of such regulations is actually imminent. A company that determines that option grants are immediately necessary to its recruitment and retention of employees may consider making option grants to key employees only and providing that any such grant by its terms will be revised as necessary to comply with regulations as issued.

2. At present we believe there is no "*de minimis*" exemption from CSRC regulation that would permit a company to make grants for either a limited number of shares or to a limited number of optionees.

U.S. $10,000 outside of China without the approval from the State Administration of Foreign Exchange nor may they purchase foreign currency for an investment abroad. This exception is unlikely to be helpful for key employees granted options under a public company plan. Although employees could, theoretically, pay the exercise price of an option with funds held outside of China, this is not a realistic alternative since most employees do not keep bank accounts abroad. The use of phantom stock, where employees are given "credit" for the cash spread on shares they never hold, is another alternative that avoids the issues related to the remittance of funds and the holding of shares, but would likely prove impractical given the lack of familiarity and understanding by Chinese employees. Option grants made by U.S. companies in foreign jurisdictions must also comply with U.S. federal and state securities laws and regulations. This obligation is usually satisfied if grants are made pursuant to an equity incentive plan under which grants to U.S. employees are in compliance with U.S. law.

Employment Issues

Chinese employment and labor law regulations generally require that an employee's wages be paid in cash. The granting of options, in the event they may be deemed wages paid "in-kind" or in "negotiable instruments", is inconsistent with this requirement but will likely not be deemed a compliance problem by regulatory authorities given the benefit to the employee.

Tax Consequences

Like most countries (including the United States) Chinese law currently provides that the grant of a stock option is not a taxable event. Instead, tax is calculated at the time of option exercise. Upon exercise the employer (whether Chinese or non-Chinese) must withhold and remit the income tax due and report the option exercise. The taxable income is the difference between the amount paid for the shares and their closing price on the date of exercise. Because of China's currency control laws, however, stock options that cannot be exercised using renminbi ("*RMB*") are usually exercised by a cashless "sell all" method in which all the shares for which the option is then being exercised are sold and the proceeds, net of the exercise price, is remitted to the employee in China. This means the price for which the shares are sold in a cashless "sell-all" usually will not be the closing price on the date of exercise. This can result in the amount realized from the sale being less than the amount that is taxable income when the closing price is higher than the sale price. Determining the amount of tax to withhold requires applying in advance for instructions from the local tax bureau to which the tax is to be paid (where operations are in more than one tax district, multiple applications will need to be made and their instructions tracked). Cai Shui [2005] No. 35, however, permits apportioning the taxable income received from a stock option exercise over a period of time of up to twelve months which reduces the effective tax rate for withholding purposes as the income is not entirely attributed to the month of exercise.

In addition, effective since July 1, 2005, each employer in China that uses stock options to compensate any of its employees (including expatriate employees) is required to submit the stock option plan documentation to each local tax bureau with jurisdiction over the employer. The documentation should be submitted in advance of making option grants from the plan. Advance notice of actual grants (and, more problematically, apparently advance notice of exercises) must be provided to China's local tax authorities.

Conclusion

Given the current restrictions and ambiguities of Chinese laws and regulations applicable to option grants, a company should take a conservative approach to granting options in China. Where a company has determined that the use of options is immediately necessary for the recruitment and retention of employees, the options should be granted in a manner that is in compliance, to the extent determinable, with the current laws and regulations. Such a practice may require that options grants are limited to key employees and that such grants, by their terms, will be revised as necessary to comply with rules and regulations as issued. Furthermore, once a company grants options in China, it should continue to closely monitor changes in applicable Chinese laws and regulations.

If you have any questions about this memorandum, please contact Fred M. Greguras (fgreguras@fenwick. com) or Tahir Naim (tnaim@fenwick.com) of Fenwick & West LLP; or Jie Chen (chenj@junhe.com) of the Jun He Law Offices.