

# 2007 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 started in China only a couple of years ago, its laws and regulations, to the extent applicable, do not specifically address certain issues and/or are ambiguous in certain aspects. In 2005 and 2006, China released several regulations<sup>1</sup> relating to the implementation of equity incentive plans, including stock options, by companies listed on China's stock exchanges (regardless of whether or not a state-owned enterprise) and companies controlled by China's government, but listed on foreign stock exchanges. **These regulations have not changed the landscape for options granted by foreign companies to their Chinese employees.**

## 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, employers in China 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 an 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). With the release of the above-mentioned regulations, however, a number of Chinese listed companies have implemented, or are now planning to implement, their own equity incentive plans. While this will place these companies on a more equal footing with their non-Chinese counterparts (thus making equity-based compensation more necessary as part of an employer's compensation package) it should also mean that Chinese employees will gradually understand the value of the stock option and other forms of equity-based compensation and companies may extend equity-based compensation to a broader range of employees without the educational burden.

## Securities Law Considerations

Chinese law permits persons in China to purchase shares of non-Chinese companies pursuant to offerings that have been approved by the China Securities Regulatory Commission ("CSRC"). There is no safe harbor exemption from CSRC regulation as there is in the U.S. for private company issuances. Neither is there a streamlined compliance process for compensatory equity arrangements.

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<sup>1</sup> These regulations are:

- (1) *Measures for the Administration of Equity Incentive Plans of Listed Companies (Provisional)* issued by the China Securities Regulatory Commission on December 31, 2005;
- (2) *Provisional Measures for Implementing Equity Incentive Plans by State Holding Listed Companies (Overseas)* issued by the China State-Owned Assets Supervision and Administration Commission and the Ministry of Commerce on January 27, 2006; and
- (3) *Provisional Measures for Implementing Equity Incentive Plans by State Holding Listed Companies (Domestic)* issued by the China State-Owned Assets Supervision and Administration Commission and the Ministry of Commerce on September 30, 2006.

The CSRC has informally indicated that at this time it does not view the grant of stock options to employees or consultants in China as being subject to such approval. However, informal guidance cannot be relied on as a defense to a formal enforcement action so reliance on such informal guidance should not be undertaken without advice of licensed counsel in China.

### Currency Control Considerations

China imposes foreign exchange controls on stock option exercises by Chinese employees and consultants. Therefore, many publicly-traded companies have chosen to use a cashless “sell-all” exercise as an alternative. 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 publicly-traded company but not as easily for a private company, though a private company could grant stock options that are not exercisable until such a “sell-all” method is possible. The use of “phantom stock,” whereby 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.

**IMPORTANT NOTE:** New regulations<sup>2</sup> issued by the People’s Bank of China (“PBOC”) and the State Administration of Foreign Exchange (“SAFE”) establish, effective February 1, 2007, an approval process pursuant to which foreign currency may be used to exercise stock options. As these regulations have just taken effect, we are uncertain of their full meaning and, of course, there is no experience with their application. We will update this memo once we have more information.

### 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, but the occurrence of the grant must be reported to the tax authorities. Instead, tax is calculated at the time of option exercise. Upon exercise by an employee or consultant, the granting company’s Chinese subsidiary 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. In this case, the taxable income is the proceeds earned by the employee from the cashless “sell all” exercise (see *Supplemental Circular on Relevant Matters Concerning the Payment of Individual Income Tax for the Income from Individual Stock Option* issued by the State General Bureau of Taxation on September 30, 2006 (also called Guo Shui Han [2006] No. 902)). 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.

### Employment Issues

Chinese employment law generally requires that an employee’s wages be paid in cash, at least in part. Therefore, stock options and other equity incentives can only supplement, but not entirely replace cash compensation.

### Conclusion

Given the current ambiguities of Chinese laws and regulations applicable to option grants, a company should take a careful approach to granting options in China. Where a company has determined that the use of options is 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, by their terms, will be revised as necessary to comply with rules and regulations as issued. Review of the SAFE approval process and of any reports of the experience of others should be undertaken with competent legal counsel. Furthermore, once a company grants options in China, it should continue to closely monitor changes in applicable Chinese laws and regulations.

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<sup>2</sup> PBOC issued *Administration Measures of Foreign Exchange for Individuals* in December 2006, which came into effect as of February 1, 2007. SAFE issued the implementation rules of such PBOC regulations which is also effective as of February 1, 2007. The PBOC regulations do not specifically mention stock options, but are of general application.