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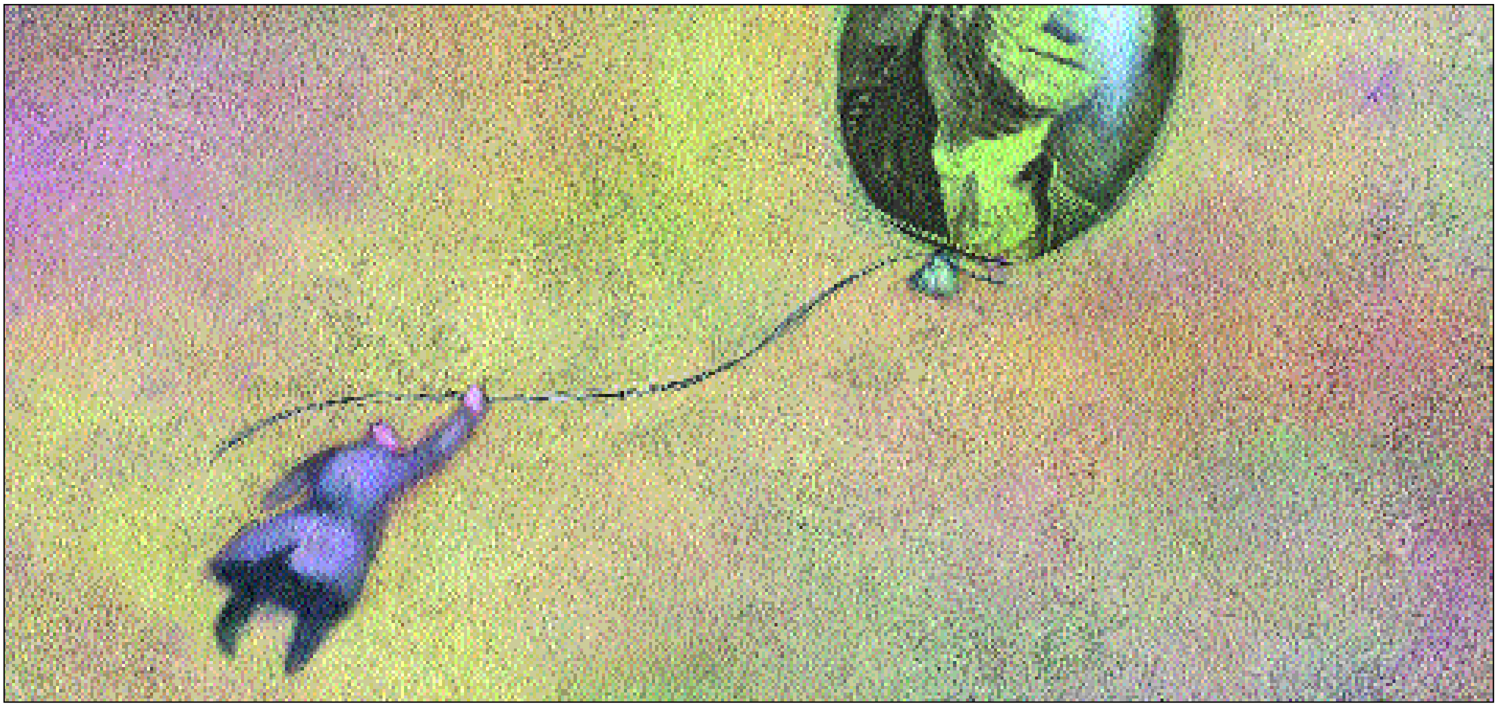

TIME TO SHARE

A basic guide to stock options in China

By Tahir Naim, Fred Greguras and Jie Chen

Retaining management talent in China, particularly in Beijing and Shanghai, has become a material problem. The competition for management talent has forced employers to try to distinguish themselves from each other through the use of stock options and other equity awards.

A Chinese employee's desire for equity as part of a compensation package is only one factor that an employer must consider in designing and making equity awards. Other factors include employee turnover rate, tax, foreign exchange and securities law as well as an understanding of Chinese cultural views of employment and compensation. China's laws and regulations are often ambiguous or provide for decentralized administration. The information provided in this article applies to foreign companies, including those based in the United States, British Virgin Islands or Cayman Islands.

Chinese law was previously ambiguous as to whether domestically listed companies could grant stock options to their executives and employees. As a result, most, if not all, Chinese companies did not implement such programs. The government has awakened to this competitive disadvantage and has issued regulations, effective Jan. 1, 2006, that permit domestic companies that are listed on either

Tahir Naim and Fred Greguras are attorneys in the corporate practice group at Fenwick & West's office in Mountain View. Jie Chen is a partner at Jun He Law Offices in Beijing.

the Shanghai or Shenzhen stock exchanges to grant stock options.

The regulations, however, are still fairly restrictive. The aggregate number of shares that may be granted to "senior managerial officers" is capped at 10 percent of the company's outstanding shares. And in cases where the aggregate number of shares issued to a single individual exceeds one percent of the company's outstanding shares, the awards in excess of that amount must be approved by the company's shareholders. These requirements are in addition to regulations issued in 2001 that require 1) the linking of management compensation to company and individual performance and 2) an assessment of whether such performance has been achieved, which must be reviewed and approved by the board of directors and explained to the company's shareholders.

China currently does not provide for any tax-favored treatment of stock options other than that they are not subject to tax until they are exercised. When that happens, the Chinese employer 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. This means a cashless "sell-all" exercise will result in the amount realized from the sale being greater or less than the amount that is taxable income when the closing price differs from the sale price. Determining what to do in such circumstances requires applying for an advance decision from the local tax bureau to which the tax is to be paid.

As of 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 stock 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.

Chinese employees may hold shares of stock in a foreign company that were issued in a "public offering of securities" approved by the China Securities Regulatory Commission. In practice, however such approval is unlikely to be given. As a result, many public companies have chosen to grant options that are exercisable only by a cashless sell-all exercise method. In such an exercise, all of the shares acquired pursuant to the exercise of an option are immediately sold with the proceeds first used to pay the exercise price and the remainder remitted to the employee (subject to tax withholding and reporting). Cashless exercise also facilitates compliance with currency exchange controls that limit Chinese employees to remitting no more than approximately $10,000 outside of China without first obtaining approval from the State Administration of Foreign Exchange. The dollar amount of this exemption is usually too small to be useful for employees of a public company but may be adequate for employees of private companies. Phantom stock awards, through which employees are given credit for the cash spread on shares they never actually hold is an alternative that avoids the above issues. But this approach may be too complex for most employees and is subject to accounting charges that may be undesirable for some employers.

Given the fierce competition for key employees in China, compensation packages play a significant role in a company's ability to recruit and retain employees. Options can inspire loyalty and commitment and, therefore, are a unique and powerful compensation tool. However, an option will not motivate an employee who does not understand its value. The cost of educating employees is often viewed as outweighing the benefit. Depending on a company's corporate culture and this educational cost, a company may choose to limit equity awards to key employees and/or senior management or may make equity awards available to all its employees in China. U.S. companies generally limit grants to their senior management and key employees in China.

In light of the current restrictions and ambiguities of Chinese laws and regulations that apply to stock option grants, a careful approach should be taken when it comes to providing such compensation 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 option grants provide by their terms that they may be amended as necessary to comply with revised rules and regulations as issued. Finally, once a company grants options in China, it should make sure that it remains current with all Chinese laws and regulations that pertain to options.

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