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New SAFE Circular Imposes Significant Regulatory Burden for Stock Options Granted to PRC Citizens

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Participation by PRC citizens in stock option and other equity compensation plans offered by offshore companies have always presented particular regulatory hurdles in the PRC. These included the need to avoid such participation becoming a “public offering” under the PRC Securities Law, and various restrictions on the ability of grantees to obtain foreign currency to pay the exercise price for options or other types of awards. Since the first batch of privately owned China-based companies listed on NASDAQ in 2000, a number of approaches to address these issues have become fairly customary, however, allowing widespread participation by PRC citizens in a variety of offshore equity compensation plans.

Although these approaches – which include, for example, allowing PRC citizens to pay the stock option exercise price with foreign currency legitimately obtained offshore – were not explicitly endorsed by the PRC government authorities, it was widely believed that the authorities tacitly accepted them. Moreover, there was no attempt to regulate the grantees of equity compensation awards (other than routine tax collection) or the manner in which the equity compensation plans were administered.

That somewhat relaxed attitude changed abruptly on April 6, 2007, when the capital account department of the State Administration of Foreign Exchange of the PRC (“SAFE”) issued on an informal basis the “Operating Procedures for Administration of Domestic Individuals Participating in the Employee Stock Ownership Plan or Stock Option Plan of An Overseas Listed Company, Hui Zong Fa [2007] No. 78” (“Circular 78”). In Circular 78, SAFE provides for the first time detailed procedures regarding its regulatory role over PRC citizens’ participation in employee stock option plans, which follow its initial announcement of its jurisdiction in this area in February 2007’s “Implementation Rules of the Measures for Administration of Individual Foreign Exchange.” Circular 78 applies to any employee stock option plan offered by a PRC or non-PRC company whose shares are listed on an overseas stock exchange, and it introduces a number of new and highly restrictive requirements, including:

- Option grantees are not allowed to use foreign currency held offshore in connection with the option award. Thus, grantees should either obtain foreign currency in China through a bank that is licensed to engage in foreign currency exchange or engage in cashless exercises of stock options.
- All proceeds received from the sale of option shares by PRC citizens must be remitted and deposited to such individuals’ designated onshore foreign currency bank accounts in the PRC. This repatriation requirement applies even if the option is exercised on a cashless basis.
- If a PRC citizen participated in a listed company’s stock option plan prior to April 6, 2007, he or she must register with SAFE and make the necessary applications and filings by **July 5, 2007**.
- For stock option plans adopted by a listed company after April 6, 2007, all participants who are PRC citizens must register with and obtain approvals from SAFE prior to their participation in the plan.

- Circular 78 also provides specific requirements as to what onshore and offshore entities should be involved in the administration of the stock option plan.

The registration process involves extensive disclosure to SAFE, including information on the underlying employee stock option plan, exercise price per share, source of renminbi funding, identity of the recipient, and relationship to the company, among other things.

Circular 78 specifically references “stock options” and any type of phantom stock option that provides equivalent economic benefits to the grantee. It remains to be seen whether SAFE will seek to extend the application of Circular 78 to other forms of equity compensation such as restricted stock awards. It is also unclear how quickly SAFE will grant approvals.

A great deal of the uncertainty surrounding Circular 78 derives from the fact that it has not yet been made publicly available nor formally promulgated by SAFE. Nonetheless, there are indications that SAFE has already begun enforcing its provisions. Circular 78 does not state the consequences for non-compliance, but given the significance of stock options to many businesses operating in the PRC, listed companies and their PRC stock option grantees will need to pay careful attention to Circular 78 and arrange for timely registrations and approvals.