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SAFE's New Rule on Domestic Individuals' Participation in Equity Incentive Schemes of Offshore Listed Companies

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The State Administration of Foreign Exchange (“SAFE”) promulgated the *Circular on Relevant Issues Concerning Foreign Exchange Control of the Participation in Equity Incentive Schemes of Overseas Listed Companies by Domestic Individuals* (关于境内个人参与境外上市公司股权激励计划外汇管理问题的通知) on February 15, 2012 (“Circular 7”). Circular 7 supersedes the *Operating Instructions for Foreign Exchange Control of the Participation in Employee Stock Plans and Stock Option Plans of Overseas Listed Companies by Domestic Individuals* by SAFE (关于印发〈境内个人参与境外上市公司员工持股和认股权计划等外汇管理操作规程〉的通知) (“Circular 78”).

BACKGROUND

China strictly regulates cross-border investments including both inbound and outbound investments. The laws and regulations promulgated by the PRC government concerning inbound investments from foreign investors since China adopted its open-door policy to foreign investments in early 1980s have been evolved into a more developed and established statutory regime to date, acclaimed internationally as a great contributor to China's economic success for the past 30 years. While the PRC government's position towards inbound investments has been generally positive, its attitude towards outbound investments by domestic entities and individuals has been prudent, partly due to its concern about capital and foreign exchange outflow. Now sitting on the world's no. 1 foreign exchange reserve, China has moved towards a more open policy for outbound investments. In 2004, the Ministry of Commerce (“MOFCOM”) introduced two outbound investments regulations which were subsequently replaced by the *Rules for the Administration of Outbound Investments* (境外投资管理办法) (the “Outbound Investment Rules”, [click here for our previous client alert](#)) on March 16, 2009. However, the Outbound Investment Rules govern only outbound investments made by domestic entities. There has been no clear policy as to how a PRC domestic individual obtains the approval to invest offshore or conduct a cross-border capital account transaction other than relying on the statutory annual US\$50,000 foreign exchange purchase quota (the “Annual Personal Forex Quota”).¹ The promulgation of Circular 7 constitutes a limited development in this regard, providing for a mechanism to allow a domestic individual to receive, exercise, cash out or otherwise realize benefits under the stock options or incentive shares issued by an offshore listed company. Nevertheless, the overall foreign exchange control over individuals' capital account transactions largely remains intact.

¹ PRC law currently permits a PRC resident to convert and wire up to USD50,000 to an offshore account on an annual basis. Such permitted conversion technically is for current account transactions (such as payment for tuition in relation to students studying abroad) only; however, there is no real system in place for the remittance bank to examine and monitor the purposes of the conversion in question and remittance application, and as such people may use this quota for capital account transaction purposes.

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HIGHLIGHTS

In general, similar to Circular 78, Circular 7 requires that an individual participating in the equity incentive plan of an offshore listed company is required to carry out, on a collective basis and through a filing agent appointed by his or her “domestic company” (as further discussed below) a foreign exchange registration for such participation.

Compared with Circular 78, major developments under Circular 7 include:

- **Clarification on Filing Obligors:** Both Circular 78 and Circular 7 require that individuals be filing obligors. There are a number of concepts that relate to the determination of whom would be deemed to be a filing obligor:
 - **Domestic Company (境内公司):** The term “domestic company” is used to define “domestic individual”. Circular 78 previously defined a “domestic company” as “*an offshore listed company, its domestic parent or any of its domestic subsidiaries or branches*”, whereas Circular 7 expands the definition to specifically include representative offices as “branches” of an offshore listed company. Circular 7 also includes partnerships controlled by an offshore listed company as “domestic companies”.
 - **Domestic Individual (境内个人):** Circular 7 specifically provides for a definition of “domestic individual”, which was absent in Circular 78. Under Circular 7, a “domestic individual” refers to one of the “directors, supervisors, senior officers or other staff of a “*domestic company*”, including PRC citizens (inclusive of Hong Kong, Macau and Taiwan residents) and foreign individuals.
 - **Equity Incentive Plan (股权激励计划):** Circular 7 specifically defines an “equity incentive plan” (referred to hereinafter as “**Incentive Plan**”) as a plan adopted by an offshore listed company to use its shares as objects to provide an equity-based incentive to individuals who have an employment or labor services relationship (雇佣或劳务关系) with a “*domestic company*” such as directors, supervisors, senior officers or other staff of the domestic company. Circular 78 contained no such definition.

There are a number of practical implications of the above-described new developments under Circular 7 that may affect the judgment as to whether a SAFE filing is required for a particular individual’s participation in an offshore listed company’s Incentive Plan. Previously, filing agents typically did not make Circular 78 filings in practice for foreign individuals nor for any contractors or staff working for a representative office of a foreign company dispatched by a labor services provider (such as a foreign enterprises services company or FESCO), and as such, filing was not specifically required under Circular 78. However, under Circular 7, a foreign individual, a contractor or a representative office staff would be deemed to be a filing obligor.
- **New Rules on Domestic Agents:** Both Circular 78 and Circular 7 require that the SAFE filings for and the option/right exercise or cash out under an Incentive Plan be handled through agents. Previously, Circular 78 required that three intermediate agents could be involved: (i) a domestic agent responsible for making the collective filing for all individuals participating in an Incentive Plan (“**Participating Individuals**”); (ii) an asset manager appointed by the afore-mentioned domestic agent responsible to purchase and sell the option shares on behalf of the Participating Individuals; and (iii) an offshore agent responsible for holding the option shares on behalf of the Participating Individuals. Circular 7 simplifies the requirement by eliminating the need to engage an asset manager. Under Circular 7, a domestic agent would be able to handle all the matters relating to SAFE filings, accounts setup and fund transfers and conversions for the Participating Individuals, whereas an offshore agent would be responsible for option exercise, purchase and trade of options shares and proceeds transfer matters. Note: the labor union of a domestic company may act as a domestic agent under Circular 78 but is no longer qualified to do so under Circular 7. A “domestic company” could act as a domestic agent by itself, and thus a domestic agent does not necessarily have to be a third-party agent. Should a third-party agent be engaged, it must be an institution that is qualified for the assets custodian business.
- **Banking Handling Procedures:** Pursuant to Circular 78, the domestic agent needs to open and maintain an onshore designated foreign exchange account in connection with an Incentive Plan and the Participating Individuals, and

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correspondingly, the offshore agent needs to open and maintain an offshore designated foreign exchange account. In practice, if a Participating Individual wishes to exercise his or her stock option, he or she may deposit all his RMB funds from all sources into an RMB account maintained by the domestic agent, who will then convert such RMB funds into foreign exchange funds and transfer the foreign exchange funds to the onshore designated foreign exchange account also maintained by it, and then remit the funds onward to the offshore account maintained by the offshore agent for the purpose of exercising the concerned stock option. If a Participating Individual already owns legal foreign exchange funds, he or she can directly deposit such foreign exchange funds into the onshore designated foreign exchange account for the purpose of exercising his or her stock option. Circular 78 prohibits a Participating Individual from directly using offshore funds to pay for his or her exercise of stock options, and all proceeds derived from selling option shares offshore are specifically required to be repatriated back to the onshore designated foreign exchange bank account.

Similar to Circular 78, Circular 7 also specifies that the domestic agent needs to open an onshore designated foreign exchange account to deal with all sorts of banking needs, including foreign exchange conversions and cross-border remittances as may be required in connection with the exercise and realization of the benefits under the options granted to the Participating Individuals. Unlike Circular 78, Circular 7 remains silent as to (i) whether the offshore agent needs to open an offshore designated foreign exchange account, (ii) whether a Participating Individual shall be allowed to directly utilize his or her offshore funds to exercise the options and (iii) whether it is mandatorily required that all proceeds from the sale of option shares need to be repatriated back to the onshore designated foreign exchange account.

The underlying motivation for making these differences remains to be clarified. We note, interestingly, that both the Administrative Regulation on Foreign Exchange (外汇管理条例) and the Administrative Measures on Individual Foreign Exchange (个人外汇管理办法) do not require Chinese residents to repatriate offshore foreign exchange savings back to China. However, given that there is currently no statutory mechanism to allow the proceeds to Participating Individuals to stay offshore, we would expect that the fund flow control system previously established under Circular 78 may continue to apply in the practice. As a matter of fact, we do not anticipate that there will be any substantial change to SAFE's official position in this regard before China fully reforms its foreign exchange control system. Having said this, we have already seen an obvious gap between the existing fund flow control system and the current reality – the majority of Chinese residents have access one way or another to foreign exchanges without going through China's foreign exchange control system. It is highly questionable as to how practical the existing fund flow control system would be, in particular, in relation to foreigners working for “domestic companies”.

- **Shortened Timeframe for Quarterly Update Filings:** Both Circular 78 and Circular 7 require quarterly filings with local SAFE branches to give the authority an update on the status of the participation of the Participating Individuals in relation to a registered Incentive Plan. However, Circular 7 requires that such quarterly update filings be completed within the first 3 working days of each quarter, as compared to the first 10 working days of each quarter. We note further that Circular 7 also pins down the bank maintaining the onshore designated foreign exchange account to these quarterly filing requirements to ensure that the transactions under a particular Incentive Plan be monitored in a timely and efficient manner.
- **De-registration Requirements:** Circular 7 requires that, to the extent that an Incentive Plan expires or terminates, the domestic agent is required to carry out a registration cancellation procedure within twenty (20) working days thereafter. This procedure was not previously contained in Circular 78 but is a logical development to make the filing system complete and sound.
- **Annual Foreign Exchange Quota:** Both Circular 78 and Circular 7 require that the option exercises under an Incentive Plan by Participating Individuals be subject to an annual foreign exchange payment quota which needs to be specifically applied for by the domestic agent on behalf of the Participating Agent. It is unclear, however, whether this annual foreign exchange payment quota would be inclusive or exclusive of the Annual Personal Forex Quota. In addition, no guidance has been provided under Circular 7 as to how to determine and assess what would constitute an appropriate amount for this annual foreign exchange payment quota under a particular Incentive Plan.

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CONCLUSION

As a general observation, it appears to us that Circular 7 streamlines and simplifies the foreign exchange filing requirements for the participation by domestic individuals of an Incentive Plan initially provided under Circular 78. Notably, SAFE also took this opportunity to specifically extend the filing requirements to foreign individuals working in China and those who may not necessarily be deemed as employees of a domestic entity (i.e., staff of a representative office of a foreign listed company). However, as always, it is not uncommon in China that the practice may be different from the rules or from one location to another. As such, the implementation of Circular 7 in real life and any further development in this regard needs to be carefully watched.

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