2008 Update to Implementing Share Incentive Schemes in China

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This memorandum is an overview of the legal and strategic issues related to implementing share incentive schemes in China, including understanding Chinese cultural views of employment and compensation, structuring share incentive schemes to comply with applicable Chinese currency controls and securities law restrictions and the tax consequences of options to the employees. 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 occurred in China only a couple of years ago, relevant 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[1] relating to the implementation of equity incentive plans, including stock options, by companies listed on domestic stock exchanges and companies controlled by China's government listed on foreign stock exchanges and domestic stock exchanges. However, these regulations have not changed the landscape for options granted by foreign companies to their Chinese employees.

Strategy

Before implementing a share incentive 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 capable employees. Share incentive schemes, 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 share 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 also means 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.

Alternatives for Share Incentive Schemes

In current practice, especially for a listed company, alternatives for share incentive schemes are usually restricted stock and stock options. Restricted stock means the stock issued by the company to its employees subject to certain terms, which stock may not be traded by the employees until agreed conditions have been

[1] 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 Finance 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 Finance on September 30, 2006.

satisfied. Stock options mean the company grants the employees a right to purchase a certain number of shares within a period in the future with an agreed price and conditions. The shares granted or sold to the employees usually come from new shares authorized by the company or outstanding shares repurchased by the company.

Securities Law Considerations

Chinese law permits persons in China to purchase shares of Chinese companies pursuant to offerings that have been approved by the China Securities Regulatory Commission (CSRC). Until the *Pilot Plan of Implementing Domestic Individual Direct Investing in Oversea Securities Market* released by the State Administration of Foreign Exchange (SAFE) on August 20, 2007, PRC laws were not clear on if a Chinese individual may directly purchase the shares of a company listed on foreign stock exchanges, but relevant laws banned Chinese individuals from purchasing foreign currency to invest abroad in the past, so Chinese individuals were actually restricted from purchasing such shares in fact. In addition, there is no safe harbor exemption from CSRC regulation as there is in the U.S. for private company issuances. Nor is there a streamlined compliance process for compensatory equity arrangements.

A share incentive scheme implemented by a non-listed company does not need the CSRC's approval, but according to the Company Law and the Securities Law, the shareholders of a limited liability company may not exceed 50, and the maximum shareholders of a non-listed joint stock limited company are 200. As a result, the employees directly participating in a share incentive scheme in a non-listed company may not exceed 200. A listed company's share incentive scheme must be filed with the CSRC before the company announces the notice of a shareholders meeting to approve such scheme. If the CSRC has an objection to the scheme in due course, the company may not announce the notice.

Currency Control Considerations

China imposes foreign exchange controls on stock option exercises by Chinese employees and consultants. Therefore, many listed 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 listed 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.

The situation has changed to some extent with the new regulations issued by the People's Bank of China (PBOC) and the SAFE, which have established an approval process pursuant to which foreign currency may be used to exercise stock options in accordance with these new regulations.[2] To further clarify the procedure of approval and the administration of foreign exchange issues relating to implementing share incentive schemes of an overseas listed company, the *Operation Regulations of Foreign Exchange Management on Domestic Individuals Participating Employees Holding Stock Plans and Stock Options Plans of Oversea Listed Companies etc* was released by SAFE on March 28, 2007.

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 or fair market value on the date of exercise. Because of China's currency control laws, however, stock options that can not 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.[3] The *Notice of Taxation on the*

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

[3] See the 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.

Issues of Levying Individual Income Taxes on Incomes from Individual Stock Options jointly issued by the Ministry of Finance and the State Administration on March 28, 2005, however, permits apportioning the taxable income received from a stock option exercise over a period 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 labor 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 share incentive schemes, a company, especially a non-listed company, should take a careful approach to share incentive schemes in China. Where a company has determined that the use of a share incentive scheme is necessary for the recruitment and retention of employees, the scheme should be implemented in a manner that is in compliance, to the extent determinable, with the current laws and regulations. Such a practice may require that share incentive schemes, by their terms, will be revised as necessary to comply with rules and regulations as issued. Furthermore, once a company implements a share incentive scheme in China, it should continue to closely monitor changes in applicable Chinese laws and regulations.

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