



Asia Pacific Alert

A publication of Nixon Peabody LLP

JULY 18, 2012

New developments on equity incentive plans in China

By David Cheng and Kelly Xiang

In an effort to regulate and improve the foreign exchange control of the participation in equity incentive schemes of overseas listed companies by domestic individuals, on February 15, 2012, the State Administration of Foreign Exchange of the People's Republic of China ("SAFE") issued the Circular on Issues Concerning the Administration of Foreign Exchange Used for Domestic Individual's Participation in Equity Incentive Plans of Companies Listed Overseas (Circular Hui Fa [2012] No.7) ("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 (Circular Hui Zong Fa [2007] No.78) ("Circular 78") and took effect upon the announcement.

Circular 7 clarifies and partially simplifies the procedural requirements on SAFE filing of equity incentive plans, while expanding the scope of the equity incentive plans and the filing obligators, and strengthening the ongoing compliance after initial SAFE registration.

Simplification of procedural requirements

Individuals participating in equity incentive plans ("Participating Individuals") are required to handle their SAFE filings and exercise their options/rights through agents. In order to simplify operating procedures, Circular 7 reduces the involvement of intermediate agents.

Three agents could be involved under Circular 78: (i) a domestic agent ("Domestic Agent") responsible for carrying out SAFE filings for all Participating Individuals, (ii) an asset manager ("Asset Manager") appointed by the Domestic Agent responsible for purchasing and selling 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 eliminates the Asset Manager, and requires the Participating Individuals to handle all the matters relating to SAFE filing through one domestic agent, and purchase, sell options shares, and transfer corresponding proceeds through one offshore agent.

Meanwhile, Circular 7 reduces the amount of documentation for initial SAFE registration to (i) application letter, (ii) public notice issued by the offshore listed company that proves the authenticity of the equity incentive plans, (iii) authorization letter or agreement appointing a domestic agent to handle SAFE registration on behalf of the Participating Individuals, (iv) proof issued by the domestic company evidencing the employment or labor services relationship between the Participating Individuals and the domestic company, and (v) other documents required by a local SAFE branch if there are any discrepancies between the documents included in (i) to (iv) or aforementioned documents cannot prove the authenticity of the transactions.

In addition, fewer documents are required under Circular 7 than those under Circular 78 when a domestic agent applies for annual foreign exchange quota on behalf of the Participating Individuals. Under Circular 7, a domestic agent, if it has obtained the foreign exchange registration certificate through initial SAFE registration, is no longer required to submit copies of broker agreements, internal control measures regarding risk control and information disclosure, and forms of employee ownership plans, stock option plans or other grant agreements.

Expansion of application coverage

Circular 7 expands the application coverage by defining the concepts of “domestic company,” “domestic individual,” and “equity incentive plan.”

- a. “Domestic Company”: in addition to the offshore listed company itself, its parent company, subsidiaries, and branches in China as specified in Circular 78, Circular 7 expands the definition for “domestic company” to include representative offices of an offshore listed company, and all parent companies, subsidiaries, and partnerships that directly or indirectly control or are controlled by an offshore listed company.
- b. “Domestic Individual”: this term is absent from Circular 78, while under Circular 7, in addition to Chinese citizens who are directors, supervisors, senior officers, or other staff of a Domestic Company being defined as Domestic Individuals in practice before the issuance of Circular 7, Circular 7 specially indicates that foreign individuals who are working for a Domestic Company are also defined as Domestic Individuals.
- c. “Equity Incentive Plan”: pursuant to Circular 78, domestic individuals participating in employee stock plans and stock option plans of overseas listed companies needed to complete SAFE registration. However, Circular 7 expanded the equity incentive plans to include employee stock plans, stock option plans, share appreciation rights plans, restricted stock/restricted stock units plans, performance share units plans, phantom shares plans, and other equity incentive plans permitted by laws and regulations.

Enhancement of ongoing compliance

Circular 7 strengthens the monitoring of fund flows, and requires the Domestic Agent to file quarterly reports with its local SAFE office within the first three working days of each quarter rather than the first 10 working days of each quarter as required by Circular 78. Circular 7 also imposes additional requirements on the bank of the Domestic Agent, and the bank should, within the first three working days of each month, submit to its local SAFE office i) a form for the particulars of the opening and closure of the designated foreign currency accounts, and ii) a form for the particulars of foreign exchange transactions of the designated foreign currency accounts.

Meanwhile, Circular 7 requires a Domestic Agent to amend its prior application within three months if there are major changes to the equity incentive plans (e.g., amendment to the key clauses of the equity incentive plan; adoption of a new equity plan; or changes to the equity incentive plans due to a merger, acquisition, or reorganization of the offshore listed company or Domestic Company). A Domestic Agent should also complete the deregistration formalities within 20 working days following the termination of the equity incentive plan due to the expiration of the plan, delisting of the offshore listed company, or restructuring and merger of the Domestic Company.

In addition, Circular 7 permits domestic individuals to participate in the equity incentive plans with their own foreign exchange, and requires such individuals to carry out SAFE registration as well.

Conclusion

Circular 7 does not substantially change the operating procedures stipulated in Circular 78. However, the expansion of application coverage and the provisions on the subsequent reporting requirements reflect the Chinese authorities' intention to strengthen foreign exchange control of the participation in equity incentive schemes of overseas listed companies by domestic individuals. Overseas listed companies offered or planning to offer equity in China should review their public filing schedules to make sure they are in compliance with Circular 7.

Circular 7 streamlines the SAFE filing procedures and has a higher degree of operability. However, like Circular 78, it still does not cover the equity incentive plans carried out by overseas unlisted companies. In such a case, lack of required legal procedures may pose a regulatory risk to the individuals participating in the equity incentive plans of an offshore unlisted company. In addition, Circular 7 still does not provide clear guidelines on how to deal with the shares and stock options held by the employees who have left the employer. Therefore, it is necessary for the Chinese authorities to issue additional regulation and rules to close loopholes under current legal regime.

For more information on the content of this alert, please contact your Nixon Peabody attorney or:

- David K. Cheng at dcheng@nixonpeabody.com or +852 9307 3900
- Kelly Xiang at kxiang@nixonpeabody.com or +86 21 6137 5517