

# New Regulations on Equity Incentives for Employees of Listed Companies

Despite its limited scope in application, China's new law on incentives for employees of listed companies is a major step towards the establishment of a more comprehensive regulatory system for employee stock option schemes.

By Lester Ross and Kenneth Zhou, Wilmer Cutler Pickering Hale & Dorr LLP, Beijing

The Measures for the Administration of the Equity Incentives of Listed Companies (Trial Implementation) (Measures) promulgated by the China Securities Regulatory Commission (the CSRC), effective from January 1 2006, are a significant advancement in the regulation of employee incentives and stock options in China. The Measures systematically provide for the first time detailed requirements for granting shares to employees, disclosure standards, pricing mechanisms and other fundamental procedures for the implementation of stock option and stock-based incentive schemes for listed company employees.

## EVOLUTION OF EMPLOYEE INCENTIVES REGULATION

In China, implementing stock-based employee incentive schemes has been problematic. Not only did the laws regarding such schemes lack clarity but they imposed many restrictions and limitations on the use of incentive schemes. Furthermore, stock-based incentives were regarded as quite a novel concept. Previously, Chinese employment regulations generally provided for the payment of wages and bonuses in cash. Before its amendment, the PRC Company Law (Company Law) did not allow companies to repurchase their shares in order to grant them to their employees as incentives. Employees in state-owned enterprises (SOEs) experienced great difficulties receiving and holding stock options due to the State's fear of loss of control. The Sino-foreign equity and cooperative joint venture laws prohibited Chinese individuals from becoming shareholders of Sino-foreign joint ventures and were excluded from receiving or exercising stock options, which would allow them to become individual shareholders of such entities. As a consequence of the legal deficiencies in regulation, foreign exchange restrictions and onerous government approval processes, foreign companies in China found it difficult to include Chinese employees, working in their subsidiaries, in their global stock-based incentive schemes.

Since the late 1990s, Chinese companies (mainly privately-owned with flexible ownership structures), especially in technology industries, increasingly started to create stock-based incentive schemes to attract and retain managerial and technical personnel. Subsequently, SOEs also adopted similar incentives in order to remain competitive. In 2002, the Ministry of Finance (MOF) and Ministry of Science and Technology jointly promulgated several regulations with respect to the granting of stock options in state-owned high-tech companies. These groundbreaking regulations became the first to allow SOEs to create stock-based incentive schemes and grant stock options to their key employees. Under *Tax Circular [2005] No. 35*, jointly promulgated by MOF and the State Administration of Taxation, Chinese domestic companies that wanted to create stock option schemes were required to file their schemes with the relevant local

tax authority for the record. Although these regulations in principle authorized the existence of option schemes, they did not, however, establish comprehensive provisions, standards or procedures for the creation of stock-based incentive schemes, employee participation or options for employees to exercise.

In 2004, the State Council promulgated the *Several Opinions on Promoting the Reform, Opening-Up and Stable Development of Capital Markets*, which officially launched the stock reform of listed companies aiming to convert non-tradable state-owned and legal person shares to tradable shares. In the following year, the CSRC, State-owned Assets Supervision and Administration Commission, MOF, People's Bank of China and Ministry of Commerce, jointly promulgated the *Guidelines for Reform of Segmented Shares of Listed Companies* (Guidelines), which provide general guidelines and specify the basic framework of their stock reform programmes. Under the Guidelines, listed companies having completed the stock reform schemes may adopt stock-based incentive schemes for its management. The State Council in its *Opinion on Improving the Quality of Listed Companies* further provides that listed companies must explore and establish incentive mechanisms to motivate their senior management and employees by adopting stock option and other incentive schemes. These regulations indicate the push by government for listed companies to adopt incentive schemes to enhance their overall management and operations.

The enactment of the amended Company Law and other regulations eliminated major legal barriers and deregulated the overall legal environment for stock-based incentive schemes. Before amendment of the Company Law, directors, supervisors and other senior officers were not allowed to transfer their shares during their term of office. By contrast, the amended Company Law allows a company to redeem up to 5% of its shares for the purpose of using them as employee incentives (see Article 143(3)). The lock-up period for directors, supervisors and other senior officers of a listed company has been reduced from the length of their respective term

of office to a one year listing on a stock exchange (see Article 142). After the expiration of the one year lock-up period, such individuals may trade their shares on stock markets, provided that the number of shares traded in any one year does not exceed 25% of the total number of shares held.

### **EQUITY INCENTIVES UNDER THE MEASURES**

#### ***Application***

The Measures only apply to Chinese listed companies that have successfully completed their stock reform programmes, which involve converting non-tradable state and legal person shares to tradable shares. There are currently 500 to 600 'pioneer' public companies, which have either completed or are about to complete such programmes; accounting for approximately 50% of the total number of listed companies in China. Unlisted companies, including SOEs, privately-owned and foreign-invested enterprises (FIEs), or listed companies that have yet to complete their share reform programmes are excluded from making any applications under the Measures.

#### ***Recipient eligibility***

Recipients of share incentive benefits must be employees of a listed company, including directors, supervisors, senior management, key technical business personnel and other individuals specified by the company. Under the Measures independent directors and individuals who are unqualified are ineligible to receive such benefits. The exclusion of independent directors is regarded as essential to maintain the independence and impartial judgement of such directors. People who are unqualified include the following: (i) those who have been publicly censured or declared as inappropriate candidates by a securities exchange, within the last three years; (ii) those who have received administrative punishment from the CSRC, within the last three years, for any material violation of laws and regulations, or (iii) those who fall within one of the categories of individuals specified under Article 147 of the amended Company Law as being ineligible to serve as a director, supervisor or senior management of a listed company.

#### ***Stock suitability***

The Measures specify three categories of stock that are suitable for employee incentive schemes:

- (i) restricted stock or shares specifically issued to plan participants;
- (ii) shares repurchased by a company to be granted to plan participants, or
- (iii) shares acquired through other methods as permitted by laws and administrative regulations.

The types of stock available under the Measures are similar to those found in employee incentive schemes used in the United States and other foreign jurisdictions. However, the Measures are silent regarding the use of treasury stock. Under China's Company Law regime, shares may not be as readily available for the purpose of incentive schemes compared with foreign jurisdictions due to the registered capital concept. In China, the registered capital concept

requires a company to increase its registered capital before the issuance of new shares. Increases of a company's registered capital usually require approval by the shareholders' meeting as well as government approval or registration.

#### ***Cap on number of shares held***

Companies are restricted in the percentage of stock that can be made available under employee incentive schemes. The number of shares allocated to a scheme may not exceed 10% of a company's total share capital and an individual may not hold more than 1% of a company's total share capital acquired using this method, unless the shareholders' meeting otherwise approves.

#### ***Qualifications for individuals to receive stock options***

The Measures generally require that individuals who are granted stock options and other incentive schemes must meet certain performance targets to be decided by the company. With respect to directors and senior management, the Measures set out certain mandatory requirements before being qualified to receive stock options.

#### ***Prohibition on insider trading and stock price control***

In order to prevent insider trading and price manipulation, the Measures provide several 'closed' periods during which options may not be granted or exercised given that beneficiaries of stock option schemes are likely to be senior management, who possess insider information. Options may not be granted during the following periods:

- (i) 30 days before the publication of periodic reports by the company;
- (ii) during major transactions or major decisions of the company and for the next two trading days thereafter, or
- (iii) during the occurrence of other important matters that may affect the share price and for two trading days thereafter.

Share option holders may not exercise their options within two trading days after the publication of a periodic report or 10 trading days prior to the publication of the next periodic report of a listed company; or during major transactions, major decisions or the occurrence of other important matters affecting the share price and for two trading days thereafter.

#### ***Protection of minority shareholders' interests***

To protect minority shareholders' interests and to prevent the granting of unreasonably profitable options to management, at the expense of other interests, the Measures require that all stock incentive schemes be approved by at least two-thirds of all shareholders present at the shareholders meeting; independent directors are required to solicit votes from all of a company's shareholders including minority shareholders. Furthermore, companies must obtain a legal opinion from outside counsel with respect to the legality and feasibility of option schemes.

### **Disclosure obligations**

To ensure the transparency and fairness of option schemes, the Measures also place a rigid disclosure burden on participating listed companies. Listed companies must disclose option schemes promptly after the adoption of relevant board and shareholders' meeting resolutions. Disclosure of such option and other incentive schemes is also required in the companies' periodical reports.

### **LIMITATIONS ON STOCK INCENTIVE SCHEMES**

The limitations and restrictions in relation to stock incentive schemes under the Measures include the prohibition by listed companies on the provision of any form of financing to option holders. The transfer, sale and pledge of options granted under a scheme and the use of the same for the repayment of debt is also prohibited. By contrast, public companies in the United States under the *Sarbanes-Oxley Act* are prohibited from providing financing to their officers and directors for this purpose but not to ordinary employees, and no such prohibition applies to non-public companies. Public companies in the United States may overcome this prohibition through cashless exercise provisions. However, the registered capital concept in China would appear to prohibit cashless exercise provisions for listed or public companies because of the general requirement that purchases take place when the new shares are created.

### **IMPEDIMENTS TO THE MEASURES**

The Measures signal remarkable progress towards the establishment of a comprehensive and sophisticated regulatory system, in China, for employee stock option schemes by drawing from international practices. However, several contentious issues remain. The Measures have limited scope, applying only to listed companies that have completed the stock reform programme. Therefore, the requirements and procedures for creating stock option schemes in other types of companies, including listed companies that have yet to complete their stock reform programmes, unlisted SOEs, privately-owned companies and FIEs, still remains unclear due to the lack of unified and detailed regulations. In addition, China's foreign exchange regulations place a registration burden on Chinese individuals, which limits their ability to hold and exercise options for overseas stock. Finally, China's statutory registered capital system and burdensome government approval and registration requirements, with respect to changes of registered capital and shareholders, still present regulatory risks regarding the exercise of options. Unless these issues are resolved, they will remain impediments for the further development of employee incentive schemes in China for the future.