

# China SAFE Requirements for Equity-Based Awards

## Introduction

For non-Chinese companies, one of the main challenges for offering equity-based awards to employees in the People's Republic of China ("PRC") are the restrictions and requirements imposed by the Central State Administration of Foreign Exchange ("Central SAFE"). Although the requirements are better understood and the filing processes have become more streamlined since the restrictions were first imposed in 2007, registering with a local SAFE office and complying with the ongoing requirements continues to be a time-consuming undertaking.

## Background

In January 2007, Central SAFE published the Implementing Rules of the Measure for Administration of Foreign Exchange of Individuals (Hui Fa [2007] No.1) (the "Implementing Rules"). The Implementing Rules officially announced SAFE's jurisdiction over foreign companies' employee share plans, requiring SAFE approval for the implementation of such plans offered to employees in the PRC of affiliates/subsidiaries of a non-Chinese company.

On April 6, 2007, the General Affairs Department of Central SAFE issued the Operational Guidelines on Foreign Exchange Administration Concerning Domestic Individuals Participating in Stock Purchase Plans and Stock Option Plans of Overseas Listed Companies (Hui Zong Fa [2007] No. 78) (the "Circular 78") to all of its local counterparts (*i.e.*, the local SAFE offices) which set forth additional procedural and documentary requirements for the approval of employee share plans by SAFE. Circular 78 was distributed to the local SAFE offices but was not initially made publicly available. However, it is understood that the approval requirements under Circular 78 became effective sometime in 2007. In addition, SAFE takes the position that the approval requirements apply even to grants made prior to the effective date of the Implementing Rules and Circular 78.



Under Circular 78, non-PRC companies granting any equity-based awards to PRC nationals had to obtain approval from SAFE, both for new grants as well as for any outstanding equity-based awards. Grants to non-PRC nationals or PRC nationals with dual citizenship or a permanent residency permit in another country (e.g., U.S. green card holders) did not require approval, nor could such individuals be included in the SAFE application.

On February 20, 2012, Central SAFE issued the Notice on Issues Relating to Foreign Exchange Control for Participation by PRC Individuals in the Stock Incentive Plan of Overseas Listed Companies ("Circular 7") to the local SAFE offices. The purpose of Circular 7 was to harmonize and streamline the application process (now referred to as a registration) as well as the ongoing requirements. Although Circular 7 does reduce the information and documents that have to be provided in the registration process, it also created several new requirements. In addition, local SAFE offices continue to have their own unique interpretations of the requirements under Circular 7, which means that complete harmonization has not been achieved. We also continue to experience that SAFE offices change their interpretation of the requirements as new examiners are appointed within the local SAFE offices.

## Purpose of Circular 78 and Circular 7

The main purpose of Circular 78 and now Circular 7 is to enable SAFE to monitor and enforce that all proceeds realized by individuals from equity-based awards (e.g., sale proceeds and cash dividends) be immediately repatriated to the PRC through a special "dedicated" foreign exchange account set up by the company in the PRC.<sup>1</sup> It is not permitted to issue the proceeds into a foreign brokerage account. By contrast, it is permissible for the individuals to hold shares outside of the PRC, as long as the company can ensure that any proceeds related to the shares be repatriated to the PRC. In addition, any proceeds that are remitted out of the PRC in relation to equity-based awards (e.g., exercise or purchase price paid by the employees to acquire the shares) also have to be funneled through the dedicated account in the PRC.

It should be noted that registration is also required for options restricted to a cashless exercise and any other awards where the employee is not required to remit any funds out of the PRC to pay for the shares (e.g., restricted stock (RS) or RSUs). These types of awards were previously thought to be exempt from any exchange control requirements in the PRC, but this is no longer the case under Circular 78 and Circular 7.

Circular 7 lists seven different award types which require registration with SAFE: stock options, stock purchase rights, stock appreciation rights, phantom awards, performance awards, restricted stock (units) and a catch-all "other type of award." With this enumeration, it is now clear that SAFE expects registration for virtually all types of awards granted to PRC individuals. Interestingly and despite the inclusion of phantom awards,

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<sup>1</sup> Under the Central SAFE guidelines, it appears to be a requirement that a separate dedicated account be set up for each plan offered to individuals in the PRC. Not all SAFE offices enforce this requirement (e.g., Shanghai SAFE generally requires only one account, regardless of the number of plans, while Beijing SAFE requires different accounts).

we are experiencing that some SAFE offices (e.g., Shanghai SAFE) do not allow registration of purely cash-settled awards.

In addition to PRC nationals, Circular 7 provides that nationals of Hong Kong, Macau and Taiwan as well as other "domestic individuals"<sup>2</sup> working for an entity in the PRC are covered by the SAFE registration requirement. This is a big shift from Circular 78 which applied only to PRC nationals. However, based on our discussions with various SAFE offices, we understand that these individuals do not mandatorily have to be included in the SAFE registration. Instead, it seems a company **may** now include such individuals, but is not required to do so.

Under Circular 78 and Circular 7, only listed companies can obtain SAFE approval. This means there is currently no avenue for unlisted companies to operate an equity-based plan in the PRC in technical compliance with the SAFE requirements (although it may be possible to make grants, provided the vesting and/or the exercise/settlement of the awards is conditional upon the company going public and completing the SAFE registration<sup>3</sup>).

## Registration Process

In Shanghai and Beijing, the SAFE registration process has become relatively predictable, although registrants still need to provide a significant amount of information and documentation. In other provinces, the process can remain challenging because the offices continue to impose new (and differing) obligations on registrants, are less familiar with employee share plans and, as a result, tend to ask more questions during the registration process. However, compared with the old Circular 78, Circular 7 has eliminated several of the documentation requirements and, most importantly, the need for translations of these documents. Certain factors (such as prior grants or an unusual entity structure in the PRC) may still complicate the registration process, but without such complicating factors, registration can often be achieved within 2-3 months of submission.

## Applicant and Filing Location

A PRC entity must file the registration on behalf of the foreign issuer. The PRC entity acting as the applicant has to be a subsidiary of the foreign issuer (e.g., a wholly owned foreign enterprise). Most SAFE offices will not accept a registration filed by a branch or representative office.<sup>4</sup>

The registration has to be completed in the province in which the applicant is located. If a company has multiple subsidiaries in the PRC in different provinces, it may choose the entity which is to act as the applicant and can, therefore, also choose the province in which to register. The registration may cover all other legally owned entities of the

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<sup>2</sup> "Domestic individuals" are defined in Circular 7 (by reference to another set of regulations) as individuals (both PRC and foreign nationals) who have stayed in the PRC for more than one year consecutively. However, another regulation defines "domestic individuals" more narrowly as PRC nationals who hold PRC ID cards.

<sup>3</sup> We note, however, that at least Shanghai SAFE has recently refused to register plans/awards that have been implemented/granted prior to an IPO, even if vesting/settlement was made conditional upon a liquidity event.

<sup>4</sup> Beijing SAFE and Guangdong SAFE have verbally confirmed upon inquiry that a representative office may act as the applicant, but we are not aware of any registrations actually submitted by a representative office as the applicant. Therefore, this position remains untested.

issuer in the PRC, including any branch and representative offices.<sup>5</sup> Thus, it is not necessary to file multiple applications in multiple provinces.

As mentioned, the registration and ongoing requirements vary by province. Therefore, if a company has a choice in which province to file the registration, it is beneficial to carefully analyze the advantages and disadvantages of each location.

### Information/Documents To Be Submitted

Circular 7 requires that the following information/documents be submitted as part of the registration:

- i. Application letter (including description of the issuer company, PRC entities to be covered, equity plan(s), type(s) of award and flow of funds);
- ii. Prescribed registration form;
- iii. Employment relationship letter (including list of eligible employees by entity with names in Chinese characters and employees' PRC ID number);
- iv. If multiple PRC entities: power of attorney from each PRC entity appointing the registrant entity to act on its behalf with SAFE;
- v. Public announcement of the equity plan(s); and
- vi. Any other documents or information, as requested by SAFE.

All documents have to be translated into Chinese.

Under Circular 7, it is no longer necessary to provide a copy of the equity plan(s) and award agreement(s), nor of the broker services agreement. This is a welcome change as it significantly reduces the translation cost. However, various of the local SAFE offices are taking advantage of their authority under (vi) to request additional documents and information. Depending on the province, companies may also be required to provide any of the following: corporate organizational chart, flow of funds chart, disclosure of prior grants (made before registration), proof of share listing and copy of business license for each PRC entity.

### Key Decisions

Some of the key decisions a company has to make with regard to the registration process and the implementation of its plan(s) in the PRC are:

- i. Whether to force the sale of shares at vesting (RS/RSUs) / exercise (options) / purchase (ESPP) to facilitate repatriation of sale proceeds to PRC;
- ii. Whether to convert the sale proceeds into Chinese Renminbi or pay them to the individuals in the currency of the issuer's country (e.g. US dollars);
- iii. Whether include non-PRC nationals in the registration; and
- iv. How to comply with tax withholding obligations.

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<sup>5</sup> Circular 7 expressly mentions that any PRC entities may be covered in the registration. This is a positive development as some of the local SAFE offices did not previously allow representative offices to be included in an application and also rejected some legal entities as being too far removed from the issuer company (i.e., any entities which were less than a second tier subsidiary of the issuer company). However, most SAFE offices still refuse to register entities that are not legally owned by the foreign issuer, such as entities over which the foreign issuer has only contractual control (e.g., variable interest entities).

As mentioned, a company is required to ensure repatriation of all proceeds related to the equity awards to the PRC through a SAFE-approved dedicated foreign exchange account. If the terms of the awards provide that shares are to be automatically sold upon vesting/exercise/purchase, this will facilitate the repatriation. By contrast, if employees are permitted to hold shares after vesting/exercise/purchase, the company will need to ensure that it can track the shares and repatriate the proceeds when the shares are later sold. In addition, companies must be able to repatriate dividends paid on the shares. Companies will need to work with their brokers to determine whether this is feasible. If companies allow employees to hold shares, most SAFE offices will require that shares be liquidated and proceeds repatriated to the PRC within a certain period of time after termination of the employment of the employee.<sup>6</sup> Again, companies will need to ensure that their brokers can accommodate this requirement and also structure their awards accordingly.<sup>7</sup>

After the proceeds are repatriated to the dedicated account in the PRC, the company must distribute at least the net proceeds directly to individual participants' accounts (*i.e.*, net proceeds cannot be funneled through local payroll). The company must decide whether to distribute the proceeds to employees in the original currency or Chinese Renminbi. There are pros and cons to each alternative that companies need to carefully consider.

In addition, companies need to ascertain how to comply with their tax withholding obligations that arise at the time of exercise (options), vesting (RSUs) and purchase (ESPP). Note that withholding shares to cover the tax liability generally is not acceptable to the SAFE offices. This leaves companies with forcing the sale of a number of the shares at the taxable event (and remitting the sale proceeds through the dedicated account to the local entity for further remittance to the tax authorities) or withholding tax from the employee's paycheck (which can be difficult if the tax liability exceeds the monthly salary).

Under Circular 7, it is no longer necessary to apply for approval for each conversion with SAFE. Instead, the bank where the dedicated account has been established will be able to complete the conversion.<sup>8</sup>

As described above, we believe it is not necessary to include non-PRC nationals in the SAFE registration. However, companies may voluntarily decide to include them. There are usually two reasons for inclusion: (i) to facilitate the remittance of ESPP payroll deductions out of the PRC, and (ii) to facilitate the remittance of tax withholding proceeds to the PRC. If non-PRC nationals are not included in the registration, funds related to non-PRC nationals cannot be funneled through the dedicated account. However, there is also no other legal avenue for a PRC entity to send

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<sup>6</sup> The permissible period of time varies but is at the most six months from termination.

<sup>7</sup> For companies that grant awards that are subject to performance-based vesting, it is common to allow employees who terminate employment for certain reasons (*e.g.*, retirement or disability) during the performance period to be entitled to receive at least a prorated portion of the award if and when the performance criteria are met at the end of the performance period. If this can lead to a pay-out of the award more than six months after termination, such a term will not be acceptable for PRC employees and require the company to either forfeit the award upon termination or to accelerate the payment of the award.

<sup>8</sup> Depending on the bank, it may require supporting documentation to effect the conversion. For example, some banks require a signed broker report evidencing the transfer of the proceeds from the issuer's country to the PRC.

and receive these funds to/from the U.S., making participation of non-PRC nationals in the plan(s) complicated.

On the other hand, inclusion of non-PRC nationals can be burdensome, because some SAFE offices allow only non-PRC nationals who have resided in the PRC for a minimum period of one year to be included in the registration. It can often be difficult to prove the residency requirement.<sup>9</sup> In addition, it will force companies to still find solutions for the remittance of funds for non-PRC nationals who do not meet the minimum residency requirement.

Furthermore, inclusion of non-PRC nationals means that they will have to be treated like PRC nationals in certain respects. For example, if non-PRC nationals are included in the registration for purposes of the ESPP (which allows the remittance of their payroll deductions from China through the dedicated account), their proceeds related to the ESPP will have to be immediately repatriated to China.<sup>10</sup> This may not be desirable for expatriate employees on short-term assignment who wish to keep their equity award proceeds in a foreign brokerage account.

### Process

After the registration documents have been prepared, most of the documents have to be "chopped" by the applicant (*i.e.*, the official seal of the local entity has to be affixed). An informal meeting is scheduled with the SAFE office during which the chopped documents are submitted. In most SAFE locations, a company representative should attend the meeting and submit the application. The SAFE examiner may preliminarily review the registration package during the meeting to ensure that all necessary documents have been submitted and, if documents are missing, can reject the registration. More typically, the registration is accepted for further review.

During the review process, it is very common for the SAFE examiner to ask for further clarification, additional information and documents and to request changes to the existing documents. The company will have to respond to these additional requests as soon as possible. Depending on the complexity of the application, there can be several rounds of comments/requests before the registration is granted. If changes are requested, some of the documents may have to be re-chopped by the PRC entities.

Once approved, SAFE will issue a registration certificate. The company must present this certificate to the local bank to open the dedicated foreign exchange account (which it should have reserved, but not yet opened, during the registration process). From then on, any funds related to equity-based awards granted to individuals covered in the registration will have to be funneled through this account.

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<sup>9</sup> In some cases, SAFE offices have requested immigration records or passport copies showing entry/exit into/out of the PRC.

<sup>10</sup> However, if the non-PRC national is not included for purposes of his/her participation in the option/RSU plan, it would not be necessary to repatriate his/her proceeds relating to such plan to China.

## Ongoing Requirements

After the registration certificate has been issued, there will be ongoing compliance requirements.

### Quarterly Report

In each province, the company is required to submit prescribed quarterly reports which require the disclosure of all share issuance events (e.g., exercises/vestings) over the prior quarter and the remittance of funds into and out of the dedicated account. The reports are due within three business days of the close of the quarter.<sup>11</sup> Under Circular 7, a new format for the quarterly report has been introduced.

### Annual Quota Approval

It is no longer required to calculate the estimated proceeds which will flow into the PRC through the dedicated account on an annual basis. However, it is necessary to calculate the estimated proceeds flowing out of the PRC through the dedicated account (usually, ESPP contributions). This amount has to be approved by SAFE every 12 months. At the same time, the company will have to provide an explanation of the extent to which the prior year's quota has been used. In our experience, the SAFE offices are scrutinizing quota requests more closely and are demanding detailed explanations of the method of calculating the quota.

### Annual Re-Registration

Shanghai SAFE requires companies to re-register their share plans offered in the PRC on an annual basis. The application for re-registrations must be submitted between October-December each year and must be completed by December 31st. There is a risk that SAFE and the local bank will not allow funds to be sent through the dedicated account in the following year until re-registration has been completed. To effect the re-registration, companies will at a minimum need to submit a new prescribed registration form and updated employment undertaking letters.

### Amendments

Any material changes to the operation of the share plans in the PRC, such as the addition of new PRC entities, introduction of new plans, broker switch, etc., will require an amended registration filing. The requirements for the amendment filing will depend on the respective SAFE province.

## Managing Risk

Although there continues to be relatively little enforcement action by SAFE, it is not recommended to continue to grant equity-based awards to PRC nationals without a SAFE registration. It is clear that the SAFE officials view Circular 7 as a streamlined tool for allowing companies to operate their share plans in the PRC. Therefore, they have less tolerance for companies not following the registration process. To this end, we are increasingly seeing penalties being imposed on or at least threatened for companies in the registration process in cases in which SAFE has

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<sup>11</sup> The deadline has been shortened from ten business days after the end of the quarter (the deadline in effect under Circular 78).

determined that the company has not previously repatriated proceeds related to equity awards or otherwise violated SAFE requirements.

For companies which are not ready to undertake the SAFE registration process, it may be advisable to consider cashing out existing awards to mitigate any risk. However, companies will need to be mindful of U.S. tender offer requirements for such cash-out offers.

Circular 7 has made clear that cash-settled awards (e.g., cash-settled RSUs) do not avoid the SAFE registration requirements. However, arguably, any cash-settled awards which are paid through local payroll and funded by the local entity should not be subject to the SAFE registration requirement, as such awards should be characterized as a local bonus payment (which is outside the scope of Circular 7). Any award documentation for such awards should be carefully reviewed to make sure the awards do not fall under Circular 7. Lastly, any cash awards which are not linked to the company's stock price arguably are also not subject to Circular 7, regardless of whether they are paid by the parent company or the PRC entity.

However, we would caution companies with respect to such awards (especially if paid into a foreign brokerage account), because SAFE's position on these awards is not well developed.

## Conclusion

Due to the war for talent in PRC, it is important for many companies to be able to offer equity-based awards to their PRC employees. However, before starting the registration process, companies should carefully weigh the burden and cost of completing and maintaining a SAFE registration against the benefits of granting equity-based awards in the PRC. Since the publication of Circular 7, it is undoubtedly easier to register share plans in the PRC and we have seen a real acceleration in the registration process for many companies. However, we continue to caution companies not to underestimate the resources it takes to obtain and maintain the registration, especially in light of the ongoing requirements.

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