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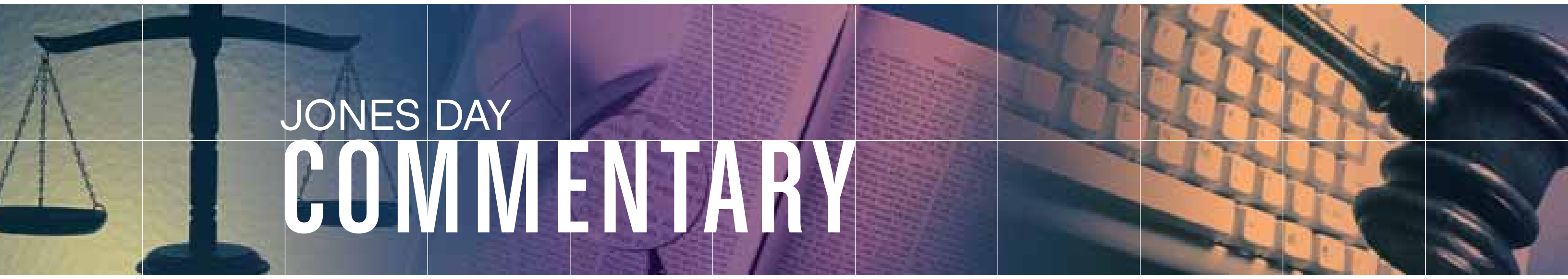

NEW SAFE CIRCULAR 7—WHAT DOES IT MEAN FOR YOUR COMPANY?

In April 2007, the State Administration of Foreign Exchange ("SAFE") in the People's Republic of China ("PRC") issued Circular 78, which required non-PRC public companies to receive exchange control approval from SAFE in connection with grants of certain types of equity awards and offers of stock to PRC nationals in China under their stock incentive and employee stock purchase plans. Just as multinational companies were becoming more proficient at navigating the SAFE approval process (and SAFE officials were simultaneously becoming more efficient in their review of applications), SAFE circulated new Circular 7 at the end of February (officially known as the Circular of the State Administration of Foreign Exchange on Issues of Foreign Exchange Administration of Domestic Individual Participation in Stock Option Incentive Plans of Companies Listed Overseas). Circular 7 supersedes Circular 78 in its entirety and immediately became effective upon circulation.

Circular 7 does not completely revamp the SAFE approval process. However, it does introduce a number of changes to both the application process and ongoing compliance requirements. Some of the modifications that simplify the application itself will be welcomed by many corporations that have not yet filed for approval, whereas other changes will increase the compliance burden for those companies that have already received approval and for those that receive approval in the future.

This *Commentary* summarizes the major changes to the SAFE approval and ongoing compliance processes introduced by Circular 7 and their effect on those multinational companies that have not yet filed for approval, those corporations that have received SAFE approval for their equity issuances to PRC nationals in China, and those companies whose applications are currently under review by SAFE. If you have any questions about Circular 7 or need any assistance with any stage of the SAFE approval or ongoing compliance process, please contact one of the Jones Day authors listed below.

CIRCULAR 7 REQUIREMENTS

Although Circular 7 has not radically altered the initial SAFE approval process or ongoing corporate compliance obligations, it has broadened the SAFE requirements to include:

- A wider variety of equity awards, including phantom stock;
- More entities, including branch or representative offices of multinational corporations in China; and
- Non-PRC expatriates and citizens working in the PRC, including Hong Kong, Macau, and Taiwanese citizens.

Furthermore, Circular 7 shortens the submission deadline for quarterly reports and requires registered companies to amend their registrations in the event of a termination of the underlying equity plan, the adoption of a new plan, or a material modification of the approved plan. The remainder of this *Commentary* describes how Circular 7 expanded on, as well as revised, certain aspects of Circular 78 and attempts to explain what those changes mean to new applicants going forward, current applicants, and companies that have already received SAFE approval under Circular 78.

For New Applicants:

Initial Application Package: Circular 7, like Circular 78, still requires any company listed on an overseas exchange and its PRC subsidiary to submit an application package to the SAFE office where the subsidiary (or the parent company's PRC headquarters) is located. As part of the package, companies must still include an application letter that provides general information about the parent company, its PRC subsidiaries, and the terms of the equity plan(s) and awards offered under them to employees in China. In addition, companies must continue to submit information to SAFE about employees who are eligible to receive awards under the plan(s) as well as provide copies of certain ancillary documents, such as an organization chart, a copy of the business license of any participating PRC subsidiary, and resolutions adopted for the equity plan(s). A representative from the local PRC subsidiary will still need to submit the application in person to the local SAFE official, and the local SAFE office will continue to have the right to request supplemental materials and information after the application is filed. Just like Circular 78, Circular 7 does not impose a time frame or deadlines for completion of the initial approval process. Moreover, once approval is received, companies will still be required to open dedicated foreign exchange accounts and comply with quarterly reporting and annual quota requirements. Circular 7, however, differs from Circular 78 in the following ways:

- **Fewer Ancillary Documents Required:** Companies are no longer required to include copies of broker agreements, a summary of internal risk control measures, or forms of grant agreements in their application packages. However, companies must provide additional business information about the local PRC subsidiaries, such as a copy of the subsidiary's certificate of approval and organizational code certificate. In addition, Circular 7 explicitly states that all documents submitted to SAFE must be in Mandarin Chinese. Although most local SAFE offices have always required documents to be translated into Chinese, Circular 78 was silent on this point.
- **New Registration Form:** Companies must now submit a Foreign Exchange Registration Form, a copy of which has been attached to Circular 7, in addition to the application letter.
- **Types of Awards Covered:** SAFE approval is no longer limited to just stock options, restricted stock/restricted stock units, and stock purchase plans. Although Circular 7 does not enumerate the types of awards to which it applies, the new Foreign Exchange Registration Form provides boxes for the following types of awards: stock options, SARs, restricted stock/restricted stock units, performance shares/performance share units, phantom stock, and stock purchase plans. It also includes a box for "Other." Therefore, it appears that a wider variety of equity awards are now subject to SAFE approval. It is not clear, however, whether "phantom stock" includes locally cash-settled bonus awards that are tied to stock performance. Certain SAFE offices have indicated that as long as an award does not result in a stock purchase or sale, the award would be outside the purview of SAFE. However, SAFE's view on this matter varies from office to office.

- **Inclusion of Non-PRC Nationals:** Grants of equity awards to expatriates or non-PRC nationals (including citizens of Hong Kong, Macau, and Taiwan) who are employees, directors, supervisors, or senior managerial personnel of a PRC subsidiary are now subject to SAFE approval. Under Circular 78, only equity awards made to PRC nationals required approval. Although Circular 7 does not address whether mobile employees who are employed by a non-PRC entity but are temporarily working at a location in the PRC should be treated differently from non-PRC nationals who are permanently on the payroll of a PRC subsidiary, the Shanghai and Beijing SAFE offices have both indicated that awards granted to assigned mobile employees should not be included in the SAFE registration.

- **Approval for Branch Offices:** Branch or representative offices of multinational corporations located in China are now expressly included in the definition of "domestic companies" under Circular 7 and, as a result, are considered eligible to apply for SAFE approval.

- **Issuance of Foreign Exchange Registration Certificate:** Once the local SAFE office approves the application, it will issue a foreign exchange registration certificate, which will include the applicant's foreign exchange quota under the applicable equity plans.

Ongoing Compliance: Once SAFE registration has been obtained, companies will need to file quarterly reports with their local SAFE office. These reports must describe the company's equity plan activity (*e.g.*, grants, exercises, share sales, and the balance of the designated foreign exchange account) during the previous quarter. Although this reporting requirement is not new, the deadline for submission has changed under Circular 7. Now, quarterly reports must be submitted to SAFE by the third business day of each month following the end of the applicable quarter. Companies with SAFE approval must also renew their foreign exchange quotas on an annual basis, but the renewal obligation has not been altered by Circular 7. Therefore, submissions for quota renewal must still be made by December 31 of each year for the subsequent calendar year. Most significantly, companies that have received approval will now be required to amend their prior applications within three months of the occurrence of any of the following events:

- Material amendment to the underlying equity plan (including as the result of a merger, acquisition, or reorganization of the parent company or PRC subsidiary);

- Adoption of a new equity plan or the grant of a new type of equity award permissible under an existing plan to employees in China;

- Any change in the parent company or PRC subsidiary, which would include any merger or acquisition activity involving these entities that impacts the administration of the registered equity plan; or

- Any change in the local entities whose employees are participating in the plan or the applicable stock plan broker.

In order to amend a prior approval, companies must submit a new Foreign Exchange Registration Form (checking the box marked "Change in Registration"), an updated application letter, and any other materials that support or identify the change to the existing equity plan or company (e.g., a copy of the plan amendment).

Moreover, within 20 business days of the expiration or termination of an equity plan, the local PRC subsidiary must cancel its SAFE registration with its local SAFE office.

For Companies With Applications Currently Under Review: Based on our experience, local SAFE offices are not requiring applicants to resubmit their applications using the new registration form. Rather, local SAFE offices have been making additional information requests in connection with registration applications that are currently under review in order to comply with the new requirements. Therefore, it seems promising that the approval process for companies with outstanding applications will not be significantly delayed due to the issuance of Circular 7. Nonetheless, it remains to be seen whether information about cash-settled awards or grants to non-PRC nationals will be requested.

Once those companies with applications currently under review receive approval, they will be subject to the ongoing compliance requirements as described above.

For Companies With SAFE Approval Received Under Circular 78:

Companies that received SAFE approval for their equity plans under Circular 78 will now have to follow the ongoing compliance requirements under Circular 7. Consequently, starting in April 2012, those companies will need to file quarterly reports with their local SAFE office by the *third* business day of each month following the end of the applicable quarter rather than the 10th business day of the month as previously required. Therefore, the first quarterly report for 2012 will be due by April 4, 2012.

Furthermore, if any changes have been made to the underlying equity plans, including their termination, as discussed above under "Ongoing Compliance," those companies must now amend their applications using the new Foreign Exchange Registration Form and checking the box for "Change in Registration" on the form.

It is still unclear, however, whether such companies must amend their prior applications to include non-PRC nationals and/or different equity award types (including cash-settled awards) for which approval was not previously received without any prompting from SAFE.

CONCLUSION

The issuance of Circular 7 has long been awaited, so its appearance is welcome to many companies that have been looking for further SAFE guidance before offering equity in China or submitting their applications to SAFE. While Circular 7 attempts to harmonize local SAFE office applications of the prior Circular 78 and clarify certain aspects of the approval process, it unfortunately leaves a number of issues unaddressed. At this point, it is unknown how the various local SAFE offices will interpret Circular 7 and, in particular, how they will apply it to non-PRC nationals as well as cash-settled awards. Undoubtedly, with the promulgation of Circular 7 and its reiteration that SAFE is entitled to impose penalties for noncompliance with its terms, the Chinese government is again emphasizing the importance of exchange control regulation in the PRC. This renewed focus provides a good opportunity for those companies that have not yet filed for SAFE approval to initiate the process or, at the very least, engage in discussions with SAFE.

LAWYER CONTACTS

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