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# CSRC New Rules on Incentive Stock Options of Listed Companies

**By Grant Chen and James Weng**

The China Securities Regulatory Commission (the "**CSRC**") promulgated the *No.1, No.2 and No.3 Memorandums on Issues in Respect of Incentive Stock Options* in May and September 2008 with an aim to further regulate the incentive stock options of listed companies. These three Memorandums are supplementary to the previous fundamental measures, namely the *Measures for the Administration of Incentive Stock Option of Listed Companies (Trial)*, the *Measures for Implementing Incentive Stock Options of Offshore State-Holding Listed Companies (Trial)* and the *Measures for Implementing Incentive Stock Options of Domestic State-Holding Listed Companies.* With the influence by such new rules, some listed companies have announced to cancel or withdraw their incentive stock option plans disclosed previously.

## Eligibility under incentive stock options

Pursuant to the previous regulations, those who are eligible under an incentive stock option of a listed company may include its directors (excluding independent directors), supervisors, senior management personnel, key technical (business) personnel and other staff who the company deems to be entitled to such option. However, the No.1 and No.2 Memorandums have imposed restrictions upon the eligibility under incentive stock options, i.e. in principle, neither a major shareholder holding more than 5% of the shares nor a de facto controller is eligible under such options; the board of supervisors of a list company is required to review the name list of the eligible and the supervisors are not eligible under an option. In addition, any person eligible under an option is not allowed to simultaneously participate in incentive stock options of two or more listed companies. The No.3 Memorandum provides for the reasonableness of the eligible scope under an incentive stock option and requires that in case any person other than the directors, supervisors, senior management personnel or key technical (business) personnel is eligible under an option, the listed company should analyze the connection of such person with the company's business or performance and specify the reasonableness of such person's eligibility.

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Since the CSRC has tightened the eligible scope under incentive stock options, it is advisable for a listed company to be more prudent when defining the eligible scope.

## The grant price

For the issue that the grant price was too low when some listed companies implemented their restricted share incentive options, it is set forth in the No.1 Memorandum that if the restricted shares under incentive options are issued on a private placement basis, the grant price shall not be less than 50% of the average price of the company's shares during the 20 trading days prior to the pricing reference date and the granted shares shall be prohibited from being transferred within a lockup period of 12 months from the date of grant; if the restricted shares are granted to a controlling shareholder or a de facto controller, such shares shall be prohibited from being transferred within a lockup period of 36 months from the date of grant. In case that any incentive stock option is not in line with the above-mentioned criteria, it shall be subject to further review by the CSRC.

## Exercising standards

In respect of the exercising standards, the No.1 Memorandum requires the exercising standards should be made on a business performance basis, and in principle, a company's performance indicators shall be no lower than the general level in the company's history. Moreover listed companies are encouraged to use the so-called "market value standard" and the "comparable sector standard".

It is specified in the No.3 Memorandum in respect of exercising and discharge of the lockup period and it is further specified that in any financial year within the waiting period under a stock option plan or a lockup period under a restricted share plan, neither the net profits that can be allocated to the listed company's shareholders nor the net profits excluding extraordinary gains and losses that can be allocated to the listed company's shareholders shall be lower than the average level for the latest three financial years before the grant date and in no event shall be a negative.

The above-mentioned provisions link the exercising by the eligible with the performance of a listed company and require that the performance of a listed company should be in an increasing manner before the implementation of an incentive stock option. That would be favorable to giving a fully play of the incentive stock option and further safeguard the medium and small shareholders of a list company.

## Exercising arrangements

It is specified in the No.3 Memorandum that listed companies shall not adopt any arrangements that may enable the eligible to accelerate the exercise of incentive stock options or shorten the lockup period in case of the change of control, the merger or the demerger of the listed companies.

## Incentive stock options and intervals of material matters

In order to prevent listed companies from inside trading and market manipulation, it is set forth in the No.2 Memorandum that a listed company shall not release its incentive stock option either during its disclosure of any material information and within 30 days thereafter or when proposing to issue new shares, inject assets or issue convertible bonds and within 30 days after such material matters are completed. In addition, a listed company shall not implement any of the foregoing material matters during the period from the disclosure of its incentive stock option and within 30 days after such option is approved by its shareholders' meeting.

In addition to the above, the Memorandums also make detailed provisions with respect to such other issues like sources of the incentive stocks, allocation of incentive fund, grant in installments, pre-allocated shares, booking and accounting, and change or cancellation of incentive stock options, which generally reflects the CSRC's intention to tighten the supervision on incentive stock options of listed companies.

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