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Hong Kong – Employee Incentive Schemes.

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Employee incentive schemes have become a standard feature for companies listed on The Stock Exchange of Hong Kong Limited ("**HKEx**"). As of 1 September, 2013, more than 70% of the companies newly-listed in 2013 have adopted employee incentive schemes in one form or another. When a company assesses which type of incentive scheme it wishes to adopt, it will have to consider several factors, including the number of grantees; restrictions imposed by the articles or pre-IPO investment agreements; and taxation of such schemes in relevant jurisdictions. This article provides a brief rundown of the most common employee incentive schemes used by companies listing on the HKEx.

Pre-IPO Share Option Schemes

Share option schemes under Chapter 17 of the of the Rules Governing the Listing of Securities on The Stock Exchange of Hong Kong Limited (the "**Listing Rules**") should be distinguished from pre-IPO share option schemes. Although the terms of the schemes are often similar, and the schemes are often implemented just before a company's IPO, the exercise price for pre-IPO share options may be substantially lower than the IPO price – subject to the condition that the HKEx will not allow any options to be issued under a pre-IPO scheme after the IPO. Names and addresses of grantees must also be listed in the company's prospectus, unless a waiver is granted by the HKEx and the Securities and Futures Commission, in which case only information on the grantees who are directors, connected persons or who is otherwise granted with an amount of options above a certain threshold, will be disclosed. Whether such a waiver is granted is determined on a case-by-case basis depending on factors such as the number of grantees. A drawback of pre-IPO share option schemes is the dilutive effect on others' shareholdings and the earnings per share of the company – which, under new HKEx guidance, needs to be made clear upfront in a company's prospectus. While some companies have historically sought to extend pre-IPO schemes to include non-employees such as business partners, in light of the HKEx's increasing vigilance with respect to companies issuing equity on favorable terms prior to their IPOs, it would not be surprising to see the HKEx casting a more inquisitive eye over such practices going forward.

Employee Share Option Schemes

By far the most common type of incentive scheme among HKEx-listed companies, employee share option schemes are governed by Chapter 17 of the Listing Rules and are primarily designed to provide an incentive and/or to reward employees. Some companies have also extended option schemes to cover suppliers, customers [1] and other third parties. Share options are vested on the grantees over a period of time – most of the share option schemes on the market vest over a period of ten years (in accordance with Chapter 17). Employee-grantees have to remain in the employ of their company for a certain period of time (usually three to four years) to have the full amount of share options vested on them, and may be subject to other vesting conditions (such as performance hurdles). If the share price falls below the exercise price, the relevant grantee can choose not to exercise the option and the option will eventually lapse. Common criticisms of share option schemes include: (1) dilutive effect on other shareholders' holdings over the long term; (2) difficulty obtaining an accurate valuation; (3) potential over- or under- compensation of executives since the market price of the shares may not reflect the listed company's performance; and (4) loss of incentive value if share price languishes well below the exercise price for an extended period.

Share Appreciation Rights Schemes

Share appreciation rights (or "SARs") schemes give employees a cash payment corresponding to the increase in the share price of a company's shares over the "exercise price" fixed at the time of the grant, multiplied by the number of rights issued. In Hong Kong, SARs are more commonly seen with H-share issuers [2]. The cash amount representing the increase in the share price over the exercise price is given to the employee upon exercise of the right, and no actual shares are involved. SAR schemes share many of the same disadvantages as share options schemes, except that there is no dilution of the existing shares as may occur under the former. Unlike share options, SARs will also impact a company's cash flow.

Share Award Schemes

A share award scheme is a direct award of shares to senior employees. To date, share award schemes have been adopted by very few companies listed on HKEx [3]. Such schemes involve the vesting of fully-paid shares to senior executives either for free or at a discount, but instead of having to exercise options, the shares are awarded directly to the grantee who can sell or keep the shares as he sees fit. The obvious advantage of share award schemes is that once the shares are vested, the grantee becomes the owner immediately without taking the positive act of exercising an option, with the down-side obviously being the dilution to the company for no tangible cash consideration.

Restricted Stock Unit Schemes

Restricted stock units ("**RSU**") schemes involve stock that are not transferrable until certain conditions are met. These schemes are typically used in jurisdictions where the tax impact of share option schemes may be substantial. Common conditions for effecting an RSU scheme are that an employee must remain employed at the company and the earnings-per-share of the listed company must reach a certain value. A trustee (the "**RSU Trustee**") is usually appointed to assist with the administration and vesting of RSUs. The company may (i) allot and issue shares to the RSU Trustee pending the vesting of the RSUs granted and/or (ii) direct and procure the RSU Trustee to purchase shares on the market to satisfy the RSUs upon vesting. Funds are provided to the RSU Trustee by order of the company's board of directors – such funds should enable the RSU Trustee to satisfy its obligations in connection with the administration and vesting of RSU.

RSU schemes favour employees who are subject to income tax in some jurisdictions, notably the United States. However RSU schemes are not common among HKEx-listed companies. Since 2010, fewer than ten companies have adopted RSU schemes during or after their IPOs [4].

For PRC incorporated companies, RSU schemes are technically subject to approval by the China Securities Regulatory Commission (the "**CSRC**"), and although the CSRC has issued guidance stating that RSUs are not subject to approval, it is important to note that RSU schemes are still subject to approval by the State Administration of Foreign Exchange.

Conclusion

Companies looking to list in Hong Kong should start thinking about an appropriate employee incentive scheme as early as possible. The choice of employee incentive scheme may impact the company's accounts in different ways and factors such as the financial circumstances of the company and where its employees are based will all need to be taken into account. In light of the new and ever-changing guidance put out by the HKEx, it is important that companies to be listed ensure that they take appropriate advice from their legal advisors when they consider adopting any incentive scheme.

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[1] For example, Chigo Holding Limited (449)

[2] The general prohibition is set out in articles 13 and 14 under the 'Essential Clauses in Articles of Association of Companies Listed Abroad' ('Essential Clauses' or commonly known as 'Mandatory Provisions') issued by the State Council's Securities Commission and the State Commission for Economic Restructuring in 1994.

[3] The most notable exception being the HKEx itself which uses the share award scheme as its primary employee incentive scheme.

[4] For example, AIA Group Limited (1299), Automated Systems Holdings Ltd. (771), AviChina Industry & Technology Company Limited (2357), China Harmony Auto Holding Limited (3836), Sateri Holdings Ltd. (1768), Samsonite International S.A. (1910) and Winsway Coking Coal Holdings Ltd. (1733)

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