Recent Developments Regarding the Establishment of Employee Share Ownership Plans in China

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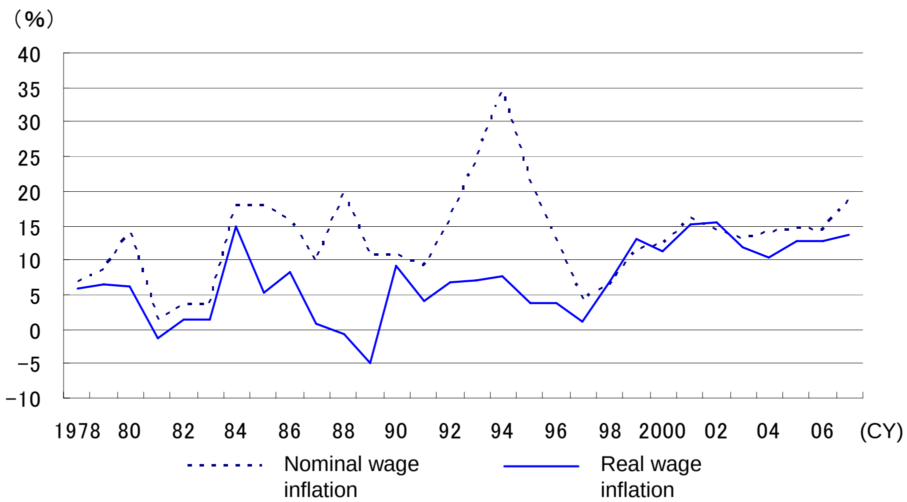
I. Need to offer employees more attractive incentives

In China average wages have been rising (in nominal terms, since 2003, and in real terms, since 2004) as a result of the rapid economic growth of recent years and increases in the minimum wage (Figure 1).

Similarly, efforts by the government to alleviate social inequality have led to the passing of a number of laws aimed at safeguarding employees' rights. One of the most important in terms of its impact on companies is the *Labor Contract Law*, promulgated in June 2007 and effective since January 2008. Other laws include the *Employment Promotion Law* (promulgated in August 2007 and effective since January 2008), the *Regulations on Paid Annual Leave for Employees* (promulgated in December 2007 and effective since January 2008), and the *Labor Dispute Mediation and Arbitration Law* (promulgated in December 2007 and effective since May 2008).

Figure 1: Chinese wage inflation (yearly average)



Source: Nomura Institute of Capital Markets Research, based on data from *China Statistical Abstract*

These wage increases and regulations have prompted foreign companies in China to try to control and reduce their employment costs. However, as well as prompting companies to restructure, they have prompted them to take positive measures to increase productivity by appointing locals to management positions and recruiting talented staff. One of these positive measures that has recently been the subject of renewed attention in China is the establishment of employee share ownership plans (ESOPs) as a means of harmonizing the interests of labor and management and creating more attractive incentives for employees.

II. Legislation and public debate on employee share ownership plans in China[1]

1. Local regulations

As part of the company reforms of the 1990s, which included the conversion of state-owned enterprises to joint stock and limited liability companies, local governments drew up regulations governing employee share ownership plans in the absence of national legislation, and schemes were set up in Beijing, Shanghai, Jiangsu and Anhui. The regulations are aimed at incentivizing employees by giving them an opportunity to invest in the companies they work for and take a more active part in how they are run. The schemes take one of three forms, depending on the local regulations: community organizations, labor unions and corporate entities.

2. Negative attitudes towards employee share ownership plans

In China some people have negative attitudes towards employee share ownership plans.

One reason is that, whereas such plans are supposed to be voluntary employee associations with the status and rights of shareholders, they are sometimes seen in practice as part of the company. For example, the members of a plan's board are supposed to be elected by the members. In practice, however, company officers have tended to serve as chairman of the board, and this caused problems when state-owned enterprises were reformed in the 1990s. One result of this was that the State Council (i.e., the government) issued a decree in the early 1990s to prevent employee share ownership plans from abusing their position.

Another reason why some people in China have a negative attitude towards these plans is that they think that the aims of such plans are incompatible with the non-profit-making goals of community organizations and labor unions.

Yet another reason is that some people think that such plans have a negative impact on companies because they are not governed by national legislation and that the absence of clear rules governing the transfer and disposal of members' shares if they

1 Chapters 1 and 2 are based on research by Zhong Lun Law Firm.

leave a plan (e.g., because they are leaving the company) results in long delays before a decision is reached.

Finally, some people think that employee share ownership plans could lead to the stripping of assets from state-owned enterprises.

As a result of negative attitudes such as these, employee share ownership plans have been dissolved in some parts of the country. However, this was not because such plans were considered illegal or not to have any merits.

3. Support from the People's Bank of China Research Bureau

In a special May 2008 issue, the Chinese magazine *Caijing* published a report on employee share ownership plans by the People's Bank of China Research Bureau.

After discussing the role of these plans in terms of income policy and mentioning some of the issues relating to them[2], the report recommends that China adopt its own version for the following reasons. First, it contends that such plans would help to improve both the structure and level of private sector incomes. Second, it argues that in combination with social security they would reduce the burden of social security on the state and help to distribute income better. Third, it argues that they would help to improve the way companies remunerate their employees, make it easier for them to recruit staff, and make them more competitive.

Finally, it proposes that these plans should be introduced in China (Figure 2) on a trial basis and that more research should be carried out on them. We therefore conclude that the introduction of such plans in China would be in line with the Chinese government's policies of reforming the pension system to encourage people to make their own provision for their old age and achieve a fair and equitable distribution of income.

2 The report also identifies the following as some of the problems facing employee share ownership plans in China, as we have to some extent already mentioned: (1) in some cases, employees have been forced to accept shares as well as having other rights violated; (2) employee share ownership plans have sometimes been used to grant employees excessive fringe benefits and to strip companies of assets belonging to the state; (3) in the absence of rules governing the sale of shares purchased via a share ownership plan, employees have sometimes had to make desperate efforts to cash in their shares; (4) plans have sometimes been used to circumvent regulatory controls or have been set up in an ad hoc fashion simply because they have become popular; and (5) there are still no national rules governing employee share ownership plans even though the first plans were set up years ago.

Figure 2: Main points of report on employee share ownership plans by the People's Bank of China Research Bureau and published in *Caijing*

Point	Details
1	Companies with a relatively high level of corporate governance, well established rules, and a high degree of competitiveness should set up employee share ownership plans
2	Employee share ownership plans should be seen mainly as giving employees the right to share in their company's profits
3	Clearer tax and accounting rules should be drawn up
4	Rules need to be drawn up for unlisted companies as soon as possible
5	Employee share ownership plans should be promoted as an integral part of the pension system
6	System for regulating and supervising employee share ownership plans needs to be established
7	Legal responsibilities of financial institutions (securities companies and trust companies), management consultants, specialist research agencies, lawyers, accountants and evaluation firms should be clarified and more done to support their work

Source: Nomura Institute of Capital Markets Research, based on data in May 2008 issue of *Caijing*

III. Some examples of setting up employee share ownership plans in China

1. Drawing up of necessary regulations by the State Administration of Foreign Exchange

As we have mentioned, China does not have any national regulations on setting up employee share ownership plans. However, the State Administration of Foreign Exchange (SAFE, the People's Bank of China's foreign exchange administration department) does have regulations and procedures governing foreign currency transactions which permit individuals to invest in foreign shares traded on overseas capital markets as part of an employee share ownership plan set up by a foreign company (Figure 3).

The regulations are the *Measures for the Administration of Individual Foreign Exchange* (promulgated on 25 December 2006 and effective since 1 February 2007, the "*Administrative Measures*"), which are based on the *Regulations for the Control of Foreign Exchange* (revised version promulgated on and effective since 5 August 2008). According to the *Administrative Measures*, when a domestic individual makes overseas investments, he/she has to deal with it through a domestic financial institution that has corresponding qualifications according to the relevant provisions. There is also a set of corresponding implementation rules, *Detailed Rules for the Implementation of the Measures for the Administration of Individual Foreign Exchange*, (promulgated on 5 January 2007 and effective since 1 February 2007, the "*Detailed Rules*"). Article 18 of the *Detailed Rules* governs foreign currency transactions resulting from investments by domestic individuals participating in employee share ownership plans and share option plans of overseas public companies.

Figure 3: Foreign exchange regulations governing the acquisition of parent company shares by the employee share ownership plans of foreign-invested companies

<table>
<tr><td rowspan="2">Regulations for the Control of Foreign Exchange (revised version)

(State Council)

Promulgated on and effective since 5 August 2008</td><td colspan="2">Chapter 3: Foreign exchange control over capital accounts</td></tr>
<tr><td>Article 17</td><td>♦ Domestic organs and individuals that engaged in overseas direct investment or the issuance and transaction of securities and derivatives abroad shall go through registration formalities in accordance with provisions of the administration of foreign exchange under the State Council.

♦ With respect to those that the approval or filing of relevant competent departments are required by the state, approval or filing formalities shall be gone through prior to the foreign exchange registration.</td></tr>
<tr><td rowspan="2">Measures for the Administration of Individual Foreign Exchange

(People's Bank of China)

Promulgated on 25 December 2006 and effective since 1 February 2007</td><td colspan="2">Chapter 3: Management of individual foreign exchange under the capital account</td></tr>
<tr><td>Article 17</td><td>♦ Where a domestic individual purchases B shares, makes financial investment involving overseas rights and interests, bonds or any other financial investments as approved by the state, he/she shall handle it through a domestic financial institution with corresponding business qualification in accordance with the relevant provisions.</td></tr>
<tr><td rowspan="2">Detailed Rules for the Implementation of the Measures for the Administration of Individual Foreign Exchange

(SAFE)

Promulgated on 5 January 2007 and effective since 1 February 2007</td><td colspan="2">Chapter 3: Administration of individual foreign exchange under the capital account</td></tr>
<tr><td>Article 18</td><td>♦ Where a domestic individual participates in the employee share ownership plan or share option plan of an overseas listed company, the foreign exchange business involved shall be handled after the listed company or its domestic agency has filed a unified application and has obtained the approval from the foreign exchange department.

♦ The foreign exchange income obtained by a domestic individual from selling the shares under the employee share ownership plan or share option plan of an overseas listed company and those from dividend may go through foreign exchange settlement formalities after being remitted to the domestic special foreign exchange account opened by the listed company or its domestic agency, or may be transferred to the employee's individual foreign exchange savings account.</td></tr>
</table>

Note: Although Article 18 of the *Detailed Rules* says "may go through foreign exchange settlement formalities," in practice we take this to mean that the income will be transferred to the employee's individual foreign exchange savings account.

Source: Nomura Institute of Capital Markets Research, from People's Bank of China and SAFE data

By allowing individuals to make foreign investments via employee share ownership plans, SAFE has created an alternative to QDIIs[3] for individuals to make overseas investments and is encouraging capital outflows from China over the longer term. However, share ownership plans require revisions not only to foreign exchange regulations but also the *Securities Law*, the *Labor Law* and the various tax laws.[4]

2. Procter & Gamble (China) becomes first foreign company with employee share ownership plan

Following the enactment of the *Detailed Rules*, Procter & Gamble (China) Ltd. became the first foreign company in China whose employees were allowed by SAFE to purchase shares in their overseas parent company by means of their employee share ownership plan. We have gleaned the following information about how the plan was set up and how it has developed from the company's Chinese website and from company press releases[5] as well as local media reports[6].

1) Creation and history of local subsidiary

Procter & Gamble (P&G) set up its first local Chinese subsidiary, P&G (Guangzhou) Ltd., in 1988. The capital of Guangdong Province adjacent to Hong Kong, Guangzhou became not only the head office for P&G's Chinese operations but also its operations in Hong Kong, Taiwan and the rest of Greater China. With subsidiaries and plants in Guangzhou, Beijing, Shanghai, Chengdu, Tianjin, Dongguan and Nanping, P&G (China) has a total of about 7,000 employees. It has also invested more than $1 billion in China. According to a 2006 Chinese Ministry of Commerce league table of foreign companies by sales revenue, P&G (Guangzhou) ranks No. 38 (with RMB18.74 billion) overall and No. 5 among US companies.

2) Events leading to company's creation of an employee share ownership plan

At a New Year party on 30 January 2008, just before the Chinese New Year, the President of Procter & Gamble Greater China, Daniela Riccardi, announced that local staff would be able to buy shares in their parent company via their share ownership plan from 1 April 2008. At the same time, she announced that the plan had been approved by SAFE after five years of negotiations conducted via SAFE's office in Guangdong, where P&G (China) Ltd. is based.

P&G operates in 63 countries, excluding the United States, and some 40% of its employees are able to purchase shares in the parent company via their share ownership plan. Some 70% of P&G Hong Kong's employees belong to its share

[3] An abbreviation for "qualified domestic institutional investors."
[4] Based on research by Zhong Lun Law Firm.
[5] See http://www.pg.com.cn/News/Detail.aspx?Id=167.
[6] See xinhuanet.com on 5 April 2008 and *Beijing Review* on 1 May 2008.

ownership plan. These plans grew in size from $100 million in 1986 to $2.0 billion by 2006.

Ms Riccardi gave P&G China's employees two reasons for setting up the plan. The first, to do with asset management, had three aspects to it: (1) to give employees an opportunity to save for the long term; (2) to enable them to invest in the company they know best and to reduce the investment risk of individual employees; and (3) to give them an opportunity to diversify their investments by investing overseas. The second, to do with human resource management, had two aspects to it: (1) to make local Chinese employees aware that they are part of P&G's global team and (2) to enable them to benefit from P&G's global development. P&G has also made it clear to its employees that investing in shares entails risk and that membership of the plan is entirely voluntary.

3) Main features of P&G China's employee share ownership plan

We have assembled the following information about P&G China's share ownership plan from the company's website and local media reports.

(1) Eligibility and terms of membership

All 7,000 of P&G China's employees are eligible to join (membership is voluntary).

Although the company may match employees' contributions, such incentives are subject to personal income tax.

(2) Plan operation (Figure 4)

Plan members pay 1–5% of their basic salary into the plan each month.

Once employees have applied for membership and registered, they have to decide what percentage of their monthly salary they want to contribute. The amount is then automatically deducted from their salary each month.

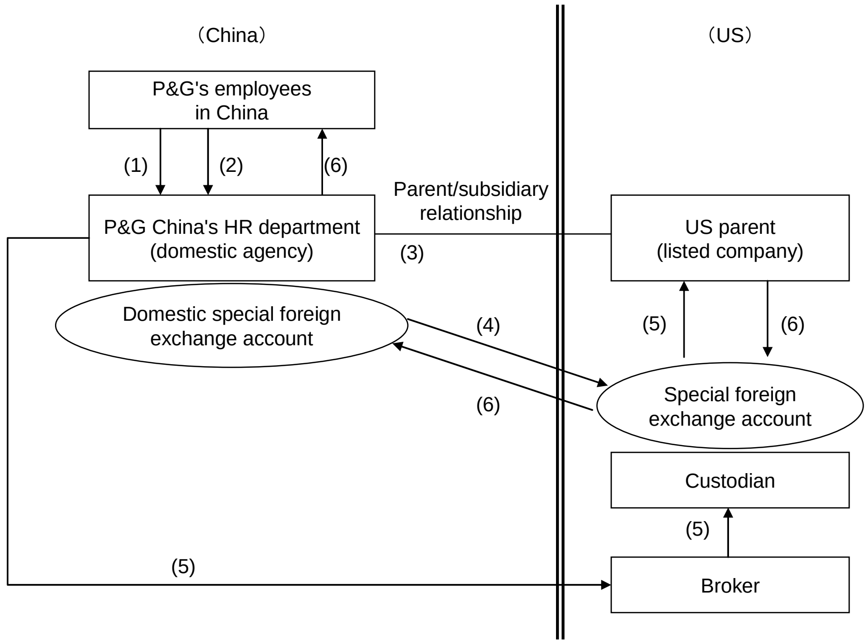
P&G China's human resources department calculates the foreign currency cost of purchasing shares in the parent company and remits this to the United States.

The shares are then purchased through a custodian.

After five years[7], members are required to sell their shares and remit the proceeds less tax and expenses along with any dividend payments to China.

[7] We assume this is the lock-up period for employees wishing to withdraw their contributions or sell their shares.

Figure 4: Schematic diagram of P&G China's employee share ownership plan's arrangements for purchasing shares in its parent company



(1) Employees join their ESOP (voluntarily), tell the HR department to deduct 1–5% from their basic wages, and register.
(2) Contributions are deducted from their wages on pay day.
(3) P&G China's HR department calculates the amount of foreign currency for buying shares in the parent company.
(4) The amount is remitted to the parent company.
(5) The shares are bought through a custodian.
(6) Employees can access the sale proceeds and dividends (after five years and deduction of any foreign taxes and expenses).

Source: Nomura Institute of Capital Markets Research, from P&G China data and local media reports

IV. Potential for local subsidiaries of Japanese companies to set up employee share ownership plans

1. China biggest base for Japanese companies outside Japan

Because of the changes in China's labor market we saw in Chapter 1, we expect the Chinese subsidiaries of a growing number of Japanese and other foreign companies to set up employee share ownership plans. According to Toyo Keizai's *Directory of Japanese Companies Abroad (2008)*, China ranked as the number one base for Japanese companies outside Japan, with 4,757 Japanese subsidiaries (or 22.4% of their local subsidiaries around the world) (Figure 5). Similarly, roughly 1.12 million Chinese were employed by the local subsidiaries of Japanese companies as of November 2007 and, of these, roughly 1 million were employed by Japanese manufacturers. This makes China the number one base for Japanese companies outside Japan in terms of the number of their employees (Figure 6). The potential for Japanese, as well as US and European companies like P&G, to set up employee share ownership plans is therefore considerable. Using the average wage of the 1.12 Chinese employed by Japanese local subsidiaries in 2007 (namely, RMB27,942) and assuming that 80% join an employee share ownership plan and contribute 3% of their wages every month, we calculate that this would generate roughly RMB750 million (or ¥10 billion)[8] of investment demand every year. However, wages can vary quite considerably from one region or job to another in China, while both wage levels and structures can vary between Japanese and US/European companies. Therefore great care has to be taken in calculating the potential impact of such plans.

Figure 5: Number of local Japanese subsidiaries in each country

	Number of subsidiaries	As %
Worldwide	21,226	100.0
US	3,367	15.9
Europe	3,349	15.8
Asia ex Japan	12,610	59.4
of which, China	4,757	22.4

Note: Data exclude cases where Japanese company's total shareholding (either direct or indirect via subsidiary) is less than 10%. Data as of November 2007.
Source: Nomura Institute of Capital Markets Research, from Toyo Keizai's *Directory of Japanese Companies Abroad (2008)*

Figure 6: Number of people employed by Japanese companies in China

	All companies			Manufacturing companies only		
	Number of employees	Number of Expatriate staff	Number of Local employees	Number of employees	Number of Expatriate staff	Number of Local employees
Worldwide	3,889,555	42,174	3,847,381	3,078,764	21,465	3,057,299
US	457,843	8,931	448,912	284,234	3,645	280,589
Europe	351,152	4,690	346,462	205,095	1,350	203,745
Asia ex Japan	2,809,570	26,646	2,782,924	2,385,989	15,619	2,370,370
of which, China	1,134,307	10,860	1,123,447	1,009,582	6,858	1,002,724

Note: Data exclude cases where Japanese company's total shareholding (either direct or indirect via subsidiary) is less than 10%. Data as of November 2007.
Source: Nomura Institute of Capital Markets Research, from Toyo Keizai's *Directory of Japanese Companies Abroad (2008)*

2. Appeal to consumers

Moves by foreign-invested companies to set up employee share ownership plans would not only boost their appeal and help them to recruit high-caliber staff; it would also probably increase their appeal to the very Chinese consumers they are targeting.

Since 2002, a Chinese recruitment agency has published a list of the 50 most popular companies among Chinese university students on its website. Noteworthy is

8 The calculation is as follows: RMB27,942/employee/year × 898,000 employees = RMB750 million.

the number of US and European companies targeting the Chinese market among the 10 most popular companies (Figure 7). P&G has been among the top 10 such companies for the past five years. Although Japanese companies have been holding their own against US/European and Chinese companies in the popularity stakes, their level of recognition among Chinese university students would appear to be quite low considering the number of local Japanese subsidiaries operating in China according to Toyo Keizai's *Directory of Japanese Companies Abroad* (see above). Employee share ownership plans could therefore not only help Japanese companies targeting the Chinese market to recruit local staff but also be of strategic importance in familiarizing Chinese consumers with their products. We will therefore continue to monitor developments in this field carefully.[9]

Figure 7: Most popular companies with Chinese university students

Rank	2003	2004	2005	2006	2007
1	Haier	Haier	Haier	Lenovo	Lenovo
2	IBM	IBM	IBM	P&G	China Mobile
3	Microsoft	P&G	P&G	Hua Wei	Haier
4	Lenovo	China Mobile	Lenovo	IBM	Hua Wei
5	P&G	Microsoft	Hua Wei	Haier	P&G
6	GE	Lenovo	China Mobile	China Mobile	IBM
7	Motorola	Hua Wei	Microsoft	Microsoft	Microsoft
8	Hua Wei	GE	LG	Tencent	China Guangdong Nuclear Power Group
9	China Mobile	Siemens	Siemens	GE	Alibaba
10	Siemens	China Telecom	GE	Siemens	Baidu
Japanese companies	Sony (17) Panasonic (32) Toyota (46)	Sony (26) Panasonic (46)	Sony (22) Panasonic (42)	Sony (38)	Panasonic (29) Guangzhou Honda (35) Sony (46)

Note: Based on results of ChinaHR's annual surveys of 50 most popular companies since 2002.

Source: Nomura Institute of Capital Markets Research, from The 21st Century China Research Institute (http://www.21ccs.jp/index.html)

9 According to JETRO's online country database (J-FILE) as of 20 February 2009, the average (monthly) wage at one Shanghai-based Japanese manufacturing subsidiary varies as follows: shop floor workers: RMB1,388–2,098 (¥18,322–27,694); engineers: RMB1,767–4,537 (¥23,324–59,888); and middle managers: RMB7,213–11,996 (¥95,212–158,347).