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The Research of the Development Process of Equity Incentive in China

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ABSTRACT
The equity incentive system originates from western developed market economy countries. In the past few decades, the development of the equity incentive system has been ignored at the beginning and then widely concerned. Since China's reform and opening up, it has gradually explored the implementation of equity incentive system in China's listed companies, among which the equity incentive system for senior managers has widely existed.
This paper first discusses the important cause of the equity incentive system: the agency problem. Then it describes the development process and types of equity incentive system in China and analyzes the obstacles and challenges in the development of the equity incentive system in China. Moreover, this paper pointed out some situations of equity incentive implementation where need to improve.

Keywords: *Agency problem, Equity incentive, Development process, Problems, Suggestions*

1. INTRODUCTION

Equity incentive originated in the United States in the 1950s and 1960s, and gradually radiated to other traditional industries based on Silicon Valley high-tech industry in the 1980s and 1990s. It grew rapidly in the late 1990s, spread to the whole world, and reached its peak in the early 2000s. In the early 21st century, with the occurrence of a series of scandals of internationally renowned enterprises and accounting firms, the problems of the corporate governance model in developed countries were gradually exposed, among which the effectiveness of the equity incentive system was questioned. Equity incentive system has been widely concerned by the governments, academic communities and other market participants.

In 2006, China's listed companies began to implement stock option and restricted stock as the main form of the equity incentive system. It is undeniable that the implementation of equity incentive system in China has played a great positive role in the management of listed companies. However, the internal governance structure of listed companies is still imperfect and there are many problems. Based on the development process and types of domestic equity incentives, this paper describes the main problems existing in Chinese equity incentives and provides some suggestions for them.

2. THE ORIGIN AND DEVELOPMENT OF EQUITY INCENTIVE

The separation of shareholders and managers now diverges the aims of managers and owners. As an effective way to solve the agency problem, equity incentive enables managers to work for the interests of shareholders to the maximum extent, reduces moral hazard behavior, and reduces the problem of risk aversion. Equity incentives appeared in the United States in the 1950s. Due to the remarkable effect of equity incentive on enterprise managers, directors, employees and key technical personnel, a large number of countries in the world such as the United States, Britain, Japan, Singapore and most countries in Europe have widely adopted this equity incentive system and then achieved good results. Compared with other countries in the world, China's modern equity incentive system developed late.

2.1. The agency problem resulted from Principal-agent theory

According to recent studies, the main tenet of agency problem is that when the interests of shareholders and managers diverge, managers probably make wrong decisions for the company (Bebchuk and Fried, 2003). In the process of business operation, the principal is the owner of the asset and the agent is the manager of the enterprise. Between asset owners and business operators, the responsibilities, rights and interests of both parties are clearly defined through a pre-agreed contract, forming a mutual restriction and incentive mechanism. They have inconsistent and even contradictory goals. The main purpose of shareholders is to obtain higher investment returns, in other words, they want to maximize the market value of the enterprise, however, managers' main purpose is to maximize their remuneration.

The inconsistency of purposes and the existence of information disclosure often leads to the behaviors of managers that damage the interests of owners, such as the short-term operation behavior of enterprises, over-investment and even laziness, thus making the owners unable to obtain the expected benefits

2.2. Introduction to equity incentive

The different goals and information disclosure between shareholders and management lead to the agency problem, which is a common problem in modern companies characterized by the separation of ownership and management. In order to solve the agency problem in modern corporations with two rights separated, it is necessary to design a mechanism to bind the interests of managers and shareholders together. Nowadays, corporations implement a variety of mechanisms to remedy adverse outcomes due to the separation of ownership and administration (Jenson & Meckling, 1976).

Equity incentive, as a long-term incentive mechanism, is developed on the basis of principal-agent theory. The fundamental starting point is to unify the interests of the managers and shareholders, encourage the managers to pay more attention to the long-term development of the company, rather than earning their private profit via the detriment of the company. Equity incentive is one of the most important mechanisms in corporate governance. This mechanism solves the conflict of interest between shareholders and managers by making employees, especially senior managers and other incentive objects hold a certain amount of company stock, to resolve the conflict of interest between the shareholders and managers, also known as the agency problem. Since managers are not focusing merely on their interests, but also the long-term interests of owners.

2.3. The evolution process of equity incentive in China.

From the perspective of the development process, the development of Equity incentive in China can be roughly divided into four periods: the gestation period, the pilot period, period of rectification and standardization and mature promotion period.

2.3.1. Gestation period

Early 1990s Chinese corporations began to employ an equity incentive method to stimulate managers. Vanke implemented the equity incentive in 1993, became the first listed company in China to use the equity incentive. Since 1997, Shanghai has been the first place to launch a trial scheme of the enterprise equity incentive, and some companies in Wuhan, Beijing, Tianjin and other places have also gradually implemented the equity incentive method. In 2002, the guidance on state-owned high-tech enterprises to carry out the pilot work of equity incentive was officially released, so equity incentive was formally introduced at the policy level in China. With the completion of the reform of shareholder structure in 2005, more than 40 enterprises have bundled equity incentive but not been approved

2.3.2. Pilot period

In 2005, China Securities Regulatory Commission (CSRC) issued the Administrative Measures for Equity Incentive of Listed Companies, which clarified the whole set of methods for implementing equity incentive of listed companies, and proposed that listed companies could implement equity incentive system according to this announcement, thus pushing China's equity incentive to a new stage of standardization and development. With the continuous improvement of laws and regulations on equity incentive, whether state-owned or private listed companies, their equity incentive system should be protected and supported, but also subject to strict supervision. In this stage, stock options and other real sense of equity incentive methods developed rapidly.

2.3.3. Period of rectification and standardization

From March to October 2007, China Securities Regulatory Commission carried out special activities to strengthen the governance of listed companies, delayed the examination and approval of equity incentive, and State-owned Assets Supervision and Administration Commission and China Securities Regulatory Commission issued supporting policies to standardize equity incentive. From March to September 2008, China Securities Regulatory Commission successively issued policy No. 1, No. 2 and No. 3 on Matters related to Equity Incentive, and In October, State-owned Assets Supervision and Administration Commission and The Ministry of Finance issued the notice on Issues Related to Standardizing the Implementation of Equity Incentive System of State-owned Holding Listed

Companies, strictly regulating the operation of equity incentive.

2.3.4. Mature promotion period

In 2009, the equity incentive related supporting policies have been constantly improved and refined, The Ministry of Finance and the State Administration of Taxation have successively issued the Notice on The Collection of Individual Income Tax on Income from Stock Appreciation Right and Income from Restricted Stock, and the Notice on the Payment of Individual Income Tax on Income from Stock Options of Senior Executives of Listed Companies. The institutional construction of China's capital market is further deepened and standardized, and the development of equity incentives in China tends to be perfected.

3. THE MAIN METHODS OF EQUITY INCENTIVE

From the perspective of accounting, the modes of equity incentive plan can be divided into share-based payment settled with equity and share-based payment settled with cash.

3.1. Share-based payment based on equity settlement

The share-based payment based on equity settlement is divided into stock options and restricted stock.

3.1.1. Stock options

Stock options refer to the rights granted by an enterprise to its employees or other parties to purchase a certain number of its own rights within a certain period in the future at a predetermined price and on predetermined terms. Stock options are characterized by high risk and high return, especially suitable for enterprises in the early stage of growth or expansion, such as network, high-tech and other high-risk enterprises. Due to the enterprise itself is at the early stage of growth, itself the demand for money is very nervous, can't come up with a lot of cash to realize equity incentive, and these enterprises have great potential for the future, the implementation of a stock option to reduce the cost of equity incentive and will be the employee's performance is linked with the enterprise, and achieved the effect of incentive and constraint. This kind of incentive method is adopted by most countries in the world. It will not lead to the outflow of cash, but almost zero risks for the enterprise to bear cash flow

3.1.2. Restricted stock

Restricted stock refers to the amount of stock that the incentive object obtains from the enterprise free of charge or at a lower price or by the terms and conditions stipulated in the share-payment agreement. The shares granted to the incentive recipients cannot be sold immediately but must be sold only after certain restrictions have been met to reap the benefits. It is less risky than a stock option and less incentive than a stock option

3.1.3. The difference between stock options and restricted stock

The Stock option is a typical way of equity incentive with asymmetric rights and obligations. Option holders only have the right to exercise the benefits, but not the obligation to exercise. The rights and obligations of restricted stock are symmetrical. The stock option model is not punitive. If the stock price falls or the performance index preset by the option plan fails to be realized, the beneficiary just gives up the exercise without actual capital loss. But the restricted stock has a certain penalty, the stock price decline will directly lead to the beneficiary's capital loss

Option pricing is generally budgeted according to the option pricing model, and the option value obtained by this forecast model does not apply the real incentive option value. The value of the restricted stock is the market price of the stock at the time of grant minus the grant price, with no future time value

Stock options focus on the restriction of the grant and exercise stage and do not restrict the selling link, resulting in the beneficiary's final income is not restricted, while restricted stock is different, which mainly restricts the selling link

3.2. Stock payments based on cash settlement

Stock payments based on cash settlement are divided into phantom stock and stock appreciation rights.

3.2.1. Stock appreciation rights

The stock appreciation right is a form of equity incentive mechanism, employees can gain a bonus in cash or an equivalent number of shares based on the increased stock value over a set period. Which equity incentive method is also beneficial for employers because they do not need to issue or transfer more shares to dilute share price.

3.2.2. Phantom stock

Phantom stock is a form of employee compensation that selected employees can receive real benefits of stock ownership without owning the actual stock. In other words, it refers to a certain amount of virtual stock granted by the company to the senior employees. Those employees can gain the company's dividends and earnings brought by the rise of the stock price, but they have no ownership of real stocks and cannot transfer and sell these phantom stocks, their phantom stocks will automatically disappear when they leave the company.

Phantom stocks are a significant method for keeping these senior employees on company during the whole vesting period and improving productivity. Moreover, for employees, they can gain benefits from phantom stock without paying for them. On the other hand, companies issue phantom stocks to employees will produce additional costs, for example, the company may need to employ some outside accounting companies to complete these stock valuations

3.2.3. The difference between stock appreciation rights and phantom stock

According to the regulations between the company and the incentive objects, the way to redeem the stock appreciation right is different: it can be redeemed in full or in part. In addition, the implementation of the stock appreciation right is not limited to cash implementation, can also be implemented in the form of stock, and even can be implemented in the form of a combination of cash and stock. Moreover, only those who run the company can be granted stock appreciation rights.

Phantom stocks are more flexible in the way they are used. Phantom stocks do not need the strict approval of the Stock Exchange, but only need the permission of the company's general meeting of shareholders, and the registration on the specific books of the company can be implemented.

Phantom stocks are only a guarantee that a representative will get a reward equivalent to either the estimation of the organization's shares or the rise in stock cost over the long run (Gora, 2020). The reward the worker gains is taxed as standard pay dependent on the time it is gotten. Nonetheless, it doesn't keep similar standards as worker stock proprietorship plans due to phantom stock isn't tax-qualified.

4. THE PROBLEMS OF EQUITY INCENTIVE DEVELOPMENT IN CHINA

The equity incentive mechanism has been proved to be effective in western countries. However, the implementation of equity incentive in China's state-owned listed companies is still during the exploratory period. Under the environment of imperfect internal governance structure, turbulent external capital market and unscientific professional manager market, many problems arise in the process of implementing equity incentives in state-owned listed companies.

4.1. Internal supervision regulations are imperfect

Chinese listed companies do not have a clear understanding of the fundamental purpose and function of equity incentive, which leads to the difference between the effect of equity incentive implementation and the expected result. In fact, the purpose of equity incentive is to help the company's operating managers to change their roles in the company, managers who are in the perspective of a shareholder can better participate in enterprise management, solve agency problem, improve the operator's work efficiency and improve information asymmetry problem between managers and shareholders. Some listed companies are short-sighted and only pay attention to the immediate interests. The exercise periods and the regulated selling period are specified very short even though they are permitted by domestic laws, which results in the loss of motivating effect of equity incentive. Moreover, most of the equity incentive systems in Chinese companies are enacted by the company managers. If the listed company does not have sufficient internal supervision over the implementation of the equity incentive system, the equity incentive system may become a tool used by the company management to earn their own interests. Company managers may not try their best to rapidly promote the development of the company, or even conceal the true strength and potential growth ability of the company, so as to make it easy to exercise stock option to make profits for themselves and harm the interests of shareholders.

4.2. Equity incentive model is not suitable for all companies

Equity incentive in China mainly uses stock options and restricted stock incentive models which are widely used in the world, so the incentive methods are too single, and the types are too few. Besides, equity incentive model cannot apply to all companies, because no matter which equity incentive model is more complex than that directly pay the cash to the employees, so a mature equity incentive system is difficult for some companies to implement, and not all the employees are interested in stock and equity, they prefer to obtain cash benefits right now, rather than in the hope of the increase of company’ future value because they have to take the risk that the company did not develop to what expected in the future.

4.3. External factors are affecting the results of equity incentive

Under the equity incentive system, the interests of the management are closely related to their management performance. Only when the managers have achieved the expected targets set by the company, can they exercise the stock options granted by the company. Therefore, the rise of the stock price in the capital market can bring real benefits to the managers. However, China's capital market is still in a developing process and the weak efficient market may lead to the problem that the capital market cannot accurately and quickly reflect the present value of enterprises, and the rise and fall of stock prices are also affected by many external factors, such as economic policies, market environment, and the public confidence. Therefore, when the managers do their best to run the company, but the stock price of the company fails to reach the expected price due to the market factor or other external factors, the managers lose the exercise right of stock options, which will greatly discourage the enthusiasm of the managers and detriment to the future development of the company.

4.4. The market for professional managers is imperfect

At present, the state-owned holding listed companies account for a large proportion of the total number of listed companies in China, while the senior managers of state-owned enterprises are mostly appointed by the superior competent departments, which cannot help to form a mature professional manager market based on market supply and demand. The proportion of manager market in these state-owned holding companies is too small, which leads to the non-marketization of the manager selection mechanism. The operating performance of state-owned enterprises is not necessarily the operating performance of the incumbent managers, and the loss of state-owned enterprises is not necessarily caused by the incumbent managers. Therefore, the performance evaluation of enterprise managers will inevitably be unfair, and it will bring some difficulties to the construction of the equity incentive system.

5. SUGGESTIONS FOR IMPROVEMENT OF EQUITY INCENTIVE IN CHINA

The ownership structure of listed companies in China is different from that in western countries. There are a large number of state-owned listed companies in China, which are distributed in all fields of the country. Therefore, the improvement of the equity incentive system of state-owned listed companies in China needs to be explored by ourselves. The following are the related improvement suggestions about the problems faced by Chinese listed companies in the process of implementing the equity incentive system.

5.1. Establish a complete legal system

The government should strengthen the legal system construction of the equity incentive system, constantly enact the laws and regulations to each step of implementation, improve and optimize the laws and regulations system that is compatible with the implementation of China's equity incentive system, and consolidate the legal basis of the mechanism is particularly important

5.2. Appraisal system of equity incentive should be more scientific

Only a scientific and effective evaluation system and fair and objective evaluation criteria can make the equity incentive mechanism achieve its due effect. In the stock right incentive scheme of establishing enterprises, therefore, to guarantee the objectivity and impartiality of the evaluation index, and maneuverability, and clear evaluation system includes the specific evaluation content, in addition to the company's financial indicators into the evaluation system, should also pay attention to consider the non-financial indicators, to ensure that the comprehensive evaluation index

5.3. Improve the supervision mechanism of the implementation of equity incentive

To perfect the supervision mechanism of equity incentive, it is necessary not only to strengthen the effectiveness of internal supervision but also to coordinate and cooperate with relevant departments. Through mutual restriction of the board of directors, the board of supervisors and other organizational institutions, enterprises can jointly supervise and promote the smooth implementation of equity incentive, so as to make all departments of enterprises operate efficiently and promote the rapid development of enterprises. Under the guidance of laws and regulations, China Securities Regulatory Commission and other relevant departments should strengthen the supervision and inspection of each enterprise, and enhance the popularization of relevant knowledge of effective implementation of equity incentive system, so as to improve the correct understanding of executives of each enterprise on the equity incentive system

6. CONCLUSION

In China, more and more listed companies choose equity incentives to motivate and compensate employees, which can effectively solve the agency problem and information asymmetry between the company's managers and shareholders. Besides, equity incentive is also a creative way for those companies which cannot use cash to stimulate and compensate employees. There are four main ways of equity incentive system: stock options, restricted stock, phantom stock and stock appreciation rights. Because of the higher understanding and recognition of stock option in the Chinese securities market, the stock option is the most commonly used equity incentive method. In China, after a long period of development, the equity incentive system is still immature. There are many complex problems and challenges, such as incomplete internal supervision mechanism, external factors affecting the stock price and professional managers in state-owned enterprises are not based on market supply. This paper comes up with several suggestions related to the development of the equity incentive system in China. Firstly, it is important that improving the laws related to equity incentives in China. Secondly, a complete supervision mechanism of the implementation of equity incentive is necessary. Finally, the performance appraisal system should be more rational and fairer.

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