Put and Call Options: Does Kapil Sibal's Green Signal imply the end of wait, for an Investor Friendly Legal Regime?

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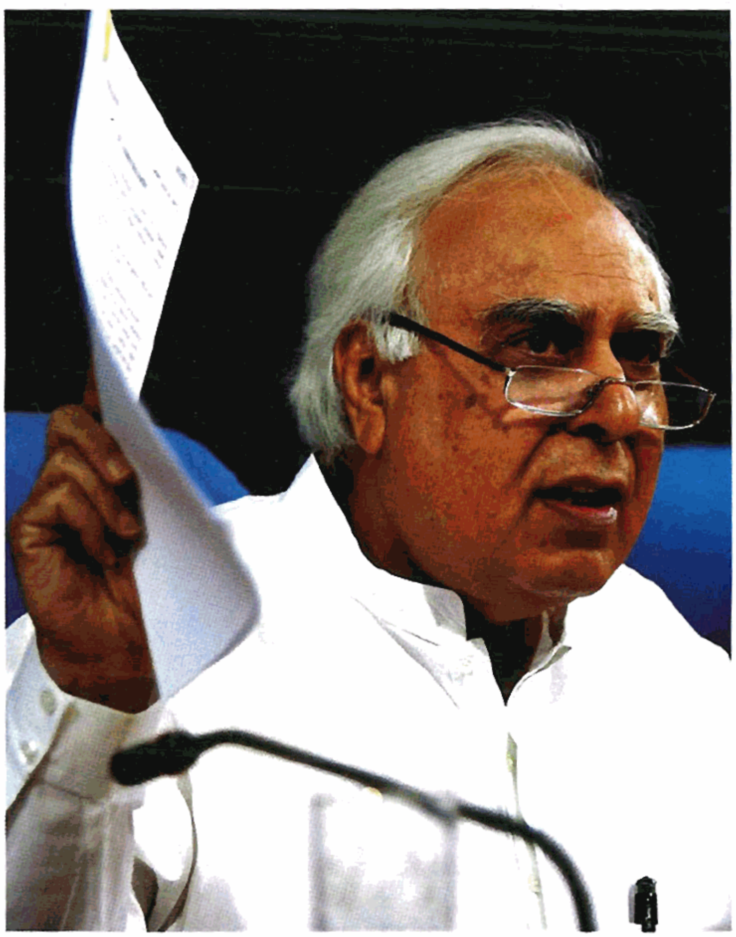

The government has decided to remove the put and call options hurdle in mergers and acquisitions (M&A) with the law ministry finally clearing the proposal to amend the Securities Contracts (Regulation) Act 1956 (SCRA).

A legal ambiguity in the Indian law that is standard M&A / joint venture practice internationally has belied the government's oft stated commitment to economic reforms. Global liquor giant Diageo had to rework a put option clause in its share purchase agreement with United Spirits Ltd. (USL) because the Securities Exchange Board of India (SEBI) had termed the clause illegal. This clause would have given the holding company, United Breweries, the right to sell its remaining shares in USL to Diageo at Rs. 1,440 per share within seven years.

Private Equity investments and Foreign Direct Investments (FDI) usually have certain exit options for the investor. This may be in the form of a put option or an offer for sale or buyback of the investor's shares. In some cases, the promoter may have a call option to purchase the investor's shares at the promoter's option. Put and call options are rights (but not obligations), which entitle the holder of shares in a company to sell those shares to another person at a predetermined price, exercisable at a future date.

The SCRA, when first enacted in 1956, explicitly prohibited options in securities. In 1969, the government also prohibited forward trading. Phased liberalisation of the securities market

Q&A

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WHAT ACCORDING TO YOU WOULD BE THE IMPACT OF SUCH A CHANGE?

Such a change would bring about regulatory clarity on the enforceability of put and call options in investment agreements that has been lacking for the last several decades. Although the previous prohibition on options had been occasioned due to the need to curb speculation, such prohibition was also gradually extended to options among investors so as to grant protection to them, which was arguably not the initial intention of the legislation. A resolution of the issue pertaining to the enforceability of options would bring about greater certainty among investors as regards the protective measures they can seek and enforce in investments made in Indian companies.

IN THE PAST RBI AND SEBI, BOTH HAD THEIR RESERVATIONS ON SUCH BUYBACKS ESPECIALLY FOR PUBLICLY TRADED COMPANIES, MORE PARTICULARLY, WOULD SEBI'S DOUBTS, AS EXPRESSED IN VULCAN ENGINEERING INTERPRETATIVE LETTER GO AWAY WITH SUCH A PERMISSION FROM GOVT. OF INDIA?

A lot would depend on the precise manner in which options are recognized. The recommendations of the Law Ministry must now been reflected in changes to the relevant rules stipulated by SEBI and the RBI. For example, as far as SEBI is concerned, it will have to repeal its notification of March 1, 2000 which, by permitting only specific transactions such as spot delivery contracts, raises questions regarding the enforceability of options. Similarly, the RBI would also have to alter its stance in recognising options granted in favor of foreign investors. These specific regulatory measures have to be taken in order to resolve the matter.

in the 1990s saw the introduction of trading in derivatives like futures and options in 1995 and lifting of the ban on forward trading in 2000. Section 18A was inserted to legalise contracts in derivatives so that the wagering nature of such contracts did not fall foul of section 30 of the Indian Contracts Act 1872, which voids agreements by way of a wager. However, section 18A made derivative contracts valid only if they are traded on a recognised stock exchange and settled on its clearing house.

A notification of 1st March 2000 issued under section 16 of SCRA created more difficulties in the way of put and call options. SEBI forbid parties from entering into "any contract for sale or purchase of securities other than such spot delivery contract or contract for cash or hand delivery or special delivery or contract in derivatives as is permissible" under SCRA. Section 2(i) of SCRA defines "spot delivery contract" as actual delivery of securities and the payment of its price, either on the same day as the date of the contract or on the next day and includes transfer of securities dealt with by a depository.

Put / call options, according to SEBI, do not conform to the requirements of a spot delivery contract or of a derivatives contract permitted under section 18A.

SEBI's informal guidance in 2011 in the Vulcan Engineers Limited and earlier the Cairns-Vedanta deals had taken a strict stand that put option in share purchase agreements would not qualify as a valid derivative contract as it was exclusively entered between two parties and not traded on a stock exchange.

Despite withdrawal of this deleterious provision under intense pressure from the industry, RBI continues to keep a check on put options favouring foreign investors treating them as derivative contracts not allowed through the FDI route, except for Foreign Institutional Investors(FIIs) and Non-Resident Indians (NRIs), who are permitted to invest in derivative contracts in equity shares of Indian companies.

Presently Put and Call options are not allowed /permissible by/under Securities Contract (Regulation) Act, 1956. However, if, what the Honourable Law Minister, Mr. Kapil Sibal has said, and the Put and Call options are allowed, it will act as boon for the foreign Players / Investors who can increase their stakes in the Indian Joint Ventures upto the permissible limit of Foreign Direct Investment (FDI) and vice versa as per the terms of the agreement entered into between them and also they can opt out of their investment at a predetermined price. In past SEBI, the Security Market Regulator, has disallowed Put and Call options in many transactions / agreements as SEBI has always been against / opposed to allow Put and Call options. However based on the recommendations of Finance Ministry (which is yet to be given by the Finance Ministry to SEBI) SEBI may allow Put and Call Options for Corporates to restructure themselves though it may restrict the use of Put and Call options in the securities market, in the interest of the investors. It would be premature to say what would be the final shape of the things to come, still allowing the Put and Call Options would certainly have both ways advantageous flow make doing business in India a lot easier for foreign investors and the Companies.

Q&A

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What further muddied waters was the introduction of Clause 3.3.2.1 in the FDI Policy issued on September 30, 2011 which introduced an External Commercial Borrowings (ECB) angle to standard pre-emption investor rights contractually agreed between parties, which investors hold for exercising at a future date. Clause 3.3.2.1 said that equity instruments granting such rights to the investor would lose its equity character and become debt instruments and require compliance as for ECB.

Despite withdrawal of this deleterious provision under intense pressure from the industry, RBI continues to keep a check on put options favouring foreign investors treating them as derivative contracts not allowed through the FDI route, except for Foreign Institutional Investors(FIIs) and Non-Resident Indians(NRIs), who are permitted to invest in derivative contracts in equity shares of Indian companies.

Conflicting voices have also emerged from the courts on the validity of options contracts. The Bombay High Court in Jethalal C. Thakkar v. R. N. Kapur (1955) 57 Bom. LR 1051 upheld the validity of an option agreement in the context of the erstwhile Bombay Securities Contracts Control Act, 1925 (precursor of the SCRA). The court held that an option agreement is a contingent contract and not a contract at all till such time the contingency occurs. Hence, it is a valid contract and enforceable in law.

The Bombay High Court, in the case of Nishkalp Investments & Trading v. Hinduja TMT Ltd. (2008) 143 CompCas 2004 (BOM) however, held that an agreement for buying back shares of a company in the event of certain defaults was hit by the definition of spot-delivery contract under the SCRA and hence, unenforceable. It differed from the Jethalal Thakkar judgement on the ground that it was rendered in the context of an earlier Act.

In MCX Stock Exchange Limited v. Securities & Exchange Board of India & Ors. 2012 (114) Bom LR 1002, the Bombay High Court provided some clarity on the validity of an os contract under the SCRA. The court said:

"...A concluded contract for the sale and purchase of shares comes into existence only when the promisee upon whom an option is conferred, exercises the option to sell the shares. Hence, an option to purchase or repurchase is regarded as being in the nature of a privilege. The distinction between an option to purchase or repurchase and an agreement for sale and purchase simpliciter lies in the fact that the former is by its nature dependent on the discretion of the person who is granted the option whereas the latter is a reciprocal arrangement imposing obligations and benefits on the promissor and the promisee... If the option were not to be exercised by them, no contract for sale or purchase of securities would come into existence. Moreover, if the option were to be exercised, there is nothing to indicate that the performance of the contract would be by anything other than by a spot delivery, cash or special delivery."

The High Court's decision clarified that options are not forward contract since they are completed only when the option is exercised and the contract performed on the spot, while a forward contract involves a contract for the purchase and sale of securities in the future at a specified price. The court did not however determine whether options constitute "derivatives" or not.

This legal ambiguity over options in investment agreements is bad news for private equity and joint venture investors. Looking at put options either as an illegal derivative contract or a debt instrument that needs to be regulated as ECB ignores the right of the investor to sell its shares to the investee company and exit in case an IPO is not forthcoming or use it to structure its exit in the event of any material breach of the agreement or dispute with the investee company.

Foreign investors, particularly private equity players look for assured exit mechanisms. Not all of them are in the business of creating "lasting interests" in India and Indian companies are also happy to oblige with pre-emption rights. Policies resting on the fear of foreign debts and favour to recalcitrant domestic industries are hardly conducive to improving FDI inflows into the country. A privately negotiated contract involving options to sell or purchase shares is not freely tradable in the manner of a derivative contract and cannot be treated alike. Removal of this uncertainty over the validity of options was one reform that was urgently required. Investors are keenly awaiting the amendment to be quickly notified and hoping that there won't be any trip up in the fine print.

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