Regulatory conundrum over put and call options

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Authors

Priti Suri

Ankush Goyal

Introduction

M&A activity in India has witnessed a number of regulatory and legal changes in 2011. Prominent examples include:

- the Competition Commission's Combination Regulations, which require notification and the regulator's prior approval for transactions above a prescribed monetary threshold; and
- the new Takeover Regulations, which provide more headroom to potential acquirers to increase their stake in Indian companies.

Policy changes in the past two months have generated uncertainty over the legality and enforceability of put and call options. These options find their place in almost all modern investment agreements, despite the fact that they are not specifically codified under Indian law.

A put or call option is the right (not the obligation) of a shareholder to sell or buy shares in a company in conformity with fair market value. Such options are incorporated into agreements subject to the Foreign Direct Investment (FDI) policy. This policy is issued bi-annually by the Department of Industrial Policy and Promotion under the Ministry of Commerce and Industry. Foreign investors holding put or call options in securities of Indian companies are also subject to the Foreign Exchange Management Act 1999 and the regulations - referred to as the FEMA provisions - issued by the Reserve Bank of India (RBI), which impose restrictions on the ability of foreign investors to enter into derivative contracts in securities.

This update discusses the latest position of such options in light of the changes introduced by the latest FDI policy and the consequent corrigendum.

Put and call options under latest FDI policy

Position before October 31 2011
Since 2010 the Indian government has been issuing a consolidated FDI policy that consists of press notes and policies and regulations as provided under the FEMA provisions. In the latest FDI policy - released on September 30 2011 and effective from October 1 2011 - the Department of Industrial Policy and Promotion had categorically prohibited put and call options in securities of Indian companies held by foreign investors. Clause 3.3.2.1 stated that:

"*Only equity shares, fully, compulsorily and mandatorily convertible debentures and fully, compulsorily and mandatorily convertible preference shares, with no in-built options of any type, would qualify as eligible instruments for FDI. Equity instruments issued/transferred to non-residents having in-built options or supported by options sold by third parties would lose their equity character and such instruments would have to comply with the extant External Commercial Borrowing (ECB) guidelines*."

This clause is broad and covers all types of option within its ambit, including both put and call options, and even extends to tag along and drag along rights and other similar rights exercisable by an investor in future. The change was aimed at ensuring that no foreign investor could execute a shareholders' or investment agreement with customary options providing an 'exit mechanism' from the investee Indian company. Such a change would have greatly affected private equity players, which only have a limited capital interest in an investee company and seek to exit through means exercisable on the occurrence of certain pre-determined and contractually agreed triggers. It would also have adversely affected parties to joint venture agreements, as these instruments increasingly provide put or call options to equip parties to buy or sell each others' stake in case of a fall-out, providing for continuity of business and a reasonable exit.

There were other areas of concern, including retrospective or prospective application and the classification of subsequent transfer as debt, rather than equity. Consequently, if it was deemed as debt, then onerous restrictions, such as an end-use requirement under ECB guidelines,(1) would come into play. This policy change by the department was perceived as a protectionist approach in favour of Indian promoters and companies.

The present position: corrective measure
Clause 3.3.2.1 invited unprecedented opposition from stakeholders and industry players, which made numerous representations to the department, highlighting and explaining the negative impact that this provision would have on foreign investment and M&A activity in India. Paying heed to the market, the department decided to review the contentious clause. Within 30 days of its introduction, the department issued a corrigendum dated October 31 2011(2) whereby it deleted Clause 3.3.2.1.

A plausible interpretation of this deletion is that the RBI considers put or call options as mechanisms that comply with the FEMA provisions, regardless of the fact that no statutory provision specifically covers these options. However, it is too early to draw such a conclusion, as some ambiguity remains and, in practice, the deletion of Clause 3.3.2.1 may be nothing more than restoring the *status quo* that existed before the latest consolidated FDI policy came into force. The RBI has had a negative attitude towards put and call options under investment agreements for quite some time, and the restoration of the earlier position could indicate that the regulator has still not taken a conclusive stand.

The RBI's position

Although the RBI has not issued any formal notification explicitly dealing with the legality of put and call options, media reports and informal discussions with RBI officials suggest that a number of financial investors of Indian companies have received show cause notices from the RBI while attempting to exercise their put and call options. According to the RBI, such an optional right fails on two counts, explained below.

Put and call options as derivative contracts
The RBI perceives put and call options as 'derivative contracts', which are not valid and legal under Indian securities law unless and until they are traded on a recognised stock exchange. Additionally, as per the Master Circular on Foreign Investment and other FEMA provisions,(3) all FDI should occur through the issuance of equity shares or fully and mandatorily convertible debentures or mandatorily and fully convertible preference shares in Indian entities. In the RBI's opinion, investment with options contravenes foreign exchange laws because it is not mandatory for the option holder to exercise the options. Moreover, only Securities Exchange Board registered foreign institutional investors and non-resident Indians are eligible to invest in stock-traded derivative contracts. No other class of foreign investor is allowed to enter into a derivative contract with equity shares as the underlying security. Under the Foreign Exchange Management (Permissible Capital Account Transactions) Regulations 2000, all capital account transactions are prohibited unless and until explicitly permitted. As investment by a foreign investor through a derivative contract is not a permissible capital account transaction, such contracts are also prohibited under these regulations.

The RBI's perception of the options equalling derivative contracts disregards the fact that no separate consideration is paid over and above the price of the securities for securing these options. Furthermore, they are not independently tradable contracts as is the case with derivative contracts. Moreover, the purchase consideration to be paid on the exercise of these options must conform with fair market value, calculated on the basis of the discounted free cash flow method prescribed under the FEMA provisions. Put and call options can be seen as being in the nature of contingent contracts, maturing on the occurrence of a specified event. In most cases, an exercise of the option will lead to the delivery of securities and the payment of purchase price in consideration thereof, either on the same day or on the next day, bringing them within the contours of spot delivery contracts which are permissible under Indian law.

Compliance with ECB guidelines
The RBI views investment through put and call options as debt rather than equity and thus asserts a need to comply with its onerous ECB guidelines (as provided in Clause 3.3.2.1). This opinion is based on the rationale that FDI is meant to create a longlasting interest in the investee Indian company. According to the regulator, put options divert a foreign investor's interest from the company, providing an assured exit gateway with no commitment in the risk capital of the company.

The RBI's reasoning seems to create a dichotomy in itself. There are various instances where these optional rights equip a foreign investor to increase its shareholding. A call option right in favour of a foreign investor providing for a gradual increase in its shareholding will lead to the inflow of more foreign funds into the country. Thus, a blanket restriction on investment agreements embodying put and call options for augmenting long-lasting FDI in the country could be perceived as illogical.

In addition, the RBI's stand of counting investment with in-built options as 'debt' could be seen as a fallacy. As mentioned, purchase consideration for exercise of options must conform with the discounted free cash flow method. As there is no pre-determined fixed exit amount, it is unclear as to how such an investment can be termed 'debt'. Generally, investment is made in a company, while put and call options may be exercised through the purchase of shares from existing shareholders via the execution of a shareholders' agreement. The effect of exercising such options could be that the beneficiary is the individual shareholder whose shares may then be diluted. The Master Circular on External Commercial Borrowings and Trade Credits does not include individuals as 'eligible borrowers', but only companies. In other words, as an individual does not qualify as an eligible borrower, there would be ambiguity surrounding compliance with ECB norms.

Comment

The department's prompt action in deleting Clause 3.3.2.1 showcases the government's sensitivities towards FDI and M&A activity in India. The deletion was necessary to capitalise on the 74% growth in FDI inflows in the 2011 to 2012 fiscal year (up to September 2011) from the previous year. However, simultaneous events such as the RBI's issuance of show cause notices to the department's release of the corrigendum, provide an unstable picture of the Indian regulatory framework, placing all the interested parties at the discretion of the regulator. The RBI should ensure that such an important policy change that has wide implications on M&A activity in India is implemented after consultations and discussions with all stakeholders.

The corrective measure by the department does not provide a complete respite to potential acquirers of Indian companies, as the RBI may serve notices on the exercise of options. The RBI must clarify its stand, even more so now, when the government has withdrawn the controversial Clause 3.3.2.1. Until then, investors must exercise caution and carefully weigh the use of such provisions given the probability of challenge and assess alternative routes to ensure a risk-free exit mechanism.

For further information on this topic please contact Priti Suri *and* Ankush Goyal *at PSA, Legal Counsellors by telephone (+91 11 4350 0500), fax (+ 91 11 4350 0502) or email (* p.suri@psalegal.com *or* a.goyal@psalegal.com*).*

Endnotes

(1) See RBI Master Circular on External Commercial Borrowings and Trade Credits, July 1 2011.

(2) See Press Release dated October 31 2011, available at http://dipp.nic.in/English/acts_rules/Press_Release/pr31102011.pdf.

(3) Regulation 5(1), Foreign Exchange Management (Transfer or Issue of Security by a Person Resident Outside India) Regulations 2000, read with AP (DIR Series) Circulars 73 and 74, dated June 8 2007.