

NEWSALERT

The ubiquitous Put Option mode of exit in Investment Agreement outlawed by Indian Regulators



Introduction

The Put Options are essentially exit rights under investment agreements, such as those involving joint ventures as well as private equity and venture capital investments. These are right (but not obligation) which entitles the holder of shares in a company to sell those shares to another person, at a pre-determined price (Strike Price). When the Put Option is exercised by the holder thereof, the other person is obligated to buy the shares at the Strike Price.

This Article examines the legal landscape of enforceability of Put Options in investments agreements in India, both under the securities and foreign exchange regulations.

Enforceability of Put option under Securities Regulation

Section 16 of Securities Contracts (Regulation) Act, 1956 (SCRA) confers powers on the Central Government to declare that no person shall enter into any contract for the sale or purchase of any security specified in the notification in a specified area without the permission of the Central Government.

In exercise of this power, on March 1, 2000, Securities Exchange Board of India (SEBI) (under the delegated powers from the Central Government) issued a notification, by virtue of which contracts in securities are considered void, unless they are spot delivery contracts or contracts settled through the stock exchange.

Section 18A of SCRA further provides that all contracts in derivative are void, unless traded on stock exchange and settled on the clearing house of the recognized stock exchange.

In 2011, SEBI buttressed this position in an informal guidance sought by Vulcan Engineers Limited. In Vulcan Engineers, SEBI instead of dealing with the specific questions posed by the company with regard to interpretation of provisions of SEBI (Substantial Acquisition of Shares and Takeovers) Regulations, 1997, went ahead and commented upon legality of Put Options. In responding to the request, SEBI

observed that the transaction involved a Put Option which was exercisable at a future date and hence, the transaction was not a spot delivery contract as defined in section 2(i) of SCRA. Further, the aforesaid Put Option would not qualify as a legal and valid derivative contract in terms of section 18A of SCRA, as it is exclusively entered between two parties and is not a contract traded on stock exchanges and settled on the clearing house of the recognized stock exchange. Hence, it declared the pre-agreed buyback of Vulcan Engineers' shares from the foreign investor through Put Option as invalid under SCRA.

To sum up, SEBI has now a clear stance with regard to Put Options in investment agreements. It proscribes the Put Option on securities of public limited companies, entered into outside the stock exchange, under SCRA and SEBI Notification No. S.O. 184(E) dated 1st March 2000 issued under SCRA.

[Enforceability of Put Option under Foreign Exchange Regulations](#)

Under the new Consolidated FDI Policy in the form of Circular No. 2 of 2011, which comes into effect from October 1, 2011, the Government under clause 3.3.2.1 of the said policy has 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 ("FDI Compliant Instruments"). It further clarifies that the securities other than FDI Compliant Instruments would have to comply with the extant ECB guidelines.

And hence, the FDI Compliant Instruments structured with a Put Option, which requires the other party to buy back shares at a fixed price, under the FDI Policy would be treated as ECBs. Accordingly, all the norms applicable for ECBs, viz. eligible borrowers, amount and maturity, end use stipulations, etc. shall apply. More importantly, the rate of return would be Rupee interest rate which will be based on the swap equivalent of LIBOR plus the spread as permissible for ECBs of corresponding maturity. In other words, the rate of return on such FDI Compliant Instruments structured with a Put Option cannot be more than LIBOR plus 3% or 5%, depending upon the maturity period of such instruments.

Concluding this section, we may say that the RBI's stance of proscribing Put Options is well-etched in the policy of the Government of India as a formal matter, under the new FDI Policy.

[Conclusion](#)

SEBI considers the Put Option a futures contract which can be traded only on a stock exchange, as against such option in investment agreements, which are exclusively entered into between the parties on an "over the counter" basis; while Reserve Bank of India sees the Put Option as an external commercial borrowing, which suffers from fetters in form of eligibility norms for borrowers, end use restrictions and fixed rate of return.

These regulatory treatments of Put Options complicate the issues surrounding their enforceability in investment agreement. This shall undoubtedly place hurdles on capital raising activities of green field Indian companies and may also change the contours of deal making, as private equity firms will now try to compensate the prohibition on Put Options through low entry valuations and different structures.