LEGALITY OF PUT AND CALL OPTIONS: ENDURING MURKINESS AND ISSUES FOR NON-RESIDENT INVESTORS

Rohit Beerapalli*

1. INTRODUCTION

One of the most widely-accepted principles of modern economic theory is that influxes of investment are required for the economy to grow at a reasonable pace. This is especially true in light of the so called *'multiplier principle'*.[1] Simplistically, it means that an investment of a certain amount of money leads to an increase in national income that may be several times the value of the original investment.[2] The investment acts as a catalyst, leading to augmentation in consumption and production.[3]

As a result, it would stand to reason that the prudent course of action for a government interested in ensuring sustained growth

* Student, III year, NALSAR University of Law, Hyderabad.

[1] SAMPAT MUKHERJEE, MODERN ECONOMIC THEORY (2002), at 673-690.

[2] Masaichi Mizuno, *Funds, Investment and Multiplier*, 88 WELTWIRTSCHAFTLICHES ARCHIV 259–286 (1962), at 280.

[3] Edward G. Bennion, *The Multiplier, The Acceleration Principle, and Fluctuating Autonomous Investment*, 27 THE REVIEW OF ECONOMICS AND STATISTICS 85–92 (1945), at 85.

would be to encourage investment to the greatest extent reasonably possible. It is essential that there be freedom of investment to prevent recessions and economic slow-downs.[4]

In India, one of the major concerns regarding investment, especially investment from abroad, are the questions of legality arising with respect to Call and Put Options. Exit options such as this are absolutely essential, because investors would be reluctant to make investments when there is a chance that such investment may end up transforming into a sinkhole from which the investor cannot escape.Regulatory authorities seem to be taking more objective and realistic approaches to the legality of such instruments. However, up until very recently, there were some lacunae in the law regarding the legality of the exit options. Even after such issues were addressed, there are some persisting issues, especially regarding exit valuations of non-resident investors.Over the course of this paper, various issues that have been raised regarding the valuation of Call and Put Options have been analysed, and an attempt has been made to offer solutions to them.

[4] KEVIN A. HASSETT, INVESTMENT, THE CONCISE ENCYCLOPAEDIA OF ECONOMICS (2nd ed. 2008).

2. POPULAR OPTIONS FOR EXITING INVESTMENTS

Private equity investors usually have a plan of exit in mind at the time they make their investment. For a long period of time, the primary exit option for investors in India has been an Initial Public Offer (IPO).[5]There are several upsides and disadvantages to this exit strategy.[6] On the one hand, it leads to a higher valuation in a buoyant market, and is usually preferred by the management of the company, as well as the investor in caseswhere along-term shareholding may bedesired. Further, there are regulatory benefits for Foreign Venture Capital Investors and Venture Capital Funds, as the lock-in period for non-promoter investors does not apply to them, and also pricing norms do not apply on both entry and exit.[7]On the other hand, the value of the investment is at the mercy of market conditions, which can be turbulent and unpredictable. There are also considerable transaction costs involved in the process, and the process itself may take a long time to be completed, during the

[5] *Exit Options for Private Equity Investors*, The Practical Lawyer, http://www.supremecourtcases.com/index2.php?option=com_content&itemid=5&do_pdf=1&id=19310).

[6] *Ibid*.

[7] Nishith Desai Associates, *Indian Private Equity: 'Venturing' into India*, 1 INDIAN VENTURE CAPITAL JOURNAL 34-38 (2005), at 36.

pendency of which the value of the investment is at constant risk of deterioration.[8]

Alternatively, there is the option of entering into agreements to buy-back shares. Under such agreements, there is usually a pre-determined rate of return for the investment. Although it may seem like an easy and safe investment, any buy-back agreement would have to comply with the strict provisions of the Companies Act, 2013.[9] It would also have to comply with the Share Capital and Debenture Rules,[10]or the Buy-Back Regulations issued bythe Securities and Exchange Board of India,[11] for unlisted and listed companies respectively.Due to the requirement of explicit provisions allowing such agreements in theArticles of the company,[12] as well as the severity of the restrictions imposed by regulations, it may not always be the best option investors looking for a good exit strategy.

Due to the problems associated with IPOs and Buy-back agreements, investors sometimes prefer to use exit instruments

[8] Monitoring & Exiting Private Equity Investments | Street Of Walls, http://www.streetofwalls.com/finance-training-courses/private-equity-training/monitoring-exiting-private-equity-investments/ (last visited Feb 7, 2017).

[9] *See* Sections 68,69,70, Companies Act, 2013.

[10] Companies (Share Capital and Debentures) Rules, 2014.

[11] Securities and Exchange Board of India (Buy Back of Securities) Regulations, 1998.

[12] Section 68, Companies Act, 2013.

such as Put and Call options to as part of their exit strategy in order to have more confidence in their ability to exit on terms that may be palatable to them, as well as ensuring that they get returns that are at least equivalent to that of the other investors.

3. PUT AND CALL OPTIONS

An option is essentially an entitlement to buy or sell an asset in the future at a price that may be predetermined.[13]"Put and Call Options" shall hereinafter be referred to as "Options" for the sake of brevity. In the current context, such assets are shares. As the title of this chapter indicates, they are two types in the instant context:

3.1. Put Options –

They are the right of a shareholder to sell the shares to another shareholder at a price that may be specified in the agreement, or which may be determined as per the agreement, exercisable at the time the shareholder may want to exit its investment. The other shareholder has an obligation to purchase the shares at such determined price.

[13] Stephan Abraham, *The History of Options Contracts*, INVESTOPEDIA (2010), http://www.investopedia.com/articles/optioninvestor/10/history-options-futures.asp (last accessed 8th February, 2017).

3.2. Call Options –

They are basically the opposite of put options, where the shareholder has the right to acquire the shares of another existing shareholder, at price that may be determined in a manner that is identical to the put options.

Currently, there are two issues that necessitate discussion:

a. *Whether options contracts are permitted by the Securities Contracts (Regulation) Act, 1956, especially prior to the notification on October 3rd, 2013.*

b. *Whether non-residents are allowed to freely enter into Options under the applicable Foreign Direct Investment Regulations*

4. VALIDITY UNDER SCRA

Prior to October 3rd, 2013, any agreement which had any clause with Options would have been invalid. This is because SEBI only allowed spot delivery contracts, and contracts of any other kind for the delivery of securities was void.[14] Spot delivery contracts have been defined as *"actual delivery of securities and payment of a price therefore either on the same day as the date*

[14] Notification No. 184(E), dated 1-3-2000, SECURITIES AND EXCHANGE BOARD OF INDIA.

of the contract or on the next day, the actual period taken for the despatch of the securities or remittance of money therefore through the post being excluded from the computation of the period aforesaid if the parties to the contract do not reside in the same town or locality".[15]

Articles published by *Nishith Desai*[16] and *Samvad Partners*[17], two well-known law firms, have explored the interpretation of the above-mentioned regulations by SEBI. It would appear that the Options are not in the nature of a spot-delivery contract, and would therefore be void. Both the articles refer to the case of *Niskalp Investments v. Hinduja TMT*,[18] wherein the Court found that the Options are illegal under SCRA as they are not spot-delivery contracts.

However, attention may also be drawn to the *MCX* judgement,[19] where the Court made a distinction between the option to decide unilaterally, and a contract of sale and purchase which involves

[15] Section 2(i), Securities Contracts (Regulation) Act, 1956.

[16] Archana Rajaram, *Escape Legally*, ASIA LAW, http://www.nishithdesai.com/fileadmin/user_upload/pdfs/Escape_Legally.pdf (last accessed 7-2-2017).

[17] Options Contracts in India, SAMVAD PARTNERS, http://www.samvadpartners.com/wp-content/uploads/2014/04/Option-Contracts-in-India_April-2014.pdf (last accessed 7-2-2017).

[18] *Niskalp Investments and Trading Co. Ltd. v. Hinduja TMT Ltd.*, [2007] 79 SCL 368 (Bom.).

[19] *MCX Stock Exchange Limited v. Securities & Exchange Board of India & Ors.*, 2012 (114) BomLR 1002.

reciprocal obligations. Since the Options would not amount to a contract of sale and delivery of securities, they may be deemed to be valid. It would appear that most experts in the fieldagreed with the fact that this judgement could set a positive precedent for the enforcement of Options clauses, but in the consent terms entered into between the parties before the Supreme Court there existed pre-condition that the MCX findings would not be binding on SEBI. Hence, it was a good-judgement on paper, but hardly the ground-breaking legalization that was called for.

5. LEGALITY AFTER THE COMPANIES ACT, 2013 AND THE OCTOBER 3RD NOTIFICATION

Matters are further complicated by Section 58(2) of the then new Companies Act, which stated that *'any contract or arrangement between two or more persons in respect of transfer of securities shall be enforceable as a contract'*.[20]This is fundamentally incompatible with the regulation discussed earlier. The contradictions and incompatibility of all the regulations, laws, and cases on point contributed to a state of confusion regarding the enforceability of Options.

The October 3rd Notification explicitly authorized any Shareholders Agreements and Articles containing clauses that

[20] Section 58(2), Companies Act, 2013.

allowed for Options.[21] However, even after this notification, more confusion was added to an already chaotic situation as the notification only validated such clauses prospectively, and invalided all such clauses that were in existence before the notification, bringing up the question of why it was not having a retrospective effect.

6. WHY NOT RETROSPECTIVELY VALIDATE OPTIONS?

This precise issue is discussed in an interesting episode of *The Firm*.[22] Two opposing views are taken by the host and the guests. One view is that the validation should have been retrospective as there was nothing illegal about the clauses in the first place. I would say that there is some merit in this argument, given the judgement in *MCX*. While issuing the notification stating that all such options are valid would have been justified, invalidating all other existing clauses was uncalled for, as there was a lacuna in the law, and nothing explicitly invalidating such options.

[21] *Notification under section 16 and 28 of Securities Contracts (Regulation) Act, 1956*, Notification No. LAD-NRO/GN/2013-14/26/6667, dated 3-10-2013.

[22] *ROFR, Tag, Drag, Call, Put: Valid!*, THE FIRM, http://thefirm.moneycontrol.com/news_details.php?autono=964230 (last accessed 7th February, 2017).

The alternative point of view seems to be that the parties can enter into new agreements or renegotiate existing agreements to make Options enforceable. However, given the time and resources required to make such changes, it would be highly improbable that the parties would be willing to renegotiate their agreements in all cases. An argument is raised that SEBI *could not* have retrospectively validated the agreements as they had prohibited them in the past, but that is not true for the same reason that is mentioned above, there was no explicit restriction of such contracts, so there was no reason to invalidate all existing contracts. Perhaps SEBI wanted to maintain consistency by not contradicting its earlier stance, but that is not reason enough to invalidate existing agreements, especially in the light of the *MCX* judgement.

7. FOREIGN DIRECT INVESTMENT AND OPTIONS

The options discussed earlier allow the investor to minimize risk and get some sort of assured return. It was the belief of regulators that foreign investors were not taking enough of a risk in Indian markets, since they were looking to assure an exit at assure prices before entering into an agreement.[23] As explained

[23] *See Press Release on FDI Policy* (Circular 2 of 2011), dated 31-10-2011, MINISTRY OF COMMERCE AND INDUSTRY; *Foreign Direct Investment – Pricing Guidelines for FDI instruments with optionality clauses*, AP (DIR Series) Circular No. 86, dated 9-1-2014, RESERVE BANK OF INDIA.

by Sandeep Parekh in an article,[24] the Reserve Bank of India allows for investment through two routes, equity and debt.[25]The debt route is heavily regulated, whereas the equity route is less so, this is due to the fact that the RBI is interested in boosting investment into the country, as opposed to guaranteeing outflow from the economy. The essential argument of the RBI is that when there is a guaranteed return, the investment is in the nature of debt and must consequently be subjected to the more stringent regulations that would be applicable.[26]

8. THE TATA-DOCOMO DISPUTE

For the corporate juggernaut that is the Tata Group, the DoCoMo dispute is the gift that keeps on giving. While the clash of the titans might be intriguing to watch, it draws attention to an important issue that affects investor confidence in India.In fact, most of the literature on the point FDI and Options seem to be regarding the Tata-DoCoMo dispute that is currently on going. DoCoMo had invested in Tata Telecommunications with the understanding that if certain milestones were not met within

[24] Sandeep Parekh, *Courts might hold guaranteed return of capital clause invalid – Business Standard*, INITIAL PRIVATE OPINION, http://spparekh.blogspot.in/2016/08/courts-might-hold-guaranteed-return-of.html (last accessed 7th February, 2017).

[25] *Consolidated FDI Policy*, dated 7-6-2016, MINISTRY OF COMMERCE AND INDUSTRY, at 3.4.

[26] *Master Circular on Foreign Investment in India*, Master Circular No. 15/2013-14, RESERVE BANK OF INDIA.

a period of five months, Tata would find a buyer at fair market value, or pay half of the original value of the investment, whichever was higher at the time of the exit.[27] Since a buyer could not be found, Tata agreed to pay half the amount of the original investment. This payment however, was blocked by the RBI as being in violation of the above-mentioned regulations, since it above the value that could be reached by accepted valuation methods and amounted to guaranteed returns.

Even a *prima facie* analysis indicates that these regulations, at least in the manner that they have been implemented, seem to do more harm than good.[28] The DoCoMo case highlights this well, as the company was willing to take a loss of 50% on its initial investment, which in no way could be considered to be a guaranteed return. This raises an interesting conundrum, should the impugned regulations be as strict as they are now, or should there be more room to interpret the provisions according to the situation at-hand?

[27] Deepali Gupta et al., TATA VS DOCOMO: TWO WARRING PARTNERS AND ONE BIG MESSTHE ECONOMIC TIMES, http://economictimes.indiatimes.com/news/company/corporate-trends/tata-vs-docomo-two-warring-partners-and-one-big-mess/articleshow/53748101.cms (last visited Feb 7, 2017).

[28] Bhargavi Zaveri and Radhika Pandey, *Tata-Docomo: What went wrong, and what we need to do different*, AJAY SHAH'S BLOG, https://ajayshahblog.blogspot.in/2016/07/tata-docomo-what-went-wrong-and-what-we.html (last accessed 7th February, 2017).

8.1. **Problems of an excessively strict regulation**

The assumption that having any sort of guaranteed return is equivalent to debt masquerading as equity is a highly problematic one. In the DoCoMo case for instance, the investor was willing to exit at 50% of its investment value, or sell the shares at the fair market value, and therefore, the original agreement did not in any way violate the impugned regulations. If DoCoMo had agreed to terms that stated that the valuation at the time of exit would be greater than the fair value, then such terms could be questioned.

If the objective was to prevent debt masquerading as equity, the current state of regulations makes no sense whatsoever. If the RBI imposes restricts on agreements that grant a guaranteed return that is more than the fair valuation at the time of exit, that would presumably have an effect on such colourable investments. However, imposing restrictions on *any* guarantees, even if the amount guaranteed is a fraction of the original investment, it would appear that the regulations are overbearing, since such an agreement can in no way be said to be guaranteeing returns on investment. Even the RBI itself has notified the Finance Ministry that the regulations may be inappropriate in certain cases. However, the Finance Ministry stubbornly refuses to budge from the *status quo*, seemingly backing the point of view that an investor willing to take a haircut after a risky investment is somehow investing through the debt route[29].

Perhaps the understanding of the term 'returns' to the RBI indicates to them '*any amount*', as opposed to '*any amount relative to the initial investment*'. That would certain explain their stance in this matter. However, the latter is considered the more appropriate understanding in the context of investments.[30] Further, only this understanding would have some sort of nexus to their intentions behind the regulations, since it affects any sort of guaranteed gains, as opposed to any sort of guarantee. Considering any amount beyond fair market value to be returns, notwithstanding the amount of the initial investment, is manifestly absurd. It would be appropriate in light of this discussion to state that the position taken by the RBI on this matter is incorrect.

[29] PTI, *India bound to enforce London court's decision on Tata: DoCoMo*, LIVE MINTHTTP://WWW.LIVEMINT.COM/ (2016), http://www.livemint.com/Companies/j8qlizNz25PvGfycVUexJK/India-bound-to-enforce-London-courts-decision-on-Tata-DoCo.html (last visited Feb 7, 2017).

[30] *Return*, INVESTOPEDIA, http://www.investopedia.com/terms/r/return.asp (last visited Feb 7, 2017).

8.2. The Delhi High Court on the DoCoMo Dispute

The recent decision of the Delhi High Court in this matter has had no substantial alteration or clarifying effect on the law discussed above.[31] The Court held that the RBI had no right to intervene because it was merely an enforcement of an arbitral award, and not a transfer of shares as such. The returning of share scrips to Tata was only incidental, and could be seen as a voluntary return of the scrips, since Docomo had no use for them.[32] The Court has essentially maintained the position that the applicable regulations would apply in the case of transfer of shares.[33] As such, even after the conclusion of the case, the fact remains that the transfer pricing norms are still applicable, and there is no change in the position of law, except the enforceability of Arbitral Awards in cases like this has been upheld.

9. CONCLUSION

I had raised two primary areas of inquiry for this paper, using the sources mentioned above, I believe it would be save to arrive at the following conclusions:

[31] *NTT Docomo Inc. v. Tata Sons Limited*, OMP (EFA) (COMM.) 7/2016 & IAs 14897/2016, 2585, 2017 (*hereinafter* 'NTT Docomo').

[32] NTT Docomo, at ¶50.

[33] NTT Docomo, at ¶54.

The Options clauses entered into prior to October 3rd, 2013 are invalid, but any such clauses inserted into an agreement after the date shall be enforceable. The power to exercise the option can be derived from the articles or a shareholders' agreement. The reasoning behind the decision to not give the notification a retrospective effect is dubious at best.

Options are permitted in the case of foreign direct investment, but only insofar as they do not guarantee a return, where a return is understood to mean any amount of money above fair value, and not relative to the initial investment. The manner in which this regulation has been utilized means that regardless of the terms of the agreement, the amount paid must not be more than the value arrived at through the prescribed methods. This would, in effect, neuter the purpose of Options clauses in the first place, as the DoCoMo case clearly shows, agreements guaranteeing even a fraction of the initial investment, let alone any profits, will be hit by the regulations.

9.1. The need for more liberal regulations

I started this paper with an explanation of why investments are considered to be important for the growth of an economy, this is especially true in the case of a country such as India, where sustained periods of growth are essential for the purpose of development. It would be in the best interest of the economy to regulate only to the extent that is necessary. There regulations with respect to Put and Call Options have undergone a lot of flip-flops in the past, and continue to be the subject of confusion.

In order to rectify this situation, the following steps must be taken to ensure that excessive regulation does not scare away investors:

a. *Allow Foreign Investors to enter into agreements that at least allow the investor to safeguard at least a fraction of the initial investment, regardless of the valuation of shares, and have a more liberal interpretation of the relevant regulations, since any amount guaranteed that is less than the initial quantum of investment cannot be said to be debt masquerading as equity.*
b. *Frame appropriate guidelines for Options, including values such as maximum amount that can be guaranteed (compared to the initial investment), and terms that must be included or excluded in the agreements (such as prohibition of sale to foreign investors). This would give investors more clarity as to what they can expect at the time of exit, instead of being blindsided by flip-flopping interpretations and regulations.*