

M&A Hotline

October 23, 2013

SEBI PERMITS OPTIONS AND PREEMPTIVE RIGHTS ARRANGEMENTS

- Pre-emptive rights, right of first refusal, tag-along, or drag- along clauses in shareholders' agreements gets SEBI's approval
- Call and put options in shareholders' agreement are now valid, subject to certain conditions

The Securities and Exchange Board of India ("SEBI") has by its recent notification¹ ("Notification"), agreed to include clauses relating to preemptive rights, right of first offer, tag-along right, drag-along right and call and put options, when contained in shareholders' agreements, as valid contracts, for the purpose of the Securities Contract Regulation Act, 1956 ("SCRA").

BACKGROUND

There has always been confusion on the kinds and the type of contracts that can be entered into with respect to 'marketable securities' under the SCRA.

SEBI issued a notification in 2000², pursuant to which it prohibited all contracts, except spot delivery contracts or contracts for cash or delivery or contract in derivatives, in territories to which the SCRA applied.

Section 16 of the SCRA empowers the Central Government to declare by notification that no person may enter into any contract for the sale or purchase of any security specified in that notification, if it is of the opinion that it is '*necessary to prevent undesirable speculation in specified securities*'. Section 28 (2) empowers the Central Government, by notification, to specify any class of contracts as contract to which the SCRA shall not apply, if it is satisfied that it is necessary in the interests of trade and commerce or the economic development of the country. Section 29A of the SCRA further empowers the Central Government, by a notification, to delegate the powers to SEBI or Reserve Bank of India ("RBI").

By a notification in 1992³, the Central Government delegated the power under Section 16 of the SCRA to SEBI.

Amending this notification, the Central Government issued another notification in 2000⁴ distributing the power among SEBI and RBI such that in relation to any contracts in Government securities, money market securities, gold related securities and in securities derived from these securities and in relation to ready forward contracts in bonds, debentures, debenture stock, securitized debt and other debt securities, the powers under Section 16 would be exercisable by RBI.

In this background, the validity of the preemptive rights, the drag along and tag along rights, call and put options was always questionable.

This issue has been the subject matter of a number of cases.

In 2005, the Bombay High Court⁵, while dealing with buy back clause in a share purchase agreement, held that such a clause would not be valid under the SCRA since it is not a spot delivery contract.

In 2011, SEBI issued an informal guidance⁶ stating that an agreed purchase of shares of a listed company through call or put option of a listed company is not valid, since it does not constitute a spot delivery contract. In addition, the contract is not a valid derivative under SCRA since it is not a contract traded on stock exchanges and settled on the clearing house of a stock exchange.

In 2012, the Bombay High Court, while dealing with options for the purchase or sale of securities between the parties, in the case of MCX Stock Exchange Limited vs. SEBI⁷, held that options are merely the privilege of the option holder, and a concluded contract for the sale and purchase would come into existence only on the exercising of the option by the option holder. The court also distinguished between a futures contract, which was a contract for the purchase or sale of securities in future at a determined price, and options, which were mere privileges in the hands of the option holder⁸. However, the appeal filed by SEBI by way of a Special Leave Petition was disposed off by the Supreme Court on the basis of the consent terms filed by the parties.

CHANGES

By way of the Notification, SEBI has enhanced the scope of contracts that are valid under the SCRA. By notification S.O. 184 of 2000, SEBI had limited the scope of permissible contracts to spot contracts and derivative contracts. However, by the Notification, the following have now been included within the scope of permissible contracts under SCRA:

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1. *contracts for pre-emption including right of first refusal, or tag-along or drag along rights contained in shareholders agreements or articles of association of companies or other body corporate;*
2. *contracts in shareholders agreements or articles of association of companies or other body corporate, for purchase or sale of securities pursuant to exercise of an option contained therein to buy or sell the securities...* "

The contract for the purchase or sale of securities pursuant to the exercise of an option under clause (d) above is subject to certain conditions:

1. *the title and ownership of the underlying securities is held continuously by the selling party to such contract for a minimum period of one year from the date of entering into the contract;*
2. *the price or consideration payable for the sale or purchase of the underlying securities pursuant to exercise of any option contained therein, is in compliance with all the laws for the time being in force as applicable; and*
3. *the contract is settled by way of actual delivery of the underlying securities.*

In addition, the Notification clarifies the following:

- the contracts now included within the scope of the SCRA shall be in accordance with the extant exchange control laws of India;
- the changes shall not affect or validate any contract which was entered into prior to the date of the Notification

ANALYSIS

■ Ambiguity with respect to validity of call and put options finally settled

Prior to the Notification, there was a lot of confusion around the validity of options. Two views existed. One view was that the contracts are not valid since they were neither spot delivery contracts, nor were they derivatives traded in stock exchanges. This was in line with the interpretation of SEBI in the case of Vulcan Engineers, USL Diageo and Cairn Vedanta. The other view, which found support from the MCX judgment of the Bombay High Court, was that the options were mere rights with the option holder, and did not constitute a completed contract, but merely an agreement to contract at a future time, and hence at the time of entering into the option, no forward contract was entered into.

By including contracts for purchase or sale of securities pursuant to exercise of an option, SEBI has put to rest a long standing debate.

■ Adding some more confusion

While the validity of options and pre-emptive rights have now been settled, the Notification seems to have added some more confusion with respect to the enforcement of option contracts.

The inclusion of preemptive contracts, right of first offer, right of first refusal, drag and tag rights, and options as a separate class of contracts, it is implied that these contracts would not fall under the two preceding clauses, i.e. spot delivery contracts, or derivative contracts.

1. Mode of settlement- As per the MCX judgment, an option, on exercise would become a spot delivery contract. Hence it would be settled as a spot delivery, on being exercised. However, by including options and preemptive rights as a separate class of permitted contracts, it is unlikely that they would be settled as spot delivery contracts. It is to be seen as to how the settlement of the contracts would take place.
2. Tradability- Since preemptive right contracts, as well as options have now been included as permitted contracts, there is now some ambiguity as to whether they can now be traded as marketable securities. For instance, if a shareholders agreement contains merely a call option, can that right be traded by the option holder.

■ Prevention of speculation

For an option contained in a contract to be valid and enforceable, the selling party must own the securities for a period of at least one year from the date of entering into the contract. Also, the contract for such sale and purchase pursuant to the exercise of an option must be by actual delivery of the underlying securities.

The intent behind this clause is to prevent any speculative transactions among the parties, which was the intent behind the introduction of SCRA.

■ Fate of existing contracts

SEBI clarifying that the Notification shall not effect or validate any contract entered into prior to the date of the Notification may be seen as implying that such contracts before the Notification might not have been valid. To such extent, the legal enforceability of such contracts might still be questionable, and hence encourage parties to reenter into contracts already existing.

■ RBI perspective

Though SEBI has permitted options in shareholders' agreements, the same have been subjected to the extant exchange control regulations. RBI has often been uncomfortable with such contracts in shareholders' agreements since it views these contracts as more in the nature of debt as opposed to equity, thereby defeating the spirit of the foreign direct investment policy⁹. The RBI has even issued various show cause notices for removal of such provisions. Unless RBI issues a notification permitting options in shareholders' agreements, these options in cross border deals might still remain questionable.

CONCLUSION

The issue of the validity of call and put options has been debated frequently. SEBI has earlier held options to be invalid in Vulcan Engineering, and recently, has even asked parties to remove put options from their agreements, as in the recent case of Vedanta Resources Plc's acquisition of Cairn India Limited. Hence the Notification is a welcome

move and will bring great relief - to the domestic investors, at least.

Having said that, the call and put options are subject to extant exchange control regulations. RBI has been holding such options invalid on 2 counts. First, that they were not valid contracts under SCRA, and second, that they were in the nature of debt. By way of the Notification, the first of the two issues have been addressed. To that extent, since put options is more pertinent to the second objection- it remains to be seen whether call option would now be permitted. It seems that SEBI may have consulted with the RBI before coming out with the Notification, and it is expected that RBI may soon permit options and preemptive rights from an exchange control perspective, thereby clarifying the issue in relation to these contracts.

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You can direct your queries or comments to the authors

¹ The Notification No. LAD-NRO/GN/2013-14/26/6667 dated October 3, 2013 available [here](#).

² Notification S.O. 184 (E) dated March 1, 2000

³ Notification S.O. 573 (E) dated July 30, 1992

⁴ Notification S.O. 183 (E) dated March 1, 2000

⁵ Niskalp Investments and Trading Co. Ltd. vs. Hinduja TMT Ltd. [[2008] 143 Comp Cas 204 (Bom)]

⁶ SEBI Informal Guidance in the matter of Vulcan Engineers Limited dated May 23, 2011 available [here](#).

⁷ 2012 (114) BomLR 1002

⁸ For a more detailed analysis of this judgment, please refer to our earlier hotline on this case [here](#).

⁹ The foreign direct investment policy only permits equity instruments or instruments compulsorily convertible into equity.

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