Business Standard

RBI clears the air on use of options by foreign investors

Enforceability of put & call options was questionable under FEMA norms

Samie Modak | Mumbai January 08, 2014 Last Updated at 10:39 IST

The Reserve Bank of India (RBI) has finally cleared the air over the use of 'put and call' options by foreign investors in their investment agreements in the country.

The central bank, through a notification dated November 12, 2013 amended the Foreign Exchange Management (FEMA) Regulations, giving its stamp of approval to the use of these popular preferential clauses.

The move will enable use of put options by foreign investors, giving them the right to sell a security at a future date while getting into any merger and acquisition (M&A) transactions.

Even though the securities market regulator Sebi had permitted the use of 'put and call' options in investment agreements back in October, there were doubts over their enforceability due to lack of clarity from the RBI.

As per FEMA regulations, the use of put options by non-residents was treated as a debt instrument, instead of equity, and hence required compliance with the external commercial borrowing (ECB) requirements.

The move by the RBI to allow use of call options by foreign investors in their investment agreements in India, albeit with strict conditions, has been welcomed by securities law experts.

“The recent notification by the RBI has cleared the air around the enforceability with respect to shares or debentures containing options with a non-resident investor. However, the RBI has imposed certain conditions. The conditions have been enforced to ensure that only genuine options in securities are valid,” said Lalit Kumar, partner, J Sagar Associates.

“The notification will ensure certainty in cases of put option vested with foreign investors. If the put option fulfills all the conditions, they will be valid, which for the want of this notification of RBI, were treated by RBI as debt and not equity,” he added.

RBI has prescribed a minimum lock-in period of one year to allow exercise of these options. Also, the central bank has allowed use of put options without any right to exit at an assured price. This is to ensure that the foreign investors are not assured any guaranteed exit price at the time of making an investment or entering an investment agreement.

More importantly, the RBI has prescribed formulae to arrive at an exit price, which legal experts believe is ambiguous and restrictive.

"Going forward, private equity investors may prefer to invest in preference shares and debentures as compared to equity shares since, for preference shares and debentures, RBI has provided flexibility to determine the put option price based on internationally accepted valuation methodology as against capping the put option price for equity shares at return on equity, which may not reflect the fair value of the portfolio company at the time of exit," said Nishchal Joshipura, partner, M&A and private equity, Nishith Desai Associates.

RBI has said that the exit price in case of a listed company will be at the market price as determined on the floor of the exchange. In case of an unlisted company, the exit price should be less than the return on equity as per latest audited balance sheet. While, in case of preference shares or debentures, the pricing can be arrived at as per any internationally-accepted pricing methods.

"The RBI notification by prescribing the maximum exit price is in a way in conflict with the discounted cash flow pricing formula (DCF) prescribed for unlisted companies. It's not clear whether a foreign investor can exit at the maximum permitted DCF pricing if that is higher than the exit price arrived as per the formula provided in this notification," said Kumar.