

PUT & CALL OPTIONS IN EQUITY
INVESTMENTS IN INDIA BY DIGPAL SINGH H.
RATHORE*

Introduction

A Financial contract between two parties a buyer and seller, an option given to save their profit in future is an option given to investor for its benefits on his investment in future, so that by such option investor can easily save its profit on investment. An option is a right, but not an obligation, for a person whether he buys or sells, as the case may be, an agreed quantity of a particular commodity or stock in future at a predetermined price. Options can be used for hedging, taking a view on the future direction of the market, for arbitrage or for implementing strategies which can help in generating income for investors under various market conditions.

Two sorts of options are exchanged. One is a call option which gives seller a chance to speculate prices of the underlying asset so that it can get the benefit in future if the price of asset is fallen and on other side put option gives buyer a chance to bet on their fall so that in future if the price of assets increases it can get a benefit out of it. Put and call option is given as an option to Purchase and sell shares in the open market to a trader.

What is a call option?

Call option is an agreement between two parties, in which the buyer of the call has the privilege, but not the obligation to purchase a concurred stock from the seller after a fix time in future as mentioned in the agreement, at a certain cost as agreed by both the parties during the time of entering into the agreement. For the implementation and execution of such contract or an agreement a premium amount is paid by the buyer to seller at the time when they enter into the agreement.

The buyer of a call option buy stock with an expectation that the cost of the stock will climb up before the option expires. The buyer of a call option had a limited risk upto the premium paid to the seller of that option.

The writer of a call option is obliged to sell the underlying asset to the buyer of the call, at an agreed price on which both the buyer and seller have agreed in the contract. The risk involved in the call option for the seller is unlimited.

What is a put option?

Put option is an agreement between two parties, in which the seller of the put option has the privilege, but not an obligation to sell a concurred stock to the buyer after a fix time in future as mention in agreement, at a certain cost as agreed by both the parties when they enter into

* LL.M Gujarat National Law University, Attalika Avenue, Knowledge Corridor, Koba, Gandhinagar, Gujarat

an agreement. For the implementation and execution of such contract or an agreement a premium amount is paid by the seller to the buyer at the time of entering into the agreement.

The seller of a put option is constantly under the apprehension of his stock that the cost may fall down before the option expires. The seller in a put option had a limited risk upto the premium paid to the buyer of that option.

The writer of a put option is obliged to buy the underlying asset from the seller of the put option, at an agreed price on which both the buyer and seller has agreed in the contract. The risk involved for the buyer of the put option is unlimited.

Evolution of Put and Call Option:

Put and call options are not new phenomenon for the world. They both exist in the same time and at the same place. There is always a clause of call and put option in the investment agreements. In Shareholders agreement and joint venture agreement; it rarely happens that such put and call options are not included. This indicates the importance of the Call and Put options for the investor's benefits in the agreements. These kinds of options always help investors to achieve their objective of getting returns from their investments in most beneficial manner. Call option and put option also give a right to investor to subscribe and acquire additional shares so that the investor can sell such shares at a pre-determined price to earn a pre-determined rate of return from that investment.

However, the enforceability of put and call options have always been a matter of debate with conflicting views on this subject. Securities Contracts (Regulation) Act, 1956 under section 20 originally sought for the prohibition of options in securities. In 1969 Government of India issued a notification in which under section 16¹ of the Securities Contracts (Regulation) Act, 1956 all forward contracts in securities had been banned excepting ready forward transactions. There after Government of India revoked the 1969 notification and delegated the powers to Reserve Bank of India under section 16 of the Securities Contracts (Regulation) Act for regulating contracts in government securities, money market securities, gold related securities and derivatives based on these securities.²

Further in June 1969, the Indian government issued a notification in which it was clearly mentioned that all contracts which includes sale and purchase of securities other than spot delivery contracts or contracts settled through stock exchange are void. In 1995 Government of India has omitted Section 20 of Securities Contracts (Regulation) Act, 1956 which speaks about options in securities shall be illegal and void. On such omission of the section 20 of SCRA, SEBI has taken a viewpoint that puts and calls are illegal for two reasons³. The first is that these options do not qualify as valid derivative contracts. In India, derivatives contracts can only be traded in secondary market and not through private contracts between buyer and seller.⁴ Therefore, according to SEBI, private contract options violate the SCRA. Second reason was that a private contract option that allows the parties to exercise a right to put or

¹ Securities Contracts (Regulation) Act, 1956 s 16.

² Reserve Bank of India. March 7, 2000 IDMC.No.PDRS.3346 /10.02.01/99-2000 [ONLINE] Available at: http://www.rbi.org.in/Scripts/BS_ECMNotificationUserView.aspx?Id=135. [Accessed 23 March 2015].

³ Securities and Exchange Board of India (SEBI) 2000 CHAPTER III(CONTRACTS AND OPTIONS IN SECURITIES) < <http://www.sebi.gov.in/acts/act02a3.html> > [Accessed 20 March 2015].

⁴ <http://www.sebi.gov.in/takeover/cairnlof.pdf> [Accessed 20 March 2015]

call at a future date and time, which is not qualify for a valid spot-delivery contract. Spot delivery contracts are the contracts in which the transfer of money and shares are made on the same day⁵. So by such reasons SEBI gave his view that call and put option should not be provided to the investors. Later in 2000, the 1969 notification was also revoke. This gave the hope to the investors that the provisions mentioned in Section 20 and the 1969 notification, which was creating a roadblocks in the enforcement of options are removed. By such repeal of section 20 and the 1969 notification, call and put option given a way to become valid. But unfortunately, that did not happen.

In 2000 Notification issued by SEBI is somewhat similarly effect provided in the 1969 notification.⁶ In 2000 Notification it is mention that no person can enter into any contract for sale or purchase of securities other than spot delivery contract or contract for cash or hand delivery or special delivery only these contracts are permissible in derivatives. Thus again 2000 notification raised the issue of enforceability of put and call options, in such circumstances SEBI taken a view that such options do not qualify as spot delivery contracts under section 2(i) of SCRA and also not qualify as legal and valid derivative contracts in terms of Section 2(ia)⁷ of SCRA. Contract in which private parties are entered into an agreement and settled transaction of shares in the clearing house of the recognised stock exchange, such trade is not considered as a contract traded on stock exchanges.

Legal provisions in India for put and call option.

Under section 2 sub clause (d) of Securities Contracts (Regulation) Act, 1956 Call and Put option are included in Option in securities.

*“option in securities means a contract for the purchase or sale of a right to buy or sell, or a right to buy and sell, securities in future, and includes a teji, a mandi, a teji mandi, a galli, a put, a call or a put and call in securities”*⁸

Prior to omission of Section 20 of Securities Contracts (Regulation) Act, 1956 read as under;
“Prohibition of options in securities-(1)Notwithstanding anything contained in this act or in other law for the time being in force, all options in securities entered into after the commencement of this act shall be illegal.

*(2) Any option in securities which has been entered into before such commence and which remains to be performed , whether wholly or in part, after such commencement shall, to this extend, become void.”*⁹

Legal Enforceability of Put and Call Option in India

In India there are many legal provisions and regulatory bodies which are protecting the Indian securities market. Among these the Securities Exchange Board of India (“SEBI”) is responsible for regulation and growth of the securities market in India. Reserve Bank of India (“RBI”) is a central bank of India, responsible for monetary policy which also includes

⁵ <http://www.sebi.gov.in/informalguide/Vulcan/sebilettervulcan.pdf> [Accessed 20 March 2015]

⁶ http://www.sebi.gov.in/cms/sebi_data/attachdocs/1380791858733.pdf [Accessed 23 March 2015]

⁷ Securities Contracts (Regulation) Act, 1956 s 2(i) & 2(ia).

⁸ Securities Contracts (Regulation) Act, 1956 s 2(d)

⁹ Securities Contracts (Regulation) Act, 1956 s 20

foreign exchange regulation. The third body is Government of India, who administrators the legal framework of put and call options¹⁰.

The main reason of opposing the put and call options given by the RBI is that, the use of these options made by foreign investors in Indian market increases the outflow of foreign exchange. In put option Reserve Bank has passed the guidelines prohibiting the securities issued by the Special Purpose vehicle (SPV) from having any put options provided either by the originator or by third parties. The Reserve Bank vide letter dated October 4, 2006 to the Indian Banks' Association has allowed third parties to provide put options. Put option by originators should also be allowed and the capital treatment for such options should be similar as applicable to take-out financing.

SEBI also does not consider put and call options as authenticated for a transaction of an assets as mention in the clause of the agreement made between private parties.¹¹ Also in the past SEBI has asked contracting parties to delete Call and Put options from their agreements, including in the Cairn-Vedanta deal and more recently in the deal involving Diageo and UB Group's United Spirits Ltd.

Since almost all private equity investments also have such options in the shareholders agreement, it become is very dangerous for a private equity investor to have conviction regarding the enforceability of such options. Call option and Put option facilitate many different objectives of a private equity investor, a call option always give the investor an option of increasing its venture in the company in which investor want to invest it fund. While a put option provides a facility of exit from the investment to the investor from the company of investee before buyback or in lock in period. Private equity investors make investments in all kinds of companies, including private firms and public limited companies whether such company is listed or unlisted. While the provisions of SCRA apply only to public limited companies whether such company is listed or unlisted but such provisions are not applied to private limited companies. Therefore, any put and call option provided to a private equity investor for investment or for exist from such investment in a private limited company, will have no concern and will not be enforceable with standing SEBI adverse views regarding such Call and put options. Thus, the concern of SEBI adverse views regarding such Call and put options is only with the enforceability in the case of public limited companies. Such kind of issue of enforceability of these options came up before the Bombay High Court in the dispute between MCX Stock Exchange and SEBI¹².

Now there is a major development occurred from the side of law ministry in its proposal to hold that call and put options is valid as per the law and they will be enforceable. after the approval of law ministry such proposal will now go to the finance ministry for approval and if approved an amendment will be brought to the SEBI laws to hold that such put and call

¹⁰ Poornima Hatt & Neela Badami , 'Enforceability of Put and Call options in India in the current regulatory environment' (Singapore International Arbitration Center 2002) <http://www.siac.org.sg/images/stories/articles/siac_articles/36th%20Article%20-%20Poornima%20Hatti%20%20Neela%20Badami%20-%20Enforceability%20Of%20Put%20And%20Call%20Options%20In%20India%20In%20The%20Current%20Regulatory%20Environment.pdf> [Accessed 18 March 2015].

¹¹ Aakash Choubey, 'Options and Pre-Emptive Rights Permitted by SEBI' [2013] Manupatra, 25-26

¹² MCX Stock Exchange Limited v Securities & Exchange Board of India Limited (W.P. No. 213 of 2011 – Bombay HC).

options are valid and enforceable. And thus this will also bring clarity in enforcement of option and it will also bring a hope in private equity investor as after this amendment they will be able to enforce such options with complete certainty even in public companies whether such company is listed or unlisted.

The Securities and Exchange Board of India has permitted listed companies to use call and put options as a clause in their contract agreement of sell and purchase of the share. It also provide rights to sell or purchase a security in a future date at a pre-determined price, in Merger and acquisition (M&A) transactions. SEBI has also allowed to use other popular preferential clauses such as 'right of first refusal, tag along and drag along'.¹³ A right of first refusal in M&A is given to a body for the first right to purchase shares whenever they are offered for sale. Tag-along gives the right to a minority shareholder to sell its shares or not when a majority stakeholder shares are kept its stake for sells in the market, while drag-along clause forces a minority shareholder to its sell their shares with a majority shareholder. Many Experts also said that new norms approved by law ministry will be beneficial for the both domestic and foreign corporate. Institutional investors like private equity investors and foreign institutional investors (FIIs) will also be benefited by the approved norms and will have a joy in their eyes.

An issue was raised in a case where a foreign private equity investor having given a put option right. The RBI said that an instrument carrying a right of put option is considered as a debt instrument and not an equity instrument thus the same principal will be applicable as a borrowing from a foreign entity. Therefore, even though the proposal of providing legality to put and call option is approved by the finance ministry, for a foreign private equity investor, then also there will be always controversial issues under the foreign exchange regulations until RBI clarifies its position.¹⁴

Cases

In the case of *Jethalal C Thakkar v. RN Kapur*¹⁵ decision taken by division bench of the Bombay High Court. In which Bombay high court taken a view that there should be applied a test for determining the validity of a contract. Test can be applied in two ways, first check whether a contract is for a purchase or sale of securities and whether it is performed in precise time which was pre determined.

Second whether no time is precise in a contract; it should be transacted or performed immediately in a reasonable time. Division bench also determined that there should be a distinction made in between the cases by its present obligation under a contract which is to be performed in future date and non present of obligation under a contract which is to be performed as per the condition being complied with or by some emergency occurrence. thus it can be said that Bombay High Court given a contrary view in this judgment.

¹³ Sebi permits put & call options in M&A deals | Business Standard News. 2015. SEBI permits put & call options in M&A deals | Business Standard News. [ONLINE] Available at: http://www.business-standard.com/article/markets/sebi-permits-put-call-options-in-m-a-deals-113100301021_1.html. [Accessed 23 March 2015].

¹⁴ India recognising put/calls would boost FDI | IFLR.com . 2015. India recognising put/calls would boost FDI | IFLR.com . [ONLINE] Available at: <http://www.iflr.com/Article/3210382/India-recognising-putcalls-would-boost-FDI.html>. [Accessed 23 March 2015].

¹⁵ *Jethalal C Thakkar v. RN Kapur* [12 August, 1955] AIR 1956 Bom 74.

In the case of Cairn–Vedanta deal¹⁶ the impact of the SCRA on contracts for pre-emption and option contracts can be seen. Vedanta Resources PLC (Programmable Logic Controller) wanted to acquire the shares of Cairn India Limited held by Cairn Energy PLC, and included provisions for pre-emption rights and put and call options in the definitive agreements.

When Vedanta Resources PLC issued a letter of offer to acquire the shares from Cairn Energy PLC¹⁷, it was disclosed that SEBI had taken the view that the right of first refusal and the put and call options stated in the definitive agreements were in violation of Notification No. SO 184(E) of 1 March 2000, since these contracts did not conform to the requirements of either a spot delivery contract or a contract of derivatives under section 18A of the SCRA.¹⁸

Under this case SEBI reinforced its stand on the void and violability of option contracts; it also exhibits the change in SEBI's view regarding the void and violability of the contracts for pre-emption. This view of SEBI was latter surprising had in its notification of 27 June 1961,[6] expressly excluded contracts for pre-emption from the purview of the SCRA, and such said notification was never repealed by SEBI.

In Vulcan Engineers Limited¹⁹ case Terruzzi Fercalx SpA (TERRUZZI), a foreign company incorporated in Italy, was holding 66.91percent shares in the share capital of Vulcan Engineers Limited (VEL), a company listed in India. VEL allotted 13.79 per cent shares to SIMEST, an Italian Financial Institution controlled by Italian Ministry of Economic Development. SIMEST requires compulsorily exit from an equity investment made in a non-European Union company, within a maximum duration of seven years. SIMEST by exercise its option to sell entered into the contract with TERRUZZI and agreed to sell VEL shares to TERRUZZI in an agreed period of time, after complying with all applicable laws in India. TERRUZZI will be obliged to purchase the shares offered by SIMEST as such purchase of shares pursuant to put option at a pre-determined price as mention in the agreement.

On the Bases of above facts and in response to the request for the interpretative letter on the above issue, SEBI opined that, as the option is in-exercisable in the future date and thus the transaction would not qualify as spot delivery contract as defined under section 2(i)²⁰ of SCRA. Further, SEBI view that the aforesaid put or call option would not qualify as a legal and valid derivative contract in terms of section 18A of SCRA as it is exclusively a Contract between two private parties who settled their transaction of shares in the clearing house of the recognised stock exchange, such trade is not considered as a contract traded on stock exchanges.

In the case of MCX Stock Exchange²¹, SEBI gave its view on Call and put option. In SEBI v MCX Stock Exchange case in which an order of SEBI was challenged before the Bombay High court. In this case Court dealt with the issue of the validity and enforceability of

¹⁶ Arun Kumar Agrawal v. Union of India (UOI) and Ors. (09 . 05 . 2013 - SC) MANU/SC/0490/2013

¹⁷ <http://www.sebi.gov.in/takeover/cairmlof.pdf> , [Accessed 21 March 2015].

¹⁸ 'Liberalisation Initiative: Contracts for sale and purchase of securities' (Indian Lawyer 250 14 November 2013) <<http://indianlawyer250.com/features/article/272/liberalisation-initiative-contracts-sale-purchase-securities/>> [Accessed 21 March 2015].

¹⁹ 'SEBI Informal Guidance holds Call / Put Option in private agreement amongst shareholders as invalid' (KPMG Flash News 16 June 2011) <<http://www.kpmg.com/IN/en/services/Tax/FlashNews/KPMG-FlashNews-Vulcan-Engineers-Limited.pdf>> [Accessed 21 March 2015].

²⁰ Securities Contracts (Regulation) Act, 1956 s 2(i) “*shares, scrips, stocks, bonds, debentures, debenture stock or other marketable securities of a like nature in or of any incorporated company or other body corporate*”

²¹ MCX Stock Exchange Limited v Securities & Exchange Board of India Limited (W.P. No. 213 of 2011 – Bombay HC).

buyback arrangements under law. And provide more specifically to SCRA on such matter. Before court three issue were raised in this case,

- (1) Whether the buyback arrangements is constitute as a forward contract, which would be construed to be illegal;
- (2) Whether the SCRA is also applicable to unlisted public companies; and
- (3) Whether the options violate section 18A of the SCRA as put and call option are not traded and settled through a stock exchange.

On the first issue raised before court observed that a buyback would come into existence only at a future point of time on the date which is decided by the company to buy back the shares, in the eventuality of the party that is granted an option exercising it. Once such option is exercised, the contract would be concluded only by the spot delivery method or through another mode that is considered lawful. On the second issue, court concurred that the SCRA will also been applied to unlisted public companies. Court refused to give its justification on the third issue by giving a reason that such issue is not cited on procedural grounds.

The Bombay High Court held that such call and put option do not violate the spot delivery contract under section 18 of SCRA and hence it is to be considered as valid. However, the court did not pass any order on contracts in derivative under Section 18A of SCRA. After such decision of the Bombay High Court the issue of enforcement of call and put option was made cleared that such put and call option do not violate Section 18 of SCRA but the picture remained blurred with respect to Section 18A. Therefore, it is said that the case was half solved and half is remaining.

SEBI filed an appeal against the order of the Bombay High Court in the Supreme Court. In the apex court, the parties agreed to the consent terms with SEBI stating that the view of the Bombay High Court is not binding on it. This diluted the decision of the Bombay High Court. In short, the issue of enforceability of put and call options remain as it is without any change and the controversy continued in which SEBI kept on believing that such options are invalid.

Conclusion

put and call option always remain in the contrivance, that whether it is permissible or not and whether it is enforceable or not in India's security market.. This dispute was cleared by SEBI many a times and also cleared by Bombay High Court in the cases of MCX Stock Exchange. A SEBI in 2013 pass a norm which has reduced and simplicity the burden on the IPO bound companies. Before these norms have approved the call and put options, they were valid in private limited companies but not in public limited company. When a public company went to the public by IPO, especially provide a right of exit to a private equity investor, SEBI used to insist the company to delete such clauses from their shareholders agreement. But now with 2013 notification of law ministry such kind of option has been became valid and enforced even after the company is listed after the IPO.

From the SEBI regulations perspective though this call and put option is held as valid but from the perspective of Companies Act, 1956 put and call options suffer ambiguity. There is always a view from the companies Act perspective that the call and put option restrict the free transferability of shares in case of public companies and hence it should be considered as void. As companies Act, 1956 says that it restrict the free transferability of share then why it is still be enforced in the case of private companies where there is already the restriction of free transferability of share in a private limited company.

Therefore, if the private equity investors have mention put and call options in their agreement in a private limited company, then there is no issue and worry in the enforcement of put and

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call options even from the Companies Act's perspective. Thus in case of public company the companies Act has to make a clear and transparent viewpoint for the enforceability of call and put option, so that the contract of sale or purchase of the shares can legally includes the option which benefits the investors.

Both the Companies Bill, 2012 and a judgment of the Bombay High Court has also given their view points and speak about the call and put option that even in the case of a public company if the parties agreed to transfer the shares in an agreed time limit at an pre determined price, then such option will not be considered as a void. The RBI, SEBI and companies Act 1956 has also given their view point on the put and call options, they all says that put and call option are creating a restriction on free transferability of shares in a public company but then also if the parties agree in a contract to provide for such options then for such contracting parties the contract will be bound for them. So to extent the risk of their enforceability can be solved and the serious issue and controversial issue can be removed.

Since SCRA is not applicable to pure private companies, the guidelines of RBI are followed by the Pure Private Companies in which Put and Call options is enforceable. In case of listed and public listed companies enforcing off-exchange options can be difficult and because of that the investors may explore other exit routes which can become dangerous for the investor and for the investee company.

The SEBI (Alternative Investment Funds) Regulations, 2012 which is primary regulations to govern FIIs in India doesn't provide any provision with regard to permissible modes of exits from portfolio companies. The Confusion regarding this would have been clarified if the SEBI would have Clarified that the Put and Call options are not prohibited for the FIIs wishing to exit and in this context put and call options are distinctive from derivatives contracts. Some indication is there that RBI and SEBI are moving towards allowing non-speculative to an option scheme, put and call options with a view to end the uncertainty in this field.

There is always a considerable confusion about the enforceability of a privilege extended to select shareholders of a corporation which give them a right to purchase additional shares in the company before the general public has given such opportunity and put and call options.

Surely if the law ministry's proposal is approved further then there will be a development and if the law is amended it will make put and call option valid which can then be used by the private equity investors to structure their investments and particularly their exit through put options at a time when other modes of exit such as the IPO are not giving good results.