OPTIONS OR NO OPTIONS – AMBIGUITY IN FDI POLICY

Jitendra Soni[*] *& Kanad Bagchi*[**]

ABSTRACT

Foreign Direct Investment is essential for any developing economy for two reasons. First, it brings much needed capital to the target country, on a long term basis to finance various big ticket projects, which is suitable for swift economic development. Secondly, Foreign Direct Investment by big Multinational Corporations is an important channel for the access to the most advance technologies by developing countries. Given this importance, a country to attract foreign investors should have incentives as well as safeguards in place to protect the investments. Incentives could be in the nature of high and consistent returns and a stable framework on economic and industrial policies. Safeguards are usually provided in terms of exit mechanisms including the most commonly used put/call options. This article is written in the backdrop of the recent decision by RBI to allow build-in options in FDI instruments subject to certain conditions. Mindful of the importance of FDI in the growth and

[*]Jitendra Soni is a fifth-year student at KIIT Law School, KIIT University, Bhubaneswar, India. The author may be reached at jeet.kls@gmail.com.
[**]Kanad Bagchi is a fifth-year student at KIIT Law School, KIIT University, Bhubaneswar, India. The author may be reached at kanad.bagchi@gmail.com.

development of any economy, the authors in the present article critically analyze the proposed policy framework as suggested by the RBI and the Government. In this process, the article also addresses some of the ambiguities and uncertainties in the proposed framework. It is submitted by the authors that certain clarifications are imperative so as to make the policy comprehensible and coherent.

I. INTRODUCTION

Over the years, offshore financial and strategic investors have executed investment agreements with Indian entities, containing a secured exit arrangement. Typically, the exit mechanism includes an initial public offer (IPO), buy back of shares by the investee company, Offer for Sale, Put/ Call Option or tag along /drag along rights.[1] However, given the fact that IPO is not a commercially viable exit mechanism in a volatile market like India, the investors have relied upon put option for their exit. It is interesting to note that eight out of ten Private Equity Investments and Foreign Direct Investments contain a put option[2] wherein the investor has a right/option but not an obligation to sell the shares to the promoter of the investee

[1]Soma Bagaria, *Exit Options in Equity Investments in India: Recent Issues on Legality*, VINOD KOTHARI CONSULTANTS PRIVATE LTD PUBLICATIONS (May 12, 2012),
http://india-financing.com/EXIT_OPTIONS_IN_EQUITY_INVESTMENTS_IN_INDIA_RECENT_ISSUES_ON_LEGALI TY.pdf.

[2]Sugata Ghosh, *Stake in local companies: RBI refuses special rights to foreign investors through FDI*, THE ECONOMIC TIMES (May 15, 2012), http://articles.economictimes.indiatimes.com/2012-01-09/news/30607349_1_fdi-deals-inflows-department-of-industrial-policy.

company in case of happening of certain triggering events.[3] This standard international practice has been followed in India for several years until the recent changes in the stance by the Indian regulatory authorities infused ambiguity in the policy framework.

With this background, this note seeks to address the issues arising out of changed regulatory positions and critically review the proposed regulatory framework for put options on FDI Instruments. Before navigating the terrain, it is imperative for us to have its clear map in our minds. For this purpose, this note has been structurized into three parts. First part will acquaint the reader with the background to the issue in hand. Thereafter the note would proceed to critically analyze the policy framework suggested by the Government in consultation with the Reserve Bank of India to address the investors' grievances. The last part would conclude suggesting the shift in the approach of the regulators for the effective regulation of these genres of instruments.

Given the breadth of this topic, it is rather imperative on the part of the authors to clearly define the scope and extent of their discussion. It should be understood that in India, the validity of put and call options is not a matter distinct only to FDI regulations, add to it, it remains an enthusiastically debated topic in the realm of corporate and securities legislation as well. From the perspective of capital market regulator SEBI, the pre-agreed buyback of shares through put/call option is a *'contract in derivative'* and not a spot-delivery contract.[4] Under Securities Contract Regulation Act, 1956, such

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[3]Norman Menachem Feder, *Deconstructing Over-The-Counter Derivatives*, 3 COLUM. BUS. L. REV. 677, 692 (2002); PHILIP WOOD, LAW AND PRACTICE OF INTERNATIONAL FINANCE 431 (University Edition); D. Gordon Smith, *The Exit Structure of Venture Capital*, 53 UCLA L. REV. 315, 349 (2005).

[4]SEBI Letter No. CD/DCR/TO/BV/OW/9093/2011 dated Mar. 18, 2011 to Cairns India Limited; Informal Guidance Letter No. CFD/DCR/16403/11, dated May 23, 2011 issued to Vulcan Engineers Limited under the Interpretative Letter under SEBI (Informal Guidance) Scheme, 2003.

contracts would be thus valid only if traded on stock exchange.[5] These views of the regulator sparked a spirited debate between the proponents and critics of the put/call options in the securities of Indian companies.[6] The issues involved therein are much complex and deserves an in-depth analysis that runs beyond the contours of this note. Moreover, the enforceability of contractual restrictions on the transfer of shares[7] is yet again an interrelated aspect which requires a comprehensive review of the judicial pronouncements, and thereby makes such discussion beyond the scope of this note. As a matter of caution, it is not the view of the authors that the developments in the aforementioned areas are insignificant to the current discussion. Instead, the authors are of firm opinion that at times when investors are hunting for stability and uniformity in the investment environment, a coherent understanding of the investors' privileged options and its operation in the interdependent spheres of corporate law, securities law and FDI Policy is much needed. A uniform stance of the regulators and the judiciary will likely make India a preferred destination for foreign direct investment. Having said that, the present note confines itself to the issues pertaining to enforceability of put/call options under the extant FDI Policy of India and an attempt has been made by the authors to bring on forefront the issues worthy of most anxious consideration.

II. GENESIS OF THE DEBATE

The spark, which ignited the debate, was the issue of notification by RBI wherein it placed an explicit bar on any kind of built in

[5]Securities Contract Regulation Act, § 18A (1956); SEBI Notification No. S.O. 184(E) §16 dated March 1, 2000 issued under SCRA.

[6]Umakanth Varottil, *Investment Agreements In India: Is There An "Option"?*, 4 NUJS L. REV. 472 (2011).

[7]V. Niranjan & Umakanth Varottil, *Enforceability of Contractual Restrictions on the Transfer of Shares*, 5 SCC J-1 (2012).

optionality in FDI instruments.[8] In the opinion of the regulator, routing of such intrinsically debt-like instruments through FDI was circumventing the regulatory framework for debt flows in the country.[9] Guided by such approach, till the mid of the year 2011, RBI had been raising objections against the issue of securities which were debt or quasi debt in nature, like convertible debentures, optionally convertible bonds, compulsorily convertible papers and preference shares.[10] Of lately, there was a sudden shift in the approach of RBI and consequently, a whole range of deals, including even plain equity investments, containing put option came into RBI's scanner and several notices were issued by the regulator against such investments.[11]

A. RBI's Stance on Options in FDI Instruments

RBI's approach has been rather on a case to case basis with respect to put options forming part of investment agreements. In essence, the objections of RBI were based on two grounds. *First*, the put option accords safe exist to foreign investors. To the extent it takes away the risk factor attached to an equity investment and assures their exit at a guaranteed price, it qualifies to a debt instrument and therefore it needs to comply with ECB Guidelines.[12] *Secondly*, it was asserted that sellback rights in the form of a put option amounts to one-to-one derivate deal.[13] Under extant laws, since equity derivatives can be

[8]A.P. (DIR Series) Circular No. 73 and 74, dated June 8, 2007.
[9]*Id,* at 1 ¶2.
[10]Sugata Ghosh, *Foreign investors, PEs may not be able to exit easily,* THE ECONOMIC TIMES (May 15, 2012), http://articles.economictimes.indiatimes.com/2011-05-30/news/29598753_1_indian-firms-foreign-equity-private-equity.
[11]*Id;* Shraddha Nair & Khushboo Narayan, *Regulators frown at put option mode of exit,* LIVE MINT (May 17, 2012), http://www.livemint.com/2011/08/14230735/Regulators-frown-at-put-option.html.
[12]Anup P. Shah, *Are Options an Option?,* BOMBAY CHARTERED ACCOUNTANTS' SOCIETY – THE KNOWLEDGE PORTAL (May 10, 2012), http://bcasonline.org/articles/artin.asp?1026.
[13]Priti Suri & Ankush Goyal, *Regulatory conundrum over put and call options*, INTERNATIONAL LAW OFFICE'S CORPORATE FINANCE/M&A-INDIA SEGMENT, Issue

traded only on stock exchanges by investors registered with SEBI[14], such over-the-counter (OTC) contracts are illegal under law.[15]

B. Industry's Stance on Options in FDI Instruments

On the other hand, the industry circles adversely reacted to such views of the RBI and categorically remarked their displeasure on two fronts. *First,* as far as the exercise of option is dependent on meeting of pricing guidelines, as applicable at the relevant time, and triggering event, these instruments cease to qualify as debt. Additionally, it was pointed out that the option was exercisable on the controlling shareholders and not on the company;[16] therefore it was not reasonable to infer borrower-lender relationship between the company and the investor. *Secondly*, it was asserted that put option in an FDI instrument cannot be treated at par with a stock option traded on exchanges for the reason that option and shares form the part of the same instrument in case of FDI unlike exchange-traded options, where options can be traded separately.[17]

C. The Present Policy Framework

While the debate between the regulator and the investors was raging, the Department of Industrial Policy and Promotion (DIPP) issued the Consolidated FDI Policy 2011,[18] wherein it was reiterated that all instruments with in-built option of any type would not qualify as an eligible instrument of FDI.[19] This Clause received sharp responses from the industry and consequently, a Corrigendum was issued by the

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IX (May 1, 2012), http://www.psalegal.com/upload/publication/assocFile/Regulatoryconundrumoverputandcalloptions.pdf.

[14]FMD.MSRG.No.39/02.04.003/2009-10 dated August 28, 2008; RESERVE BANK OF INDIA, Master Circular No. 15/2011-12 dated Jul. 1, 2011.

[15]*Supra* note 5.

[16]*Supra* note 6.

[17]Ruchir Sinha and Surya Binoy, *FDI Policy on Options in Equity Instruments Amended*, INDIA LAW JOURNAL 4 (2011).

[18]Vide Circular 2/2011 (September 2011).

[19]*Id,* clause 3.3.2.1.

DIPP deleting the above Clause.[20] Recently, the RBI and the Government decided to concur with the industry's sentiment and they agreed to mellow down the regulations to allow such in-built option, subject to certain compliances.[21] Since this policy framework will have a significant bearing on FDI in India, it is imperative to critically review the framework proposed by DIPP.

D. The Proposed Policy Framework

In line with the policy mandate to attract long-term equity investments, a consensus was reached between the Government and the RBI to come with prudential norms to regulate this alleged misuse. As reported, the regulators are considering one formulation which will allow instruments with built-in options under FDI route, subject to certain conditions.[22] Apart from meeting terms and conditions under extant laws, the investment shall be made subject to a lock-in period of 3 years, separate disclosure requirement, and separate accounting treatment.[23] A plain perusal of these policy recommendations will illustrate that this framework, if given the force of law, will add more confusion rather than presenting an apt solution to the present policy imbroglio.

[20]F.No.5(19)/2011-FC-1 dated Oct. 31, 2011; V. Umakanth, *Reversal of FDI Policy on Options*, INDIAN CORPORATE LAW BLOG (Mar. 25, 2012) http://indiacorplaw.blogspot.in/2011/10/reversal-of-fdi-policy-on-options.html.
[21]Timsy Jaipuria & Rajat Guha, *RBI to be lenient on debt-like FDI,* INDIAN EXPRESS (May 10, 2012), http://www.indianexpress.com/news/rbi-to-be-lenient-on-debtlike-fdi/929388/0.
[22]*Id.*
[23]*Id.*

III. CRITICAL ANALYSIS OF PROPOSED FDI POLICY FRAMEWORK ON OPTIONS

A. Ambiguity as to the Operation of Lock-In Period

It is understood that a lock-in period will ensure stability of investments in the economy and prevent quick exits. However, the fundamental question still remains unanswered as to the scope, extent and nature of such kind of restriction. It is unclear as to whether the said lock-in period will be applicable on the *'options'* and *'shares'* separately or the *'investment'* as a whole. This distinction becomes particularly important in the present case where it has been a constant opinion of the RBI that put options in FDI instruments are illegal as they are akin to derivative contracts under securities law.[24] Given the fact that the policy makers have not even remotely touched this aspect, it is submitted that there is no nexus whatsoever between the restrictions sought to be imposed and the object intended to be achieved.

Moreover, it is apprehended that in absence of a concrete definition of the term *'options'* clearly indicating the types of options to be covered under the proposed restriction, there are strong chances that the investors will remain suspicious as regards the enforceability of agreements containing an *'exit'* clause and this would ultimately hamper foreign direct investments in India.

As mentioned above, typically the exercise of such option is based on happening of certain triggering event. This event could be a default of the shareholders agreement, failure to meet certain obligation, provisions relating to deadlock resolution mechanisms, material breach of obligations of parties, failure to initiate an IPO, etc. It is asserted that the lock-in period will prejudice the rights of the other party to exit the arrangement on its default. In essence, such

[24]*Supra* note 9.

restriction hits the core of the concept of the freedom of contract wherein the party other than defaulting party will be left remediless on default. Alternatively, it is argued that the extant laws already ensure that any transfer of security from a non-resident to a resident, the pricing guidelines needs to be adhered to. It is our view that as long as pricing guidelines of FEMA are adhered at the time of sale, there is no reason whatsoever for the regulators to interfere in such transaction.

B. The Proposed Policy Framework – Retrospective or Prospective?

If the policy reform is to be read in its present form, the language used therein, in no manner clarifies the prospective or retrospective operation of such change. In essence, the regulators have not clarified that whether the said proposals are in the nature of a new policy change or a mere clarification. If former is the case, then it is a step in the right direction, however, if it is the latter, regulators need to draw their attention on the possible effect of such policy on overseas investments made during past years, particularly in real estate sector.

It needs to be appreciated that in its retrospective application, such change will put investors in a position where their investments will be adjudged on the grounds of new policy. In event of non-compliance with these technical requirements, their Indian counterparts could claim to have no obligation to honour existing clauses, leaving investors with no option to exit. It is submitted that if an investor cannot exercise his legitimate right which he has under a private arrangement like this, capital inflows through foreign direct investment may dry up.

At this stage, it is important to note that as per the extant securities laws; *'put'* and *'call'* options in a JV Contract are valid. Authorization to use such options stems from Section 28 of the Securities Contracts Regulation Act, 1956 and the June 1961 Notification of the

Government of India.[25] Therefore, in this context, it is submitted that the present policy changes need to be appreciated in light of these laws. It is submitted that a unified approach would result in an investment friendly environment.

C. Separate Disclosure for Options and Shares?

Other policy recommendation which draws our attention is the requirement of a separate reporting and monitoring mechanism of such instruments in the FDI reporting formats. This proposal again reflects the confusion as regards the policy intended to be brought in force. The contentious point here is whether the regulators seek to classify option itself as a separate instrument, distinct from the shares. If this is not the case, then there are no grounds available for the regulator to demand separate disclosure as regards the instruments which fall under the same class.

IV. CONCLUDING REMARKS

Over the years, it has been an unsaid custom to include *"options"* at the time of executing investment agreements. In *form*, inclusion of an option may look like a mere exit mechanism which is normally exercised to reduce risk attached with an investment, but in *substance* such clause ensures successful discharge of respective rights and obligations of the parties. It is asserted that it is the substance which needs to be appreciated and not its form. In this background, it is submitted that it is the exercise of option which needs to be regulated rather than prohibiting options *per se*. Consequently, unless and until industry receives clarification as to the precise, the net result of the policy recently proposed could have an unnerving effect on the number as well as the size of the foreign investments.

[25]Notification S.O. 1490, dated June 27, 1961.