Article

Optionality Clauses permissible in FDI instruments – the heydays for exit rights

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Article

The optionality clause in equity shares/ compulsory convertible debentures/ preference shares has been a gray area from the regulatory perspective in India for years. These instruments did not find their eligibility under the FDI norms or Securities Contract (Regulations) Act, 1956 (SCRA) provisions and did not have the nod from SEBI and RBI either. The position for such instruments remained ambiguous till SEBI's notification on enforceability of pre-emption right and call and put options in securities of Indian companies and the recent RBI notification that followed thereafter which expressly granted eligibility to such instruments under the FDI regulations. This article elucidates on the latest developments in this segment and its impact thereof.

Cause and effect of regulatory uncertainty

The phase from 2006 - 2010 saw several private equity/ angel investors investing in Indian entrepreneurs. The investment deals were brimming with opportunities for private equity investors, eyeing angel investments in India increasingly in 2009-10 and first half of 2011. Several investments deals were undertaken with pre-emption rights/ optionality clauses as commonly used exit options. India had become a hot destination for global private equity investors to expand their allocations to India next only to China and the global financial crisis of 2008 aided in channelizing the funds to India. This continued till the first two quarters of 2011. However the situation changed drastically, when the regulators raised concerns on issuance of equity shares/ compulsory convertible debentures/ preference shares with optionality clause and put an express bar on such instruments under the FDI norms in 2011. There was a 25% decline in private equity investments in the first three quarters of 2012 as compared to the similar period in 2011. With regard to exits, while the volumes of exit increased during 2012, the exit values fell substantially from USD 1.8 billion to USD 1.1 billion[1]. This was later withdrawn due to sharp criticism from the investors' community.

Legal issues in call and put options:

In 2011, the FDI circular expressly stated that any equity instrument or compulsorily convertible preference shares/ debentures with in-built options of any type shall not qualify as eligible instruments for FDI. Any such instruments will lose their equity character and will have to comply with the provisions of ECB guidelines.

As per SCRA, the put and call options being contingent in nature are invalid in law[2]. Legality of put and call arrangements and the right of first refusal was discussed by SEBI in case of *Cairn India Limited*[3] and *Vulcan Engineers Limited*[4] and SEBI held that such

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[1] http://www.kpmg.com/in/en/issuesandinsights/articlespublications/kbuzz/pages/pe-october2012.aspx

[2] In the matter of *Niskalp Investments and Trading Co. Ltd. v. Hinduja TMT Ltd* [2008] 143 Comp. Cas. 204 (Bom). Also read our article on Exit Options in Equity Investments in India: Recent Issues on Legality, https://india-financing.com/EXIT_OPTIONS_IN_EQUITY_INVESTMENTS_IN_INDIA_RECENT_ISSUES_ON_LEGALITY.pdf

[3] http://www.sebi.gov.in/takeover/cairnlof.pdf

arrangements was not in confirmation of requirements of spot delivery nor was in compliance with section 18A of the SCRA.

Series of regulatory amendments clearing ambiguity

The first signs of change were when SEBI issued notification[5] in October, 2013 on the enforceability of pre-emption rights and call and put options[6]. SEBI permitted certain contracts as legitimate contracts which were earlier not permitted and included a) 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 and b) contracts for purchase or sale of securities pursuant to exercise of an option contained therein to buy or sell the securities which comply with FEMA regulations apart from certain other conditions. Further these contracts shall be valid notwithstanding anything contained in section 18A read with Section 23 (1)(d) of the SCRA.

Thereafter, RBI vide its notification dated 12th November, 2013[7] had made amendments to the Foreign Exchange Management (Transfer or Issue of Security by a Person Resident outside India) Regulations, 2000 and permitted equity shares or compulsorily convertible preference shares/ debentures to be issued to foreign investors with the optionality clause subject to certain conditions. The Seventeenth Amendment of 2013 of the aforementioned regulations inserted the following clause after Regulation 5(1) (i):

> *"Further, shares or convertible debentures containing an optionality clause but without any option/right to exit at an assured price shall be reckoned as eligible instruments to be issued to a person resident outside India by an Indian company subject to the terms and conditions as specified in Schedule I ."*

The optionality clause will enable the buy-back of the securities from the foreign investors at a price determined at the time of the exercise of the option so that the investors can exit without any assured returns.

RBI legitimizes optionality clause instruments for FDI

Very recently, RBI vide its notification[8] dated 9th January, 2014 issued the pricing guidelines for FDI instruments with optionality clauses. RBI has permitted issuance of

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[4] http://www.sebi.gov.in/informalguide/Vulcan/sebilettervulcan.pdf

[5] http://www.sebi.gov.in/cms/sebi_data/attachdocs/1380791858733.pdf

[6] Read our article on Analysis of SEBI notification on pre-emption rights and options, http://indiacorplaw.blogspot.in/2013/10/analysis-of-sebi-notification-on-pre.html

[7] Foreign Exchange Management (Transfer or Issue of Security by a Person Resident outside India) (Seventeenth Amendment) Regulations, 2013, http://rbi.org.in/Scripts/NotificationUser.aspx?Id=8680&Mode=0

[8] Foreign Direct Investment- Pricing Guidelines for FDI instruments with optionality clauses http://www.rbi.org.in/scripts/NotificationUser.aspx?Id=8682&Mode=0

equity shares or compulsorily convertible preference shares/ debentures with optionality clauses to foreign investors under the extant FDI scheme with a view that such optionality clauses will permit exit mechanism for the investors. The condition precedent to such eligibility is that such instruments should not provide for an assured return as it gets a color of debt and not equity or equity type investment and is subject to certain conditions as well. The provisions of the optionality clauses were made subject to the following conditions:

a. Minimum lock-in of one year or such higher lock-in period as prescribed under FDI regulations. The lock-in shall be effective from the date of allotment of such shares/ debentures.

b. Post the lock-in period the non-resident investor shall be allowed to exercise the option to exit without any assured return, provided:

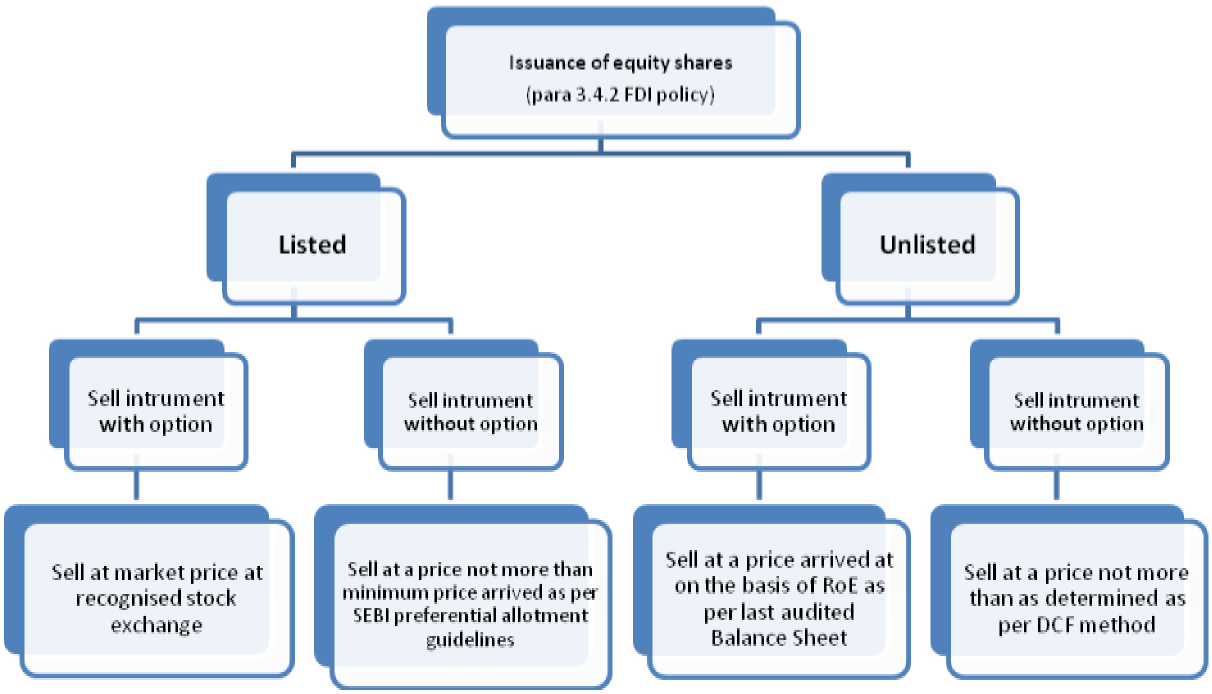
    i. In case of listed companies, the non-resident investor can exit at the prevailing market prices at a recognised stock exchange.
    ii. In case of unlisted companies, the non-resident investor shall be eligible to exit at a price not exceeding that arrived at on the basis of Return of Equity (RoE[9]) as per the last audited balance sheet of the investee company.

c. Investment in compulsorily convertible debentures/ preference shares can be transferred at a price worked out as per internationally accepted pricing methodology at the time of exit duly certified by a Chartered Accountant or SEBI registered merchant banker.

As per the notification all existing contracts will have to qualify with the above conditions to be FDI compliant.

So there are multiple combinations that may work for foreign investors when they invest vide such instruments whether with or without options. The situation that emerges from this notification and under the extant FDI policy with regard to equity shares is illustrated as below:

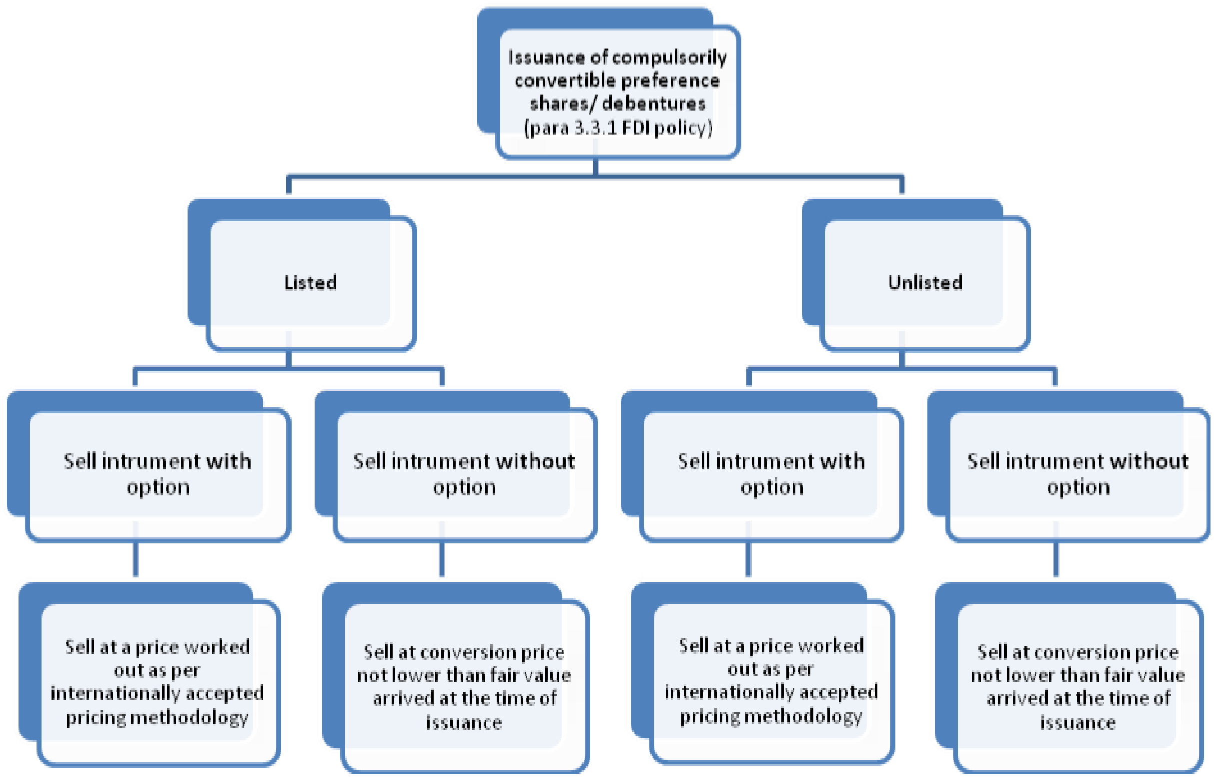
[9] RoE shall mean profit after tax/ net worth; networth would include paid-up capital and all free reserves.



When the foreign investor has to buy the equity shares with or without option, in case of listed companies, they can buy the shares at a price not less than as determined as per the SEBI pricing guidelines and in case of unlisted companies the foreign investors can buy shares fair valued as per DCF method done by SEBI Merchant Banker or Chartered Accountant.

The variation in the exit pricing is what makes several combinations mechanisms possible for investors. In case the foreign investors invest in equity shares of listed company with optionality clause, the investor will buy the shares at a price determined by SEBI pricing guidelines and can sell at the prevailing market price at a recognised stock exchange. In case the foreign investors invest in equity shares of unlisted company with optionality clause, the investor will buy shares at a fair valued price as per DCF method but will sell shares at a price arrived on the basis of RoE of the company as per last audited balance sheet.

The situation that emerges from this notification and under the extant FDI policy with regard to compulsorily convertible preference shares/debentures is illustrated as below:



When the foreign investor has to buy the compulsorily convertible preference shares/ debentures with or without option, in case of listed companies, they can buy the instruments at a determined as per the SEBI ICDR guidelines and in case of unlisted companies the foreign investors can buy instruments fair valued as per DCF method done by SEBI Merchant Banker or Chartered Accountant.

In case of exit mechanism available after the RBI's notification, if the instrument were issued with optionality clause, the instrument is to be sold at a price arrived as per the internationally accepted pricing methodology, whereas if the instruments were issued without optionality clause, the instrument is to be sold at a conversion price not lower than fair value arrived at the time of issuance.

Several observations that arise from the RBI notification are as follows:

a. In case of investment in case of equity shares of unlisted company, where the investor has to purchase at a price arrived at future projections but will have to exit at prices *based on or linked to* RoE as per last audited balance sheet. The observations are:

i. The returns at the time of exit are linked to RoE and RoE itself. Hence the shareholders' agreement will have to clearly lay down the exit price computation *linked* to RoE.

ii. If the RoE based price does not render the returns expected by the investor, the investor will let the option expire and shall sell the shares at the market price which may be reflective of the fundamentals of the company. This gives investors flexibility of choosing mode of exit within the same contract.

b. In case of compulsorily convertible debentures/ preference shares:

i. If the instrument is issued with option the foreign investors have more flexibility in choosing the mode of valuation of the instrument as long as it is internationally acceptable methodology.

These options now available to the foreign investors has made the investment domain open and available for strategising which may be welcomed by the investors.

Applicability of Companies Act, 2013

Section 58(2) of the Companies Act provides for free transferability of shares or interest of a member, in case of a public company. However, the proviso[10] to the section seeks to give recognition to restrictions on transfer in shareholders' agreements, thereby covering preferences like right of first refusal.

Further under section 194 of the Companies Act, 2013 there is a prohibition on forward dealings in securities of company by directors or key managerial personnel. The section states that the director or key managerial personnel shall not have the right to call for delivery or make delivery of any shares or debentures in the company, its holding, subsidiary or associate company. The contravention with the provisions of this section are severe and are punishable with imprisonment which may extend upto 2 years or fine which shall not be less than Rs. 1 lac which may extend upto Rs. 5 lacs or with both.

It is noteworthy that the express prohibition is on the directors and the key managerial person and not on the relatives of such persons. Further, writing of a call is not barred under this section also, if the right to call for delivery or right to make delivery is at market price then such transaction is not barred by this section.

[10] The proviso to Section 58(2) of the Companies Act, 2013 stipulates "*any contract or arrangement between two or more persons in respect of transfer of securities shall be enforceable as a contract*".

Conclusion

Typically for such investors exit mechanisms include initial public offer, buy-back of shares by the investee company, optionality clauses (call/ put options), tag along/ drag along rights, trade sales etc. However the optionality clause renders flexibility in devising the strategy for investment for the foreign investors. For instance a call option allows the investors to increase the stake in the investee company and is useful where the investors are actively involved in the functionality and operations of the company. The call option allows foreign investors to increase their shareholding when desired or as permissible under the regulations. Likewise put options permits foreign investors to reap the benefit of their investments when the valuation of the investee company increases.

While in the recent times the importance of initial public offering as an exit mechanism has greatly diminished considering the state of the capital markets; with the permissibility of such instruments and pre-emption rights along with the amendments in the Companies Act, 2013 will pave way for these investors to keenly consider other exit options. The relaxation in the FDI norms is an attempt to facilitate FDI inflows into the country which had dropped substantially in 2013[11] and these amendments seem to be supportive to the cause from the regulatory perspective. Also what is paramount to the investors is some clarity in regulations which was missing all this while, hence the RBI notifications probably will be welcomed by the investors' community.

[11] FDI in India dropped by 15% between April-October, 2013