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EY Regulatory Alert

Put and Call Options



Executive summary

Regulatory Alerts cover significant tax news, developments and changes in legislation that affect Indian businesses. They act as technical summaries to keep you on top of the latest tax issues. For more information, please contact your EY advisor.

This Regulatory Alert summarizes the notification issued by the Reserve Bank of India (RBI) with respect to “put and call options” associated with the Equity shares and Compulsorily Convertible Debentures treated as instruments of Foreign Direct Investments (FDI) in India. This notification is in line with the notification issued by the Securities Exchange Board of India (SEBI) on 3 October 2013 whereby it legitimised the instruments issued with “put and call options”. It is a positive step to streamline the SEBI notification, the intent as captured in the Companies Act 1956 and the Foreign Exchange Management Act 1999 along with the FDI policy,



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Background and facts

- ▶ The enforceability of pre-emption rights and put/call options in securities of Indian companies has been fraught with difficulties for a number of years. SEBI had been actively considering proposal to ease the restrictions on the enforceability of these provisions and it legitimised them with a notification dated 3 October 2013 whereby it permitted various pre-emptive rights along with put/call options.
- ▶ The RBI has often been uncomfortable with the inclusion of put/call options in investment agreements since it viewed such agreements more in the nature of debt as opposed to equity, thereby defeating the spirit of the FDI Policy. Another impediment for the absence of options in the FDI policy has been the RBI's perception of such options being regarded as derivative contracts separate from the underlying equity security.
- ▶ The Department of Industrial Policy and Promotion (DIPP) had revised the consolidated FDI policy on the use of put/call options. Under the FDI Policy, effective from October 1, 2011, DIPP had introduced Clause 3.3.2.1, which provided that instruments with built-in options of any type would not qualify as an eligible instrument of FDI. However, this amendment was met with a strong disapproving reaction from the Indian industry and the aforesaid amendment to the FDI policy was withdrawn within a month's time.

Amendment by RBI

- ▶ RBI has now issued a notification FEMA 294/RB wherein it has specified certain amendments with respect to the put/call options.

Addition to Clause 5 (1) (i)

- ▶ *"...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...."

Addition to Clause 9 (1)

- ▶ *".... subject to minimum lock-in period of one year or minimum lock-in period as prescribed under" (the FDI Policy eg. Real Estate) "...whichever is higher, a person resident outside India holding the shares or debentures of an Indian company containing an optionality clause in accordance with these Regulations and exercising the option/right, may exit without any assured return, subject to the following conditions:*
 - *(i) In case of listed company, at the market price determined on the floor of the recognised stock exchanges;*
 - *(ii) In case of equity shares of unlisted company, at a price not exceeding that arrived on the basis of Return on Equity (RoE) as per latest audited balance sheet. Any agreement permitting return linked to equity as above shall not be treated as violation of FDI policy.*
 - *Explanation - RoE shall mean Profit After Tax / Net Worth; Net worth would include all free reserves and paid up capital.*
 - *(iii) In case of Preference shares or debentures, at a price worked out as per any internationally accepted pricing methodology at the time of exit, duly certified by a Chartered Accountant or a SEBI registered Merchant Banker. The guiding principle would be that the non-resident investor is not guaranteed any assured exit price at the time of making such investment/agreements and shall exit at the price prevailing at the time of exit, subject to lockin period requirement."*

- ▶ With these additions to the FEMA regulations RBI has made an effort to permit the put/call option in a regularised manner. The RBI has further specified that there shall not be an assured price for exit.

- ▶ When a foreign investor invests in an unlisted Indian company, the foreign investor invests at a discounted cash flow (DCF) based calculation or investment price. Now, when the shareholder shall exit it shall if there is an optimality involved at an RoE linked price.
- ▶ Further the exit price for preferential shares and debentures can be done as per an internationally accepted pricing methodology as long as there is a CA certificate or a certificate for merchant banker.
- ▶ Though it is a good step to address the long pending issue, there shall be more clarity required to convince a foreign investor to invest in unlisted entities at DCF valuation but allowing exit only at book value.

Comments

The RBI has put an end to long pending controversy with regard to its position on Put/Call Options focusing on non-residents. However, in the process of legalising Put/Call Options, it has put in conditionalities which could be perceived negatively by the long term foreign investors as RoE may not be the appropriate mechanism to determine fair value of shares particularly when they are required to invest using DCF valuations as the floor price. We shall wait for the A.P DIR Circular to provide further clarity on this issue. The positive development is a fair degree of flexibility introduced by RBI, of investing via compulsorily convertible preference shares or debentures, accepting the present business environment.

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