Introduction
Put and call options are extremely popular exit mechanisms for investors in India – both domestic and foreign, and in different types of transaction structures including joint ventures (“JV”), private equity (“PE”), venture capital (“VC”) and angel investments. In layman’s terms, a ‘put’ option enjoyed by A against B is A’s option to sell a certain number of securities to B at a future date, at an agreed price. A ‘call’ option enjoyed by A against B is A’s option to compel B to sell a certain number of securities to A at a future date, at an agreed price. In this article, we will focus on the use of these options by PE and VC funds (collectively, “Alternative Investment Funds” or “AIFs”), and their enforceability in India.

These options are founded in commercial practicalities. For example, AIFs are set up with a determinate life cycle. They are then required to return to these investors the principal as well as returns on their investment at the end of the life cycle. For this reason, AIFs ensure that shareholder agreements entered into with their portfolio companies and promoters contain a range of exit mechanisms. These include initial public offerings (“IPO”), strategic sales, tag-along and drag-along rights, liquidation of the company and the ubiquitous put and call options. These put and call options are typically directed against the promoters.

It must be noted that very few start-ups and mid-size companies eventually end up going public. Moreover, liquidating or winding-up a company in India is a long-drawn out and unviable process, and is virtually never resorted to by AIFs. In this background, put and call options against or with (respectively) promoters assume importance, as a feasible exit option, apart from the sale by AIFs of their securities to other third party financial or strategic investors.

Regulatory Framework
The Indian regulatory framework around options is subject to the jurisdiction of multiple regulators, notably:
- the Securities Exchange Board of India (“SEBI”),
- the Reserve Bank of India (“RBI”),
- the Ministry of Finance, and
- the Ministry of Company Affairs.

1 In India, the primary regulations governing AIFs established and operating in India are the Securities Exchange Board of India (Alternative Investment Funds) Regulations, 2012, available at http://www.sebi.gov.in/cms/sebi_data/attachdocs/1337599839661.pdf
The SEBI is responsible for regulation and growth of the securities markets in India and investor protection. The RBI is India’s central bank, responsible for monetary policy including foreign exchange regulation. SEBI, RBI, and the Government administer the legal framework surrounding options.

Each regulator seems to approach options through their own unique perspectives. This note looks at them one by one.

An important statute, the Securities Contracts Regulation Act, 1956 (“SCRA”) originally sought to prohibit ‘options in securities’ (defined to include puts and calls) as being undesirable transactions in securities. While the ban on options was removed by the Government in 1995, the SEBI has taken a different tack. The SEBI is of the view that these options do not qualify as valid derivative contracts. In India, derivatives contracts can only be traded on the stock exchanges and not through private contracts between parties. Therefore, according to SEBI, privately contracted options violate the SCRA. The second reason appears to be that a privately contracted option that allows the parties to exercise a right to put or call at a future date in time does not qualify as a valid ‘spot-delivery’ contract. Spot delivery contracts are contracts where the transfer of money and shares happens on the same day as the contract.

Simply put, what SEBI seems to be suggesting is that only ‘spot-delivered’ puts and calls are valid, and that all other puts and calls are a species of ‘derivative’ that are not recognized under the SCRA. In our view, SEBI’s approach that put and call option contracts are a species of derivative contract overlooks the fact that put and call options are clearly covered under the SCRA’s definition of ‘options in securities.’

While SEBI views options through the lens of securities markets regulation, the RBI’s paradigm is that of foreign direct investment (“FDI”) into India. The RBI’s primary concern is that the use of options by foreign investors may lead to volatility through outflow of foreign exchange. This concern also finds expression in its ‘pricing guidelines,’ which govern the manner of arriving at the floor price for share sales between Indian residents and non-residents.

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2 This regulatory strictness can be attributed in part to the fact that complex derivatives can cause systemic problems, witness their role in the recent global financial crisis.

3 The SEBI has taken these approaches in two recent cases. See for example, the 2011 Letter of Offer issued in the Cairn-Vedanta deal (available at http://www.sebi.gov.in/takeover/cairnlof.pdf) discloses that “SEBI is of the view that put and call option arrangements as well as Right of First Refusal do not conform to the requirements of a spot delivery contract nor with that of a contract of Derivatives as provided under section 18A, and therefore, SEBI is of the view that the above-mentioned put option and call option arrangement along with the right of first refusal are in violation of the 2000 Notification.” Also in 2011, in its Informal Guidance to Vulcan Engineers Limited (available at http://www.sebi.gov.in/informalguide/Vulcan/sebilettervulcan.pdf) SEBI stated that: ‘As [this] (put / call) option would be exercised in a future date (June 30, 2015 onwards) the transaction would not qualify as a spot delivery contract under SCRA S. 2(i), nor as a legal and valid derivative contract in terms of S. 18A.’
The RBI has stated that only instruments that are fully, mandatorily and compulsorily convertible into equity qualify as FDI, and all other instruments are classified as debt, and subject to separate, more stringent rules. This is a well-established rule, one which is included by the Ministry of Commerce in its annual FDI Policy. However, the Ministry of Commerce caused a hue and cry when it notified the FDI Policy in October 2011 with the above rule but with a new clause, stating that any instrument supported by options sold by third parties would not be reckoned as FDI but as debt. The controversial clause was hastily deleted one month later. Whether such deletion by the Government now implies that ‘options sold by third parties,’ (i.e option contracts between AIFs and promoters) are now allowed is not clear, since another regulator, the RBI, does not seem to have retracted from its stance.

**Takeaways for arbitration**

From an arbitration perspective, news reports state that in an arbitration between the Indian Government and aluminium-refiner Sterlite, over Sterlite’s option to call the Indian Government’s 49% stake in Bharat Aluminium Company, the arbitral tribunal found Sterlite’s call option to be against the public policy of India, as being violative of a company law provision that mandates free transferability of a public company’s shares. While this arbitral award is not public, it is important to note that the relevant company law provision (regarding transferability of shares in public companies) is itself the subject of much controversy in Indian law. This controversy revolves around the question of whether or not shareholders of a public company can bind themselves to dispose of their shares in a certain way.

Moreover, since the Indian Government was one of the parties to the dispute, public policy considerations were likely more sharply focused. Therefore, it is by no means a foregone conclusion that arbitral awards (whether foreign or domestic) enforcing options can always be successfully challenged in Indian courts on the basis that they violate Indian public policy. Arbitrators may be concerned about granting interim relief as well in cases involving puts and calls. In our experience, in disputes around exits from portfolio companies, exit routes are rarely limited only to options. In exit-related disputes, we have seen courts granting interim relief in the form of, for example, the freezing of assets of the investee company or of the promoters. We understand that the SIAC’s emergency arbitration provisions too have been successfully used in this context.

**Conclusion**

In our opinion, in pure private companies, as long as the RBI’s pricing guidelines are followed, put and call options would be enforceable (since the SCRA does not apply to pure private companies), and arbitral tribunals would uphold the same. In listed and public unlisted companies, there may be difficulty in enforcing off-exchange options, and investors would do well to explore other exit routes.

It is also apt to note that the primary regulations governing AIFs in India, the SEBI (Alternative Investment Funds) Regulations, 2012 are silent on permissible modes of exits from portfolio companies. Perhaps, if SEBI were to...

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4 The FDI Policy consolidates the Government’s policy announcements, circulars and so on in one place. It is of relevance for AIFs incorporated outside India. Available at [http://dipp.nic.in/English/Policies/FDI_Circular_01_2012.pdf](http://dipp.nic.in/English/Policies/FDI_Circular_01_2012.pdf)

5 This clause impacted put and call option contracts entered into between AIFs and promoters of their investee companies.
clarify that put and call options are not prohibited for AIFs seeking exits, as well as the fact that put and call options in this context are distinct from ‘derivatives’ contracts, a lot of the confusion would be cleared. There is also some indication that the Indian Government, the RBI and SEBI are moving towards allowing non-speculative put and call options with a view to end the uncertainty in this area.*

*Please note that these views are general in nature and are not intended, and should not be construed to be legal advice. Please contact us if you have specific requirements.

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