CLIENT UPDATE

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RBI PERMITS CALL/PUT OPTIONS IN SHARES AND CONVERTIBLE DEBENTURES

In Brief

On December 30, 2013, the Reserve Bank of India (the "**RBI**") notified the Foreign Exchange Management (Transfer or Issue of Security by a Person Resident Outside India) (Seventeenth Amendment) Regulations, 2013 (the "**Regulations**") which expressly allow Indian companies to issue shares or convertible debentures with put and call option provisions to persons resident outside India.

BACKGROUND

Until recently, the legality and enforceability of options contracts for securities was uncertain. In particular, the RBI had taken a ***view*** that foreign investments secured by options granted to the relevant foreign investors would be treated as **quasi-debt, rather than equity**.

However, now:

- The Companies Act, 2013 has permitted share transfer restrictions, including options on shares for public companies.
- The Securities and Exchange Board of India has expressly permitted option and pre-emption provisions contained in shareholders agreements or articles of association of public companies; and finally
- The RBI has permitted the issuance of equity shares, compulsorily convertible preference shares and compulsorily convertible debentures subject to call and put option clauses to foreign investors through the foreign direct investment route subject to certain conditions.

KEY AMENDMENTS

The RBI has mandated that buy-back of securities from the investor shall be at the price prevailing/value determined **at the time of exercise of the call or put option** so as to enable the investor to exit, but ***without an assured return***.

The conditions required to make the relevant provisions fall within the ambit of the recent amendment are:

(a) A minimum lock-in period of one year or a minimum lock-in period as prescribed under FDI Policy, whichever is higher (e.g. defense and construction development sector where the lock-in period of three years has been prescribed);

(b) After the lock-in period, the non-resident investor exercising the option shall be eligible to exit without any assured return, as under:

(i) In case of a listed company, the exit price shall be the prevailing market price;

(ii) In case of an unlisted company, the exit price shall be no higher than that arrived at on the basis of Return on Equity ("**RoE**")[1] as per the latest audited balance sheet;

(iii) Compulsorily convertible debentures and compulsorily convertible preference shares may be transferred 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.

All existing contracts that do not comply with the conditions above will have to be amended.

[1] For the purpose hereof, RoE shall mean Profit After Tax / Net Worth; Net Worth would include all free reserves and paid up capital.