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PUT AND CALL OPTIONS – RBI SAYS YES (*OR MAYBE NOT*)?

Recent news reports state that the Reserve Bank of India (“**RBI**”) has permitted Tata Sons Limited (“**Tata Sons**”) to buy NTT Docomo INC’s (“**Docomo**”) in their joint venture company, namely Tata Teleservices Limited (“**Company**”) at the price which was pre – agreed between the parties even though the price was higher than the price computed as per RBI’s pricing guidelines.

This highly welcome news is a drastic change in RBI’s stance towards validity of put and call options at pre agreed prices in favour of foreign investors (“**Pre – Agreed Price**”).

We have set out the key takeaways from this landmark precedent set by the RBI.

The History of Put and Call Options in India

The two regulators in India monitoring the trading of securities in India and foreign direct investment namely Securities Exchange Board of India (“**SEBI**”) and RBI have always maintained that any contract granting a fixed return on equity (“**RoE**”) in favour of non – resident investors are invalid due to reasons as under:

a. SEBI’s stand

A contract granting Pre – Agreed Price Rights is in fact a forward contract and not a spot delivery contract thereby violating Notification No. SO 184(E) dated March 1, 2000 issued by SEBI. Please note that SEBI guidelines will not apply to private companies.

b. RBI’s position

RBI has maintained that any instrument granting a fixed RoE is in fact an External Commercial Borrowing (“**ECB**”) and cannot be termed as a Foreign Direct Investment (“**FDI**”) in the form of an equity infusion.

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The Overhauling

Pre - Agreed Price Rights and fixed RoE clauses are integral to most private equity (“PE”) deals and joint ventures entered all over the world. India was witnessing an increasing trend where the Indian promoters would agree to enter into such covenants and commit to a fixed RoE at the time of signing but would refuse to fulfil their obligations at the time of exit to of the foreign parties under the deal citing regulatory hurdles. It has been understood that at the time of granting exits, many Indian promoters would write to RBI and SEBI (as applicable) seeking their permission to honour such commitments. Upon being unable to get proper permission from the regulatory bodies for reasons explained above, such deals were practically unenforceable in India thereby creating a fear in the mind of PE players and joint venture partners. In order to curb this trend and encourage investment in India, the law ministry had written to both SEBI and RBI urging to legalise Pre - Agreed Price in favour of non – resident investors.

In 2013 SEBI vide its notification dated 3 October, 2013 amended the Securities Contracts Regulation Act, 1956 (“SCRA”) and permitted contracts entered into by listed companies to contain such clauses for Pre – Agreed Price Rights provided that it met certain requirements *inter alia* (i) a lock in period of one year; (ii) price of such sale should be in compliance with provisions of FEMA and (iii) there should be an actual delivery of the underlying securities. To bring FEMA in line with the said notification of SEBI amending the SCRA, RBI vide its circular dated 9 January, 2014, finally laid down pricing guidelines for FDI instruments with optionality clauses thereby making such optionality and Pre – Agreed Price legit under FEMA (“RBI Circular”). Expectedly so, such pricing guidelines were not devoid of conditions. While the conditions for listed companies were same as those laid down by SEBI; unlisted companies were permitted to enter into such contracts only on the condition that a non – resident investor shall be permitted to exit such unlisted company only at a price which does not exceed the RoE at the time of exit. Any other pre agreed valuation or fixed RoE for exit was accordingly, still banned under FEMA.

NTT Docomo - Tata Sons Chapter

According to the latest reliable news reports in India, RBI has written to the Finance Ministry of the Government of India seeking permission to allow Tata Sons to buy back the investment of Docomo in the Company at the agreed rate of INR 58.04 per share (*pre agreed in the agreements signed between Docomo and Tata group*). The fair value for the exit by calculating the RoE as per the pricing guidelines laid down under the RBI Circular and as arrived at by Price WaterHouse Coopers is only INR 23.34 per share. From the news reports it seems that RBI, which had previously always argued against granting such assured returns on equity investments to non – resident investors and also affirmed it in the RBI Circular, has now allowed such an exit citing reasons as under:

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- a. A fair contractual commitment should be given credence;
- b. Such a transaction should be permitted in view of the latest improved business relations between India and Japan (Docomo is a Japanese Company);
- c. A downside protection to the investor should be permitted.

In what is viewed by the industry as a highly welcome move from RBI, the general reactions to this purported order of the RBI have been positive. However, what remains to be seen is whether the RBI Circular will be rescinded and replaced with a circular which permits such assured returns on investment to non – resident investor or whether RBI will only state this as a one – off case which was only an exception and not the rule. Nonetheless, every non – resident investor can now always use this decision of the RBI as a precedent and a point of argument while presenting its case before the RBI to get assured returns on their investments which has been contractually agreed between the promoters, the investee company and the non – resident investor.

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