



news flash

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SEBI ratifies Pre-emption Rights & Put and Call Options in Contracts

Securities and Exchange Board of India (“SEBI”) has issued a notification dated 3 October 2013 whereby it has liberalized and elaborated its stand on contracts containing an option for purchase or sale of securities, contracts for pre-emption including right of first refusal, tag-along or drag-along rights in the shareholders agreements or articles of association of companies (“**Notification**”).

The Notification is hailed in corporate circles as momentous because it reverses the position SEBI has maintained for long (since its previous notification SO 184(E) dated 1 March 2000- “**Notification of 2000**”) prohibiting all contracts for sale or purchase of securities other than spot delivery contracts or contracts for cash or hand delivery or special delivery. Under the present Notification, SEBI has conceded to the longstanding demand from industry and excluded ‘contracts for pre-emption’ and ‘option contracts’ satisfying certain criteria, from the contracts in securities that a person was not allowed to enter, without its permission.

To fully appreciate the Notification, it is necessary to understand its evolution. The Securities Contracts (Regulation) Act, 1956 (“**SCRA**”) which originally made illegal, any options in securities, thereafter permitted contracts in derivatives to be legal and valid, if traded on a recognized stock exchange and settled in its clearing house. Relying on its Notification of 2000, SEBI therefore held, even stating so in the informal guidance notes issued by it, that in the case of put/call option to be exercised in the future, the transaction would not qualify as a ‘spot delivery contract’ or as a legal and valid derivative contract and to such extent put/call options were not permissible under the SCRA. The issue of put and call options has since seen much furore, with Reserve Bank of India and Department of Industrial Policy and Promotion authorities too contributing to the storm over their concerns in respect of such contracts but the law ministry is stated to have raised the proposal to exclude non-speculative options in shareholder pacts from the restrictions of SCRA and the Notification of 2000. This momentum has finally culminated in the issue of the present Notification.

The Notification

The Notification states that no person shall enter into any contract without the permission of SEBI for the sale or purchase of securities other than a contract that falls under one or more of the following:

- spot delivery contracts;
- contracts for sale or purchase of securities or contracts in derivatives permitted by SEBI;

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- 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];
- contracts in shareholders agreements or articles of association of companies or other body corporate, for purchase or sale of securities pursuant to exercise of an option contained therein to buy or sell the securities, where:
 - i. the title and ownership of the underlying securities is held continuously by the selling party to such contract for a minimum period of one year from the date of entering into the contract;
 - ii. the price or consideration payable for the sale or purchase of the underlying securities pursuant to exercise of any option contained therein, is in compliance with all the laws for the time being in force as applicable; and
 - iii. the contract is settled by way of actual delivery of the underlying securities.

Analysis

The Notification permits Indian companies (listed as well as unlisted public companies) to execute contracts containing exit options in the nature of put and call options and other restrictive covenants including right of first refusal, or tag-along or drag-along rights etc. and such provisions are now capable of being enforced without concerns on their validity under SCRA.

While contracts granting pre-emption rights are now permitted without any conditions and restrictions, in respect of options contracts, SEBI has been careful to specify that such contracts do not encourage speculative trade in securities and are only used in the context of shareholder agreements. Accordingly, purchase or sale of securities pursuant to exercise of an option in contracts are not restricted under the Notification, only if (a) the underlying security is held continuously by the selling shareholder for a minimum of one year from the date of the contract; and (b) the purchase or sale of securities pursuant to exercise of an option are settled by actual physical delivery of the underlying securities. The Notification further requires that though the sale or purchase of securities may occur pursuant to the exercise of an option in a pre-agreed contract, the price of the securities sought to be traded should be in accordance with the pricing norms prescribed by the Reserve Bank of India and other applicable laws in India and the contracts themselves must conform to the Foreign Exchange Management Act, 1999 and rules made thereunder.

Conclusion

The industry has been agitating for clarity on such contracts since exit clauses and other pre-emptive provisions are very common in other jurisdictions and are warranted in commercial contracts. This Notification has liberalised and elaborated SEBI's stand to discourage speculative contracts and gives assurance that contracts of the nature described within the exclusionary clauses of the Notification are enforceable and hence can be acted upon by the parties to such contracts.

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