

Validation of options provided to non-residents

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The notification issued by the Securities and Exchange Board of India (SEBI) on 3 October 2013 provided much needed clarity on the validity of contracts relating to right of first refusal, tag-along and drag-along rights, and options to buy or sell securities contained in shareholders agreements or articles of association of companies. A criticism levelled at this notification was that it only addressed the validity of such contractual rights in the domestic context, and did not validate these contractual rights in arrangements between foreign investors and Indian investee companies.

An amendment to the Foreign Exchange Management (Transfer or Issue of Security by a Person Resident outside India) Regulations, 2000 (FEM Regulations), followed by a notification from the Reserve Bank of India (RBI) on 9 January 2014, partly addresses this concern of foreign investors.

Eligible instruments

The amendment to the FEM Regulations (FEM amendment), together with the RBI notification, permits Indian companies to issue equity shares and mandatorily and compulsorily convertible preference shares and debentures with “optionality clauses” to persons resident outside India (collectively called “instruments” below). The transferability of these instruments is subject to a minimum lock-in period of the higher of the period prescribed under the FEM Regulations or the foreign direct investment (FDI) scheme, or a lock-in period of one year.

The RBI notification further recognizes that these “optionality clauses” will provide the foreign investor an option to exit by obliging Indian companies to buy back such instruments. Notably, as such buybacks must take place at

the prevailing price, the foreign investor would be denied an assured return.

Where the instruments issued by an Indian investee company are listed, a foreign investor can exit at the market price determined at a recognized stock exchange.

Where the Indian investee company's shares are unlisted, the foreign investor can exit at a price not exceeding the price determined on the basis of “return on equity” as per the investee company's most recent audited balance sheet. The FEM amendment defines return on equity as the ratio of profit after tax to net worth (including paid-up capital and free reserves) of the investee company.

Where the Indian investee company's preference shares or debentures are unlisted, the foreign investor can exit at a price determined as per any “internationally accepted pricing methodology” certified by a chartered accountant or a SEBI-registered merchant banker. The FEM amendment further provides that the guiding principle for determining this exit price is that the foreign investor should not be guaranteed any exit price at the time of investing, and any exit should be in accordance with the prevailing price.

No fixed returns

The condition in the FEM amendment linking exit prices to prevailing prices may discourage foreign investors as it is market practice for agreements between foreign investors and Indian investee companies to stipulate a pre-agreed exit price. This price usually is in line with the investment objectives of the investor and does not necessarily reflect the prevailing price of the instrument. Unlike the discounted cash flow method, exiting at the prevailing price may also have the effect of not considering the future value of the business.

The restriction on assured returns appears to be consistent with the RBI's long held view that arrangements between foreign investors and Indian investee companies providing for fixed returns are in the nature of debt rather than FDI, and should therefore comply with regulations relating to foreign currency borrowings.

Another potential problem is that the FEM amendment does not have a “grandfathering” provision validating any arrangements containing “optionality clauses” prior to the amendment coming into force. This has led to lack of clarity on the prospective application of the FEM amendment as the RBI notification states that “existing contracts will have to comply with the above conditions to qualify as FDI compliant”, a provision that is not in the FEM amendment.

Conclusion

While the FEM amendment is a welcome measure as it provides certainty on the validity of arrangements with “optionality clauses”, it has been criticized for the absence of a grandfathering provision and the pricing mechanism it prescribes.

Further, the lack of clarity on the prospective application of the amendment gives rise to a possible interpretation that agreements between foreign investors and Indian companies containing options not compliant with the FEM amendment may need to be re-executed – a route which is impractical for both investors and investee companies. For this reason, a subsequent amendment or notification clarifying the prospective application of the FEM amendment would be desirable.

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