

A look at SEBI notification allowing contractual rights

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With the issuance on 3 October of a notification under the Securities Contracts (Regulation) Act, 1956, the Securities and Exchange Board of India (SEBI) provided much needed clarity on the validity of contracts relating to the right of first refusal, tag-along and drag-along rights, and options to buy or sell securities (collectively referred to as “contractual rights”) contained in shareholders’ agreements or articles of association of companies.

On 1 March 2000, SEBI issued a notification prohibiting “all contracts for sale or purchase of securities”, other than spot delivery contracts or contracts for cash or hand delivery or special delivery or permitted contracts in derivatives. This created considerable difficulties for domestic as well as foreign investors, as contractual rights in one form or another were considered essential for deal-making.

The validity of contractual rights has also been the subject of litigation, with Bombay High Court holding in 2005 that a provision relating to buy-back of shares in a share purchase agreement would be invalid as it was not a spot delivery contract.

In contrast, the same court in its 2012 judgment in *MCX Stock Exchange v SEBI* held that an option contract was only “a privilege”, and that a concluded contract would only come into effect on the exercising of the option by the option holder.

This further exacerbated the lack of clarity on the validity of contractual rights as SEBI had provided informal guidance in 2011 stating that an option contract for sale or purchase of shares would not be valid as it did not constitute a valid spot delivery or derivative contract.

Effect of the notification

By expressly permitting contractual rights in shareholders’ agreements or

articles of association of companies, the 2013 notification has conclusively removed the prevailing confusion on their validity. This notification has also repealed the notification of 2000 on a prospective basis, thereby validating only contractual rights entered into on or after 3 October 2013. Notably, the 2013 notification is also in line with the proviso to section 58(2) of the Companies Act, 2013, which states that “any contract or arrangement between two or more persons in respect of transfer of securities shall be enforceable as a contract”.

Key provisions

While contractual rights have been allowed, options for buying and selling securities are subject to the following conditions: the securities that are the subject matter of the option contract should be held by the seller for a minimum period of one year from the date of the contract; the price for the sale or purchase of securities that are the subject of an option contract must be in compliance with applicable law; and the option contract should be settled by actual delivery of the securities underlying the option contract. The above conditions for option contracts are believed to have been incorporated to prevent speculative transactions.

Additionally, where applicable, all contractual rights should comply with the provisions of the Foreign Exchange Management Act, 1999, and the rules made under it.

Criticisms

While the permitting of contractual rights is expected to go a long way in easing the concerns of deal-makers regarding doing business in India, the notification has also been criticized on two counts.

The notification only validates contractual rights in agreements entered into on or after 3 October 2013 and is silent on the validity of such arrangements entered into prior to that date. This is of some concern to investors as there is no similar final outcome on the validity of contractual rights in agreements entered into on or prior to 3 October 2013. The only way to remove such ambiguity would be to re-execute any agreements containing any contractual rights, a route which may be impractical for both investors and investee companies.

Further, it is widely acknowledged that the Reserve Bank of India (RBI) tends to view arrangements in the nature of contractual rights as debt rather than foreign direct investment. The absence of a parallel notification by the RBI has the effect of denying the benefit of the notification to contractual rights in agreements entered into between foreign investors and Indian investee companies, thereby only allowing domestic investors to enter into arrangements containing contractual rights with Indian investee companies.

Conclusion

By settling a long running debate with contrasting interpretations taken by various forums, the 2013 notification has injected some much needed clarity into the Indian business environment. However, the full intent of the issuance of the notification of validating all arrangements in the nature of contractual rights cannot be achieved in the absence of further clarifications from the RBI and SEBI on the abovementioned criticisms levelled at the notification.

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