

Dispute Resolution Hotline

April 22, 2019

BOMBAY HIGH COURT SETTLES DUST OVER VALIDITY OF 'OPTIONS' UNDER SECURITIES LAW

- A put option is not a forward contract.
- A contract is performed on a spot delivery basis so long as delivery of shares and payment of price are taking place simultaneously.
- Presence of put option clause in an agreement does not make it a "*contract in derivative*".

INTRODUCTION

The Bombay High Court ("**Court**") in the recent case of *Edelweiss Financial Services Ltd. v. Percept Finserve Pvt Ltd. and Anr*¹, upheld the validity of a put option clause which related prior to 2013 and held that it is neither a forward contract, nor a "*contract in derivative*" which is prohibited from being traded against the provisions of the Securities Contracts (Regulations) Act, 1956 ("**SCRA**"). The Court, in this judgment, has affirmed Nishith Desai Associates' earlier analysis of this issue in 2012 which can be found [here](#)

FACTUAL MATRIX

Edelweiss Financial Services Limited ("**Edelweiss**") entered into a share purchase agreement dated December 8, 2007 ("**SPA**") with Percept Finserve Private Limited ("**Promoter**") for purchase of certain shares of Percept Limited ("**Percept**"). The SPA provided that upon breach of certain conditions by Promoter / Percept, Edelweiss shall have the option (a) to re-sell the shares back to the Promoter on such price as would give Edelweiss an internal rate of return (IRR) of 10% ("**Put Option**"), or (b) to continue to hold shares of Percept subject to certain undertakings from Promoter.

Edelweiss claimed that the Promoter and Percept failed to fulfill certain obligations under the SPA. As a result it exercised the Put Option and called upon the Promoter to purchase its shares. However, the Promoter refused to comply with the Put Option. Consequently, arbitration was invoked and a sole arbitrator was appointed to adjudicate the disputes between the parties.

AWARD

The arbitrator concluded that the Promoter and Percept had in fact breached their obligations under the SPA, but rejected Edelweiss's Put Option claim on the ground that the same was illegal. The arbitrator held that the Put Option was illegal on primarily two counts i.e.

- it constituted a forward contract, which is prohibited under Section 16 of SCRA read with SEBI circular dated March 1, 2000; and
- Put Option being a contract in derivatives and not being traded on recognised stock exchange in accordance with Section 18-A of the SCRA was illegal.

KEY ARGUMENTS

Edelweiss Arguments

Edelweiss argued that the award is directly contrary to the judgment of Bombay High Court in *MCX Stock Exchange Ltd v. SEBI*² ("**MCX Judgment**"). The MCX Judgment provided that the put option contracts are not forward contracts³ as the contract is formed on the date the option is exercised and then the same could be performed as a spot delivery contract⁴. Secondly, Edelweiss argued that the Put Option cannot be said to be a derivative as envisaged under Section 18-A of SCRA.

Promoter / Percept Arguments

Promoter argued that the present case is different from MCX Judgment. In the present case, Edelweiss exercised its Put Option and called upon the Promoter to purchase the shares within a stipulated time and not immediately. There was postponement of purchase of shares even after exercise of the Put Option. Hence, it constituted a forward contract which is prohibited. Promoter further argued that the Put Option, being an option to repurchase shares in future constituted a derivative which, if not dealt with in accordance with Section 18-A of SCRA, was prohibited.

It was also argued that there was a SEBI circular dated October 3, 2013⁵ ("**SEBI 2013 Circular**") which saved option contracts that were contained in a shareholders agreement. Our analysis of the SEBI 2013 Circular can be found [here](#). The said SEBI 2013 Circular expressly stated that it does not validate any contract prior to its date. Hence, entering into such option contracts was certainly prohibited under law at least prior to 2013.

JUDGEMENT

The Court held that the present case fell squarely within the purview of MCX Judgment which held that a put option cannot be treated as forward contract. It is performed on a spot delivery basis i.e. both the delivery of shares and

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payment of price take place either simultaneously or within one day from the date the contract comes into existence. The contract comes into existence, if at all, at a future point of time, when two conditions are satisfied, namely, (i) failure of Promoter to restructure within stipulated time and (ii) exercise by Edelweiss of its option to require repurchase by Promoter upon such failure. It also held that the Put Option cannot be said to be a forward contract, just because Promoter was given sometime to repurchase after the exercise of Put Option. There was nothing to suggest that there is any time lag between payment and delivery of shares or whether shares would be delivered first and price would be paid later or vice versa.

The Court then analysed the Put Option on the back drop of Section 18-A of SCRA. Section 18-A provided that “*contracts in derivative*” shall be legal and valid if such contracts are (a) traded on a recognised stock exchange, (b) settled on the clearing house of a recognised stock exchange, or (c) between such parties and on such terms as central government may, specify in accordance with rules and bye-laws of such stock exchange. The Court held that Section 18-A never prohibited entering into a call or put option *per se* but only regulated trading or dealing in such option as a security.

With respect to SEBI 2013 Circular, the Court clarified that it was not a saving notification, but a prohibitory one as it prohibited all contracts except the ones mentioned therein. Secondly, the Court held that if a contract was merely an options contract, then there was no question of it being saved by SEBI 2013 Circular because entering into such contract was never prohibited in the first place.

The Court held that the arbitrator went wrong on these fundamental aspects as he treated the contract as a “*contract in derivative*” merely because it contained a put option in respect of securities. Accordingly, the Court set aside the arbitral award on grounds of illegality.

ANALYSIS & CONCLUSION

It has been more than 60 years since SCRA came into force, but the dust over spot delivery contracts has not settled till the present day. The present judgment is commendable as it gives hope that these issues are now meeting their rightful end, which at the same time, may be a little late in coming.

In 2000, SEBI issued a circular dated March 1, 2000,⁶ which prohibited all contracts, except spot delivery contracts or contract in derivatives. Thereafter, in 2011, SEBI issued an informal guidance⁷ stating that a call or put option is not valid, since it does not constitute a spot delivery contract. Thereafter in 2013, following MCX Judgment, SEBI enhanced the scope of permissible contracts under the SCRA and included within it, option contracts (such as put / call) contained in a shareholders agreement as permissible and valid by SEBI 2013 Circular.

Presently, the definition of “spot delivery contract” contemplates actual delivery of securities and payment of price within one day from the date of contract. The date of contract is typically the date on which the contract comes into existence or is entered into by the parties. This leads to a difficulty as the actual delivery of shares and payment are typically never concluded on the date of contract or within one day thereof. However, the Court has now indicated that so long as the delivery of shares and payment of price are taking place simultaneously, it would amount to a spot delivery contract. This appears to be the true intent of the provision.

With regard to Section 18-A of SCRA, the Court held that it does not by its own force invalidate any contract. It only validates contracts which have certain features as provided in clauses (a) to (c) thereof. Thus, to hold a contract illegal or invalid, one will have to look outside Section 18-A. This interpretation of Court is a step in the right direction as it clarifies that the provision only means what it says and nothing more. Additionally, the Court has now clarified the true purport of Section 18-A i.e. it only governs trading or dealing in options as a security and not entering into options contracts *per se*. This interpretation of Court also affirms our earlier analysis of this issue in 2012 which can be found [here](#).

Interestingly, owing to their freely transferability, courts have earlier held SCRA to be applicable to shares of public companies only (see *Bhagwati Developers Pvt. Ltd. v. Peerless General Finance and Investment Company Ltd. and Ors*⁸ or *Dahiben Umedbhai Patel & Ors. v. Norman James Hamilton & Ors.*⁹). However, an argument can now be made on the basis of new Companies Act, 2013 (“**CA 2013**”) that SCRA also applies to securities of private companies. This is because the definition of “securities” under CA 2013 is now linked to the definition of “securities” provided under SCRA.¹⁰ Hence, “securities” issued under CA 2013 are arguably nothing but “securities” under SCRA on which provisions of the SCRA may become applicable. Further, in certain cases the shareholders agreement itself provides that the shares of investors are freely transferable. In such cases too, the provisions of SCRA may become applicable. It however, remains to be seen how the courts will apply SCRA in light of the new CA 2013 in the future.

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You can direct your queries or comments to the authors

¹ Arbitration Petition NO. 220 of 2014 decided on 27 March 2019

² Judgment of Division Bench (Chandrachud and Mohta, JJ.) of Bombay High Court dated 14/03/2012

³ *Securities And Exchange Board of India vs. Rakhi Trading Pvt. Ltd.* (2018) 13 SCC 753- Para 17.2- A future contract is an agreement between two parties to buy or sell an asset at a certain time in future at a price agreed upon on the date of the contract.

⁴ Section 2(i), Securities Contracts (Regulation) Act, 1956. “spot delivery contract” means a contract which provides for,—
(a) actual delivery of securities and the payment of a price therefore either on the same day as the date of the contract or on the next day, the actual period taken for the dispatch of the securities or the remittance of money therefore through the post being excluded from the computation of the period aforesaid if the parties to the contract do not reside in the same town or locality;
(b) transfer of the securities by the depository from the account of a beneficial owner to the account of another beneficial owner when such securities are dealt with by a depository;

⁵ Notification No. LAD-NRO/GN/2013-14/26/6667 dated October 3, 2013.

⁶ Notification S.O. 184 (E) dated March 1, 2000

⁷ SEBI Informal Guidance in the matter of Vulcan Engineers Limited dated May 23, 2011.

⁸ [2013] 179 Comp Cas 421 (SC)

⁹ 1985] 57 Comp Cas 700 (Bom)

¹⁰ Section 2(81), Companies Act, 2013. “securities” means the securities as defined in clause (h) of section 2 of the Securities Contracts (Regulation) Act, 1956 (42 of 1956);

Section 2(h), Securities Contracts (Regulation) Act, 1956. “securities” include— (i) shares, scrips, stocks, bonds, debentures, debenture stock or other marketable securities of a like nature in or of any incorporated company or other body corporate;

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