

## M&A Hotline

April 20, 2012

### SEBI V/S MCX - HAS THE VALIDITY OF 'OPTIONS' ATTAINED FINALITY?

The Supreme Court of India on April 11, 2012 disposed off the Special Leave Petition ("SLP") filed by the Securities and Exchange Board of India ("SEBI"),<sup>1</sup> against the Bombay High Court judgment in MCX Stock Exchange Limited vs. SEBI<sup>2</sup>. The SLP was disposed off on the basis of consent terms filed by the parties which make for the Regulator to amend the Securities Contracts (Regulation) (Manner of Increasing and Maintaining Public Shareholding in Recognized Stock Exchanges) Regulations, 2006 ("MIMPS Regulations") and to take a relook at the application filed by MCX Stock Exchange Limited ("MCX SE") to operate as a stock exchange in light of the amended MIMPS Regulations.

Notably, the Bombay High Court in its judgment has provided clarity on the validity of 'option contracts' under the Securities Contracts Regulations Act, 1956 ("SCRA"), which has been the subject matter of constant debate amongst the investor community. Although the High Court has clarified that option contracts differ from 'forward contracts' prohibited under the SCRA, the High Court has not provided clarity on whether such contracts are in the nature of 'derivative contracts'. Under the SCRA, contracts in derivatives are legal and valid if such contracts are traded on the floor of a recognized stock exchange and settled through the clearing system of the stock exchange. The views of the High Court in relation to option contracts appear to be hotly contested by the SEBI so much so that the consent terms filed with the Apex Court clearly absolve the SEBI from being bound by the same in its relook of the application filed by MCX SE.

A detailed analysis and impact of the above is provided as below.

### FACTS AND BACKGROUND TO DISPUTE

The dispute, which became the subject matter of adjudication before the Bombay High Court, arose out of MCX SE's challenge of the order of the Whole Time Member of the SEBI rejecting the application filed by MCX SE seeking SEBI's approval to undertake the business of a stock exchange ("SEBI Order"). Upon receiving of the SEBI Order, MCX SE approached the Bombay High Court, invoking its writ jurisdiction under Article 226 of the Constitution challenging the legality of the SEBI Order.

Initially, on August 12, 2008 MCX SE had filed an application before the SEBI to operate as a stock exchange. On August 23, 2008 the SEBI granted an in-principal approval to MCX SE for the same, subject to full compliance with the provisions of the MIMPS Regulations, such regulations inter alia impose a cap of 5% on the shareholding of any resident in the equity capital of a stock exchange.

In order to comply with the requirements of the MIMPS Regulations, MCX SE and its promoters undertook various measures including entering into arrangements with the banks for preferential issue of shares, share purchase agreements, a scheme of reduction and arrangement under section 391 to 393 of the Companies Act, 1956 to reduce the shareholdings of the promoters of MCX SE ("Scheme"). Amongst the banks that were allotted shares on a preferential basis was Punjab National Bank ("PNB"). As a term of its investment, PNB was offered an exit option in the form of a buy back arrangement exercisable against MCX SE or its promoters. IL&FS Financial Services Limited ("IL&FS") was also offered a similar exit option as a term of its investment (collectively referred to as "Options"). Each of the options had a fixed exercise period and also included an IRR component in the price at which the option could be exercised.

On April 7, 2010 MCX SE informed the SEBI of having complied with the MIMPS Regulations. However, on September 23, 2010 the Whole Time Member of SEBI passed the SEBI Order rejecting the application primarily on the grounds of MCX SE failing to comply with modes of reducing promoter shareholding as prescribed by the MIMPS Regulations, concentration of economic interest of MCX SE in the hands of its promoters, failing to seek SEBI's opinion of the compliance of the Scheme with the MIMPS Regulations, non-disclosure of the Option arrangements with IL&FS and PNB and the illegality thereof on the ground that they were in the nature of forward contracts not valid and legal under the SCRA. This in SEBI's mind lead to a conclusion that MCX SE failed to meet the 'fit and proper' criteria required of an entity desirous of operating a stock exchange.

The Bombay High Court, whilst setting aside the SEBI Order on various grounds including that there was a honest, genuine and bona fide attempt by MCX SE and its promoters to reduce shareholding under the MIMPS Regulations, formed clear views on the alleged illegality of buy back options under the SCRA. These formed a pivotal role in the Bombay High Court's decision to set aside the SEBI Order but may have an even greater influence on the way investments in public companies are now carried out.

### RELEVANT ASPECTS OF THE BOMBAY HIGH COURT JUDGMENT CONCERNING THE OPTIONS

It was the submission of the SEBI that the Options which were to be exercised at a future date were in the nature of

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'forward contract'. Hence, such Options did not fall within the permitted categories of contracts for sale or purchase of securities under Section 16 of the SCRA and thus were illegal.

It may be noted that the SCRA was enacted to prevent undesirable transactions in securities by regulating the dealings therein. The SCRA also deals with contracts in securities which are in the nature of options in securities, spot delivery contracts, contracts in derivatives etc. Section 16 of SCRA empowers the Central Government, if it is of the opinion that it is necessary to prevent undesirable speculation in any state or area, to prohibit persons in the State or area specified from entering into any contract for the sale or purchase of any security. By Notification No SO 184(E) dated 1 March 2000, SEBI, the appropriate regulatory authority, issued directions under Section 16 of SCRA to state as under:

1. "no person in the territory to which the said Act extends, shall, save with the permission of the board (i.e. SEBI), enter into any contract for sale or purchase of securities other than such spot delivery contract<sup>3</sup> or contract for cash or hand delivery or special delivery or contract in derivatives as is permissible under the said Act."

Analyzing the submissions of the SEBI, the High Court observed that in case of options, the same constitute the privilege of the option holder, the exercise of which depends upon their unilateral volition. If the option holder declines to exercise it, the counterparty cannot compel performance of the contract. Hence, the High Court observed that a concluded contract for sale and purchase of shares would come into existence only if the option was actually exercised by the party holding the option. If the option were not to be exercised by them, no contract for sale or purchase of securities would come into existence. The High Court further distinguished an option contract from a forward contract stating that the latter involves a contract for the purchase and sale of securities in future at a specified price.

The High Court further observed that there was nothing to suggest that once the Options were exercised by either PNB or IL&FS, the performance of the contract would not be in the nature of spot delivery contract, which is a permissible mode of transacting under the SCRA. It further held that specifically, where the securities are dealt with by a depository, the transfer of securities by a depository from the account of one beneficial owner (seller) to another beneficial owner (purchaser) is within the ambit of spot delivery.

In its submissions before the High Court the SEBI also put forth an alternate argument that even if the Options were not held to be 'forward contract' in contravention of Section 16 of the SCRA, the Options were actually in the nature of contracts in 'derivatives'<sup>4</sup> which are prohibited under section 18A of the SCRA. In this context, it may be noted that section 18A of the SCRA states that contracts in derivatives shall be legal and valid if such contracts are traded on the floor of a recognized stock exchange and settled on the clearing house of a recognized stock exchange in accordance with the rules and bye-laws of such stock exchange. However, since this argument of the SEBI was only put forth during SEBI's submissions with the High Court and the same was not dealt with by the SEBI Order or otherwise, the High Court did not opine on this aspect.

## APPEAL TO SUPREME COURT

The SEBI subsequently filed an SLP before the Supreme Court of India, from the judgment of the Bombay High Court, under Article 136 of the Constitution. For reasons stated above, the SLP was disposed off by the Supreme Court under the consent terms.

## ANALYSIS

The decision of the Bombay High Court draws a clear distinction between a 'forward contract', which are prohibited under the SCRA, and options for sale and purchase of securities and stresses on the fact that the nature of an 'option' in that of a privilege and the conclusion of contract to purchase and sell securities comes about only at the time of exercise of the option. Notably, the Supreme Court too has not made any adverse remarks on such observations of the High Court.

The recognition of the validity of options, which are prevalent in share purchase agreements, share subscription agreements, shareholder's agreement etc. as terms helpful in structuring exit rights of investors, right of first refusals, right of first offer etc., which rights are practicable and inevitable in granting comfort to the relevant parties, is a welcome precedent. This may not however allay the fears of foreign investors investing in India in their tussle with the Reserve Bank ("RBI") of India regarding 'put options'. The RBI has raised concerns whilst foreign investors exercise their put options with respect to their equity investments in Indian companies on the grounds that such inflows take colour of debt as opposed to equity defeating the spirit of the Foreign Direct Investment<sup>5</sup> route.

Despite the aforesaid, in the absence of a clear dictum of the High Court on the validity of the Options under section 18A of the SCRA, the fear of the uncertain still haunts option agreements. It should be possible for parties to privately negotiated deals who hold options to sell or purchase shares, to argue that a mere option, which in itself is not freely transferable, should not be treated as a 'contract in derivative'. This is because from a bare perusal of section 18A, it appears that what is prohibited thereunder is a contract in derivative which is in itself a subject matter of trade, and not a mere option agreement which cannot be assigned freely and which is tailor-made to cater to specific requirements of parties to negotiated agreements. However, a final word on this aspect is awaited, thereby leaving a scope of ambiguity as regards the validity of options in securities viz-a-viz the SCRA.

Another point of concern, however, is the SEBI's clear statement in the consent terms filed with the Supreme Court in the SLP that it would not be bound by the views of the Bombay High Court in terms of Section 16 of the SCRA. Whether such a statement is limited only to the dealings of the SEBI with respect to the arrangements with MCX SE is again a matter of interpretation, increasing the uncertainty for the time being. In this backdrop, SEBI's next steps would largely indicate the approach of the regulator towards option arrangements, an indication which the industry would closely follow.

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<sup>1</sup> Special Leave to Appeal (Civil) No(s).11738/2012

<sup>2</sup> Writ Petition No. 213 of 2011 decided on March 14, 2012

<sup>3</sup> Section 2(i) of SCRA defined "spot delivery contract" as 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.

<sup>4</sup> Section 2(ac) of the SCRA defines "derivative" to include— "(a) a security derived from a debt instrument, share, loan, whether secured or unsecured, risk instrument or contract for differences or any other form of security; (b) a contract which derives its value from the prices, or index of prices, of underlying securities;

<sup>5</sup> Under the current Foreign Direct Investment regime of the Reserve Bank of India, only equity and equity linked investments are permitted to be made. All debt and optionally convertible instruments are required to comply with the External Commercial Borrowing Regulations which are more stringent in nature.

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