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Fallout of New FDI Policy: "In built Options" - When Foreign Investments can become Loans

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Background

Section 3.3.2.1 of the new FDI Policy states that only:

(i) equity shares,

(ii) fully, compulsorily and mandatorily convertible debentures; and

(iii) fully, compulsorily and mandatorily convertible preference shares,

in each case with no in-built options of any type, would qualify as eligible instruments for FDI. Equity instruments issued/transferred to non-residents having in-built options or supported by options sold by third parties would lose their equity character and such instruments would have to comply with the extant external commercial borrowings ("ECB") guidelines.

Analysis

With the new FDI Policy comes so much confusion for corporates and their advisors since the Policy does not define what constitutes "in-built options". Practitioners can only surmise that it has to do with the recent stance of the Reserve Bank of India ("RBI") on put option and pre-agreed buy back arrangements. The RBI is of the view that such arrangements are nothing but foreign loans. The RBI has further classified such arrangements as futures or derivative transactions which can only be undertaken by registered institutional investors and not by private parties. The RBI stance seems to support the view of the Securities and Exchange Board of India on this issue.

The controversy clouding put options is not new. As early as in 2008, the Bombay High Court had in Niskalp Investments and Trading Co. Ltd v. Hinduja TMT Ltd. ("Hinduja case") held that a buy-back arrangement is in violation of the Securities (Contract Regulations) Act, 1956 ("SCRA"), which provides that all transactions in securities other than on a "spot delivery" basis or unless settled through the stock exchange are illegal. In other words, a buy back arrangement is not a "spot delivery" contract.

There have been discussions at length on the reasoning of the Court in the Hinduja case – the Court had relied on a Supreme Court ruling in a case that dealt with the legality of ready forward transactions in the context of repo transactions and buy/sell transactions, and was subsequently dismissed. There are also discussions whether or not the SCRA applies to private companies and/or unlisted public companies. However, until superseded or overruled by a superior bench, the Hinduja case remains binding precedent.

Despite the clamour from corporates and other stakeholders for an amendment or clarification of the decades' old 1956 law, Government policy as evidenced in the new FDI Policy seems to indicate objection to put option arrangements by venture funds and private equity players.

Put option arrangements are quite common in investment agreements entered into by venture capital funds, private equity players and other strategic investors. To address the situation created by the Hinduja case, lawyers adopted creative drafting to structure put option arrangements as “spot delivery” contracts, with the contract becoming effective only upon the exercise of the option. Some went as far as to secure their clients through delivery of the underlying securities in escrow until the exercise of the option. In the effort to secure a guaranteed return, most investments end up looking like dressed up loans.

With effect from October 1, 2011, the new FDI Policy puts paid to all such arrangements. In fact, it appears all kinds of options are now covered though the restriction is more relevant to put options.

Conclusion

The Government’s decision to consider instruments issued to non-residents with built in options as ECBs appears to be severe. An investment must be realised at some point in time, whether or not an option is involved – the option being just an instrument to facilitate exit. Venture capital funds start looking for an exit as early as 2-3 years into the investment, and depending on market conditions the most favoured and preferred exit route is an initial public offering. However, considering market conditions in recent times, put option arrangements have more appeal, being less expensive and not so time consuming.

The regulatory treatment of options may have implications from tax and accounting purposes, and the different treatment by the RBI and the SEBI (as a futures contract) on the one hand and the new FDI Policy (as ECBs) on the other hand, will lead to confusion. In a nutshell, the new FDI Policy would have an adverse impact on foreign investors, especially venture capital funds and other strategic investors, whose investments always have a shelf life. There is a general perception that the Government would need to revisit this issue. Until then, investors are watching.