FDI Policy clarifies position on Exit Options but PE Investors await RBI's Verdict

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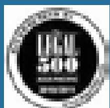

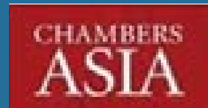

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International private equity and venture capital funds and investors ("PE Investors") have been fairly active in India making innovative investments in growth stage and early stage entrepreneurial ventures. While the Indian growth story coupled with the liberalized foreign direct investment ("FDI") policy has made India an attractive investment destination, PE Investors usually seek exit options such as buy back of shares and put options to ensure safe exit from the investee company owing to fluctuating capital markets.

Simply stated, put option is an obligation assumed by the promoters to acquire the PE Investor's shares on exercise of such option at a pre-negotiated price which may be based on an internal rate of return of x%, compounded annually on the value of the aggregate amounts invested by PE Investor or the fair market value of the shares then held by PE Investor, whichever is higher. The divestment consideration payable to a foreign PE Investor however needs to be subject to the Reserve Bank of India's ("RBI") transfer pricing methodology.

Of late RBI has shown resistance to foreign PE Investors trying to exit through a pre-agreed put option route as RBI views it as a redeemable instrument and therefore an external commercial borrowing ("ECB"), which is permitted only in certain sectors.

According to the FDI norms, foreign investment is allowed only through equity shares, compulsory convertible preference shares or compulsory convertible debentures. RBI treats such securities as equity instruments with associated risk of capital and the price therefore cannot be pre-determined for the exit, i.e., the exit must take place at the prevailing fair market valuation.

Securities and Exchange Board of India ("SEBI") treats options contract as a type of derivative contract which gives the buyer/holder of the contract the right (but not the obligation) to buy/sell the underlying asset at a predetermined price within or at the end of a specified period and considers inclusion of such put options under a private shareholders' agreement in violation of the Securities Contracts (Regulations) Act, 1956.

According to RBI, in terms of the Foreign Exchange Management Act, 1999 ("FEMA"), "only SEBI-registered foreign institutional investors and non-resident Indians are allowed to invest in exchange-traded derivative contracts where the underlying securities are equity shares of an Indian firm and no other class of foreign investor is allowed to enter into any derivative contract where the underlying security is an equity share of an Indian company."

PE Investors on the other hand consider put option as a spot delivery contract which is an actual delivery of security and payment of a price thereof is either on the same day as the date of the contract or on the next day. It is also argued that a debt is redeemable by the company as opposed to a put option which is exercised by the PE Investors only against the promoters and not against the company. Such arguments have however not cut ice with RBI which has held to its position of treating put options akin to a debt and even issued notices in the past to several companies for violation of the ECB guidelines.

Section 3.3.2.1 of the fourth edition of the consolidated Foreign Direct Investment Policy of India released by the Department of Industrial Policy and Promotion, Ministry of Commerce and Industry, ("DIPP") on September 30, 2011 ("New FDI Policy") has made the matter worse. In terms of section 3.3.2.1 of the New FDI Policy, only equity shares, fully, compulsorily and mandatorily convertible debentures, and fully, compulsorily and mandatorily convertible preference shares, would qualify as eligible instruments for FDI. Any instruments with in-built options of any type would not qualify as an eligible instrument of FDI and such instruments would have to comply with the ECB guidelines. As this would impact a host of options, including call options, put options, tag along and drag along rights, several representations were made especially from the private equity funds to DIPP to revoke section 3.3.2.1 of the New FDI Policy. On October 31, 2011, DIPP issued a press release deleting section 3.3.2.1 of the New FDI Policy.

Deletion of the above section however does not automatically bring relief to the PE Investors. In terms of the New FDI Policy, in case of any conflicting interpretation between the New FDI Policy and any relevant notification issued by RBI under the aegis of FEMA, the latter shall prevail. RBI is yet to clarify its stand on the above deletion in the New FDI Policy and its view on inclusion of put options under investment agreements. In other words, while the status quo existing prior to the New FDI Policy has been restored, it is not clear whether RBI will continue to treat such options in violation of the ECB guidelines. It can therefore be concluded that a substantial degree of uncertainty still remains on the enforceability and validity of these exit options and PE Investors have to carefully assess their reliance on such options as an exit mechanism in light of the risks of enforceability of such options.

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