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**Legality of Put Option Under Securities Contract Regulation Act, 1956**

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*Pg. No.: 64-76*

### **Abstract**

The put option is very important and commonly found in different types of transaction structures such as private equity, joint venture, venture capital, angel investors. Now it has become the most popular exit mechanism in India and Foreign countries. Even though Put Option has become acceptable worldwide way before but in India, till 2013 the legality of put option was in question. Various amendments and notifications have been brought but controversies and legal battles didn't end until SEBI issued a notification in 2013 to expand the scope of permissible contracts under the Securities and Contract Regulation Act, 1956 to include option contracts in its sphere.

This paper begins with a basic understanding of the put option and its relevance. It tells how put options are helpful to investors. Further, this paper discusses the obstacles in enforcing an option contract under SCRA, 1956, and the status of put option in India before it is made enforceable by SEBI. This paper throws light on the SEBI notification 2013 that reversed the position SEBI has maintained for a long and opened the door for options in India. This paper further discusses put option's legal position before 2013 and how it became enforceable after the landmark judgment passed by Bombay High Court in MCX Stock Market v. SEBI. This paper concludes that the 2013 notification is a welcome move and will bring great relief to the domestic investors along with RBI's perspective on permitting options.

**Keywords:** Put option, SEBI Notification, Legal position.

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## **CHAPTER 1**

### **Introduction**

#### **1.1. Meaning of Put Option**

Options are very popular exit mechanisms in India and various other countries. They are often found in different types of transaction structures like angel investors, private equity, joint ventures, venture capital, etc. In India, the Securities Exchange Board of India, The Reserve Bank of India, The Ministry of Finance, The Ministry of Corporate Affairs take care of the rules and regulations for option trading.

According to Securities Contract Regulation Act, 1956 section 2(d) “option in securities” means a contract for the purchase or sale of a right to buy or sell, or a right to buy and sell, securities in future, and includes... a put, a call or a put and call in securities.

Options are the derivatives contracts. Option in securities is of two types- call option and put option. The call option is a right of buying the shares at a future date but a predetermined price. The put option is a right of selling the securities or shares at a future date but a predetermined price.

A put option is nothing but a contract for the sale or purchase of a right to obtain securities at a predetermined rate in the future. “Buying a put option is not an obligation but a right of selling an agreed amount of a financial instrument or particular commodity to the seller at a future date for a predetermined price called the exercise price.”<sup>75</sup>

For better understanding let’s consider an example, suppose an investor realized that at this point of time the stock market is bullish and the market rate of the share is high say Rs 1000, so he will buy a put option for one share by paying put option premium for 30 days. On the 29<sup>th</sup> day, the investor realized that the rate of the share fell and the market rate of the share became Rs 800. So, on that day investors will strike and buy a share for Rs 800 and exercise

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<sup>75</sup> The Commissioner of Income Tax v. Bharat R Ruia, (Bombay HC, 2010).

his right to sell the same share at Rs 1000. Hence, the net profit of the investor will be Rs 200 on a share.

## 1.2. Relevance of Put Option

Put options have become famous in commercial practice and commonly feature in various agreements. These options are usually exercised by an investor when he wants to liquidate his investment, either to reduce the risk of loss of capital. Investors use put options in a risk-management strategy and this strategy is known as a protective put. The protective put strategy is adopted so that it can be ensured that losses in the underlying asset do not go beyond a certain amount called the exercise price or strike price and this strategy is used as a form of investment insurance.<sup>76</sup> Many Disagreements and conflicts are there while enforcing these options under various circumstances which we will discuss in detail.

## CHAPTER 2

### **The Prohibition Years**

The Securities and Contract Regulation Act (SCRA) regulates contracts in securities of any incorporated company or any other body corporate. SCRA's preamble states that it was enacted to avert undesirable transactions in securities. Initially, section 20 of the SCRA declared 'options in securities' as illegal.

A notification issued by the Central Government in 1961, in which it was stated that the rights which are contained in the promotion agreements or collaboration agreements or the Articles of Association of limited companies such as pre-emption contracts or any other rights similar to pre-emption contracts, would not come under the ambit of SCRA. Even though the option contracts are similar to pre-emption rights, but it was not clear whether this 1961 notification would hold good to option contracts or not. Section 20 of SCRA was in force when this

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<sup>76</sup> Kuepper, J, (2020, August11). *Put Option definition*, Investopedia.  
<https://www.investopedia.com/terms/p/putoption.asp>.

notification was issued, and it was interpreted that this notification would not hold good to option contracts.<sup>77</sup>

## 2.1. 1969 Notification

In 1969 Central Government issued another notification under SCRA where under all contracts for the purchase or sale of securities were declared void except ‘spot delivery contracts’ or those contracts which settle through the stock exchange.<sup>78</sup>

According to SCRA, 1956 section 2 (i) spot delivery contract is a contract which provides for

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a) payment of price on the date on which contract is entered into or on the next day for actual delivery of securities;

b) or transfer of securities done by a depository.

Notification of 1969 expressly eliminated the options in contracts and considered them as non-spot delivery contracts. However, some amendments were made in 1995 in the provisions of SCRA. This amendment removed the words “by prohibiting options” from the Preamble of SCRA. Also, it eliminated section 20 of SCRA which considered options in securities as illegal.

## 2.2. 2000 Notification

This 2000 Notification repealed the 1969 notification. This notification introduced a new section 18-A to the SCRA which provides that, notwithstanding anything contained in any other law for the time being in force, derivatives contract will be treated as legal, if they are traded and settled through the stock exchange after complying with all the norms and bye-laws

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<sup>77</sup> Law Associates, D. H. (2013, May), *Enforceability of options in Investment Agreements*, Manupatra. [https://www.manupatrafast.in/NewsletterArchives/listing/Newslex%20DHLaw/2013/Resources\\_%20Newslex%20-%20May%202013%20-%20D.%20H.pdf](https://www.manupatrafast.in/NewsletterArchives/listing/Newslex%20DHLaw/2013/Resources_%20Newslex%20-%20May%202013%20-%20D.%20H.pdf).

<sup>78</sup> Ibid.

of such stock exchange in which options are traded. However, in March 2000 SEBI too issued a notification containing provisions similar to those in the 1969 notification.<sup>79</sup>

The reason behind introducing Section 18-A was to bring clarity among investors and authorities about the derivatives which being introduced by the said notification. Those derivatives do not form a wagering contract under section 30 of the Indian Contract Act, 1872. Hence, section 18-A was introduced to remove the confusion and to keep away from the chance of such derivatives being declared as void in the name of being wagers.

The use of options in the agreements was prohibited by SEBI in the case of the Cairn and Vedanta merger and Diageo and United Spirits merger.<sup>80</sup> In 2011 SEBI issued informal guidance to Vulcan Engineers Limited wherein it restated that only spot delivery contracts are valid and a call or a put option does not fall under the category of spot delivery contracts. Hence, options were considered as forward contracts or derivatives by SEBI and could not be enforced under SCRA.<sup>81</sup>

Even though Put Option has become acceptable worldwide way before but in India, till 2013 the legality of put option was in question. Various amendments and notifications have been brought but controversies and regulatory obstacles didn't end until SEBI issued a notification in 2013 to expand the scope of permissible contracts under the Securities and Contract Regulation Act, 1956 to include option contracts in its sphere.

### **CHAPTER 3**

#### **Inclusion of Option Contracts by SEBI Notification, 2013**

SEBI issued a notification on October 3, 2013, which revoked the 2000 Notification issued by SEBI to expand the scope of permissible contracts under the SCRA to include option contracts in its sphere. This notification was issued after the landmark judgment passed by the Bombay

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<sup>79</sup> Supra note 3.

<sup>80</sup> Begur, R. (2016, May 5) *India: Option Contracts: Enforceability issues*, Mondaq. <https://www.mondaq.com/india/securities/488800/option-contracts-enforceability-issues?type=mondaqai&score=74>.

<sup>81</sup> Vinod, J., Chakarbarti, P., Agarwal, A., Basu, P (2019, November 4) *India: Put options- Enforcement and Claiming Damages & Indemnity*, Mondaq. <https://www.mondaq.com/india/fund-management-reits/860054/put-options--enforcement-and-claiming-damages-indemnity>.

High Court in favor of trading options in the securities market. This notification stated that the trading of option contracts would be valid in agreements of shareholders and the Articles of Association of various companies if it follows certain conditions. Conditions are:

1. The minimum period for the holding of ownership and title of the underlying securities by the seller should be one year from the date on which the contract is entered into.
2. the amount which is due on sale or purchase of derivatives under the exercise of any option contained therein should comply with all the laws.
3. The mode should be actual delivery to settle the contract of underlying securities. These contracts of underlying securities have to follow the provisions of the Foreign Exchange and Management Act, 1999.

The SEBI explained in its 2013 notification that according to section 18-A of SCRA (which was introduced in 2000 notification of SEBI) if derivatives are traded as per the norms and bye-laws of a recognized stock exchange and settled by the recognized stock exchange on the clearinghouse then contracts in derivatives will be valid in the eyes of law and hence are enforceable.<sup>82</sup>

## **CHAPTER 4**

### **Judicial Decisions on the Nature of Put Options**

It is important to note that SEBI's notification in 2000, regulates only 'contract for the sale' or 'purchase of securities'. If we talk about the nature of the options, options are considered as a contingent contract that means they will become contract only on the event of actual sale or purchase. Hence, options belong to the category of contingent contracts that do not come under the category of the SCRA and notification passed in 2000 by SEBI. The nature of put options has been debated frequently. Let's understand what was the view of the Bombay High Court in regard to this matter.

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<sup>82</sup> *THE GAZETTE OF INDIA EXTRAORDINARY PART -III -SECTION 4 PUBLISHED BY AUTHORITY NEW DELHI, OCTOBER 3, 2013 SECURITIES AND EXCHANGE BOARD OF INDIA NOTIFICATION Mumbai, the 3 SECURITIES AND EXCHANGE BOARD OF INDIA Notification under Section 16 and 28 of Securities Contracts (Regulation) Act, 1956, 2013.* [https://www.sebi.gov.in/sebi\\_data/attachdocs/1380791858733.pdf](https://www.sebi.gov.in/sebi_data/attachdocs/1380791858733.pdf).



#### **4.1. Jethalal C Thakkar v. R. N. Kapur**

In the *Jethalal C Thakkar v. R. N. Kapur*,<sup>83</sup> a question arose before a Bombay High Court that whether contingent contracts belong to the category of ready delivery contracts. Ready delivery contracts are considered valid or legal under the Bombay Securities Contracts Control Act, 1925. When the scope of the ready delivery contract is analyzed under the Bombay Securities Contracts Control Act, 1925 (which on similar lines with SCRA) it was held that ready delivery contracts should be performed within a reasonable period of time and no particular time is specified for the performance of such contracts. Hence, Bombay HC concluded that where there no present obligation exists in contracts for purchase or sale of shares, and if due to some condition obligation arises then the occurrence of any contingency would be valid and such contracts would fall within the scope of ready delivery contracts. Because of the similarity between the nature of ready delivery contracts and put options, it was interpreted in this case that put options would be enforceable in law.

#### **4.2. Nishkalp Investments and Trading Company Limited v. Hinduja TMT Limited**

The principle laid down in *Jethalal C Thakkar v. R. N. Kapur* was rejected by the Bombay High court in *Nishkalp Investments and Trading Company Limited v. Hinduja TMT Limited*.<sup>84</sup> In this case, Bombay High Court observed that a contingent contract is within the scope of SCRA, 1956, and is lawfully applicable under it. In this case, there was a repurchase of a certain number of shares and those shares were unlisted by a certain agreed date. The Bombay High Court interpreted that the provisions of a spot delivery contract under the SCRA, 1956 are not in the lines with the provisions of the ready delivery contract as provided under the Bombay Securities Contracts Control Act, 1925. Therefore, the Bombay High Court held that as a contingent contract for an arrangement of buyback of shares did not fall within the scope of a spot delivery contract (section 2 of SCRA) and it cannot be made enforceable.

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<sup>83</sup> *Jethalal C Thakkar v. R. N. Kapur*, (Bom HC, 1956).

<sup>84</sup> *Nishkalp Investments and Trading Company Limited v. Hinduja TMT Limited*, (Bombay HC, 2008).

## CHAPTER 5

### **Legal Position in the Light of MCX Stock Exchange Ltd. v. SEBI**

The Bombay High Court in its judgment has provided clarity on the enforceability of option contracts under the SCRA, 1956, which has been the subject matter of constant controversies and debates amongst the investor community.

#### **5.1. Facts and Background**

MCX Stock exchange challenged the order of the Whole Time Member of the SEBI as SEBI rejected the application filed by MCX Stock exchange seeking SEBI's approval to undertake the business of stock exchange. After receiving SEBI's order MCX Stock exchange moved to the Bombay High Court, challenging the legality of the order passed by SEBI. On August 12, 2008, the MCX Stock exchange applied to the SEBI to work as a stock exchange. Later, on August 23, 2008, the SEBI allowed an in-principal approval to MCX Stock exchange for the same, subject to full compliance with the provisions of the MIMPS Regulations. Numerous measures have been undertaken by MCX Stock Exchange and its promoters to reduce shareholdings or ownership of the promoters of MCX Stock exchange such as share purchase agreements, making arrangements with the banks for preferential issue of shares, a scheme of reduction, and arrangement under section 391 to 393 of the Companies Act, 1956. Punjab National Bank was one of the banks to which shares were allotted on a preferential basis. An exit option was offered to Punjab National Bank in the form of a buyback arrangement exercisable against the MCX Stock Exchange or its promoters as a term of its investment. A similar kind of exit option was offered to IL&FS Financial Services Limited as a term of its investment (collectively mentioned as "Options"). Each option had a fixed exercise period and an IRR component was also included in the price at which the option could be exercised.<sup>85</sup>

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<sup>85</sup> Sharma, S., Sharma, V., Reis, S., (2012, April 20), SEBI v. MCX – HAS THE VALIDITY OF 'OPTIONS' ATTAINED FINALITY? Nishith Desai Associates. [http://www.nishithdesai.com/information/research-and-articles/nda-hotline/nda-hotline-single-view/article/sebi-vs-mcx-has-the-validity-of-options-attained-finality.html?no\\_cache=1&cHash=0b96cccc6ef82856f7708435a364f18e](http://www.nishithdesai.com/information/research-and-articles/nda-hotline/nda-hotline-single-view/article/sebi-vs-mcx-has-the-validity-of-options-attained-finality.html?no_cache=1&cHash=0b96cccc6ef82856f7708435a364f18e).

On April 7, 2010, after complying with all the regulations of MIMPS, the MCX Stock exchange informed the SEBI. However, on September 23, 2010, the Whole Time Member of SEBI passed the order on behalf of SEBI and rejected the application of MCX Stock Exchange primarily because it has failed to abide the MIMPS regulations in complying with modes of reducing promoter shareholding, the concentration of economic interest of MCX Stock Exchange within the hands of its promoters, failing to seek the opinion of SEBI in 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 like forward contracts not valid and legal under the SCRA. This is SEBI's mind leads to the conclusion that the MCX Stock Exchange failed to meet the 'fit and proper' criteria required of an entity desirous of operating a stock exchange. The Bombay High Court realized that there was a bona fide and a genuine attempt by the MCX Stock Exchange to reduce the shareholding under the MIMPS Regulations and hence set aside the SEBI's Order.<sup>86</sup>

## 5.2. Submissions by SEBI

SEBI made the following submissions:

- the Options which were to be exercised at a future date were like 'forward contract'. Hence, such Options do not fall under the scope of contracts for purchase or sale of securities under Section 16 of the SCRA, 1956, and are not valid.
- SEBI also contended that the SCRA was enacted to avert undesirable securities transactions by regulating the dealings therein. Also, the provisions of SCRA deals with the contracts in securities which are like options, contracts in derivatives, spot delivery contracts, etc. To prevent undesirable speculation the Central Government can prohibit any person or state or area from entering into the contract related to the security. This power has been provided by SCRA to Central Government. By Notification on 1 March 2000, SEBI, issued directions under Section 16 of SCRA to state as under:

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<sup>86</sup> Ibid.

1. If any person wants to enter into the contract related to the sale or purchase of securities other than a spot delivery contract can enter into a contract after getting the permission of SEBI.<sup>87</sup>

### 5.3. Observations Made by Bombay High Court

After analyzing the submissions of the SEBI, it was observed by the High Court that options constitute the privilege of the option holder, the exercise of which depends upon their unilateral volition. It depends on the discretion of the option holder whether he wants to exercise this privilege or not. The counterparty or opposite party cannot compel the option holder for the execution of the contract. Therefore, it was observed by the High court that if and only if options are exercised by the option holder a concluded contract for sale and purchase of shares would come into the picture. The High Court observed a significant difference between an option contract and a forward or futures contract and concluded that a forward contract involves a contract for the purchase and sale of securities at future date and a specified price.<sup>88</sup>

Spot delivery contract is a permissible mode of transacting under the SCRA. Further, the High Court observed that if the options were exercised by Punjab National Bank or IL&FS it would not come under the category of spot delivery contracts. The High Court also observed that if securities are dealt with by some depository and depository transferred the securities to the purchaser's account from the seller's account then it would come under the purview of spot delivery.

SEBI also contended before High Court that options are like derivatives and SCRA was enacted to prohibit the trading of such derivatives. It further argued that derivatives are prohibited under section 18-A of the SCRA which was recently introduced by the 2000 notification. In this context, the High court observed that if derivatives are traded on the floor of a recognized stock exchange after complying with all the norms and bye-laws of such stock exchange then such trading would be valid under section 18-A of the SCRA.<sup>89</sup>

The Special Leave Petition was filed by the SEBI in the Supreme court under Article 136 of the Constitution of India as it was not satisfied with the decision passed by the Bombay High Court. But Supreme Court disposed of the Special Leave Petition for the reasons stated above.

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<sup>87</sup> Supra at 11.

<sup>88</sup> Supra at 11.

<sup>89</sup> Supra at 11.

## **CHAPTER 6**

### **Conclusion**

The question of the validity of put options has been raised frequently. Even though SEBI made the option contracts enforceable but if we talk about RBI, it has often been uncomfortable with such kind of contracts. RBI's perspective on put option was that these contracts are like debt if compared to equity, therefore such contracts defeat the spirit of foreign direct investment policy. It seems like SEBI consulted with the RBI before coming up with this notification. Later, on 9<sup>th</sup> January, 2014, RBI also issued a circular to permit options.

As discussed above, it can be said that the 2013 notification was a welcome move by the SEBI to make put options enforceable. Bombay High court cleared the doubts regarding the enforceability of options which was a very controversial topic until judgment in MCX Stock Exchange v. SEBI was not passed. If we talk about the recent decisions related to put options, the Bombay High Court in March 2019 passed a similar judgment as of MCX Stock Exchange v. SEBI in Edelweiss Financial Services Ltd v. Percept Finserve Pvt. Ltd.<sup>90</sup> and upheld the validity of put options under SCRA, 1956.

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<sup>90</sup> Edelweiss Financial Services Ltd v. Percept Finserve Pvt. Ltd., (2019, Bombay High Court).