Legality of Put Option under the Securities Contract Regulation Act, 1956

Harshad Pathak, National Law University, Delhi

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I. INTRODUCTION

An “‘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”. ¹ A put option is a contract for the purchase or sale of a right to buy securities in future, at a predetermined price. “The buyer of a put option has the right, but not the obligation to sell an agreed quantity of a particular commodity or financial instrument, to the seller at a certain time for a certain price called strike price.” ²

Time and again, it has been observed by relevant judicial authorities that options are not legally enforceable in India. The reasoning behind the same dictates that as far as ‘securities’ are concerned, only certain specified transactions are permissible. One of the permissible transactions in securities is a ‘spot delivery contract’. This paper intends to analyze the legal validity of put options under the Securities Contract Regulation Act, 1956 (“SCRA”); and simultaneously put forth the view that such options amount to ‘spot delivery contracts’; and are therefore, enforceable in law.

Put option is a transaction that is assumed to takes place in the future, for a price agreed today, and consequently, is often labelled as a forward contract. Such contracts, alleged to be speculative, are thus, rendered unenforceable. It is this proposition that the paper endeavours to negate. The judicial opinion, declaring options as forward contracts is not only erroneous, but based upon an incomplete understanding of the meaning and scope of ‘securities’.

Spot Delivery Contract provides for the actual delivery of securities and the payment of a price thereof either on the same day as the date of the contract or on the next day. The paper puts forth the idea that a put option is a transaction in securities that takes place, not at a future point of time, but in the present itself. There is an actual delivery of securities involved taking place on the same day as that of the contract. The idea rests on understanding the scope and meaning of ‘securities’, as defined under the SCRA. Pursuant to the same, the author has first attempted to define the subject matter of ‘options’, which is, rights in securities, as opposed to shares, stocks etc. and deliberate upon the recognition of rights as a valid consideration in law. Second, the concepts of ‘delivery’ and ‘possession’ are subject to a discussion so as to draw a distinction between actual, physical and constructive delivery of tangible and intangible goods. Third, in order to appreciate the changing economic context, emphasis is laid on the gradual change in the legislative intent behind the SCRA, especially

¹ Securities Contracts (Regulation) Act, § 2 (d) (1956).
since the advent of the New Economic Policy in 1990. The author attempts to highlight the gradual inclination towards the acceptability of options as being legally enforceable. It is asserted that the legislative intent behind the enactment of any Statute is with respect to the substantial provisions of the Statue itself. Therefore, an amendment to the statute must be construed as an amendment to the legislative intent at the time of its enactment. The purpose behind such discussion is to interpret the SCRA in context of the current economic scenario, keeping in mind the needs of the market. Fourth, and last, a summarizing conclusion is sought in response to the various questions raised while addressing the issue the legality of put option.

However, before proceeding with the idea intended to be put forth, it is apt to initially assess the current legal position as far as the legal validity of options in India is concerned. It is necessary to understand the recent judicial trends, in order to negate them satisfactorily.

A. CURRENT LEGAL POSITION

In view of the provisions of the SCRA and notifications issued there under, the validity of Options has been often called into question by the Securities and Exchange Board of India (‘SEBI’). The recent trend reflects the inclination of SEBI towards declaring such options to be legally unenforceable in India.

In 2010, SEBI first outlawed the clauses in agreements dealing with forward contracts such as buyback agreements and put and call options in its order against MCX Stock Exchange Limited. It was followed by the BALCO Arbitration Award, wherein Sterlite Industries had call option on a 49% stake in BALCO’s shareholding and it sought to enforce this option and purchase the BALCO shares from the Government of India. The Arbitral Tribunal ruled, by a majority of two arbitrators against one, that the call option was illegal. However, the issue involved in the BALCO Arbitration Award was that of free transferability of shares of a public company, as mandated by § 111A, Companies Act, 1956, instead of the question of actual delivery of securities.

A similar stance was also visible in SEBI’s recent directive to Vedanta Resources and Cairn Energy to drop the put and call options, and pre-emption right clauses from their original deal agreement. Recently, Vulcan Engineers had informally approached SEBI to determine the legality of its preferential allotment of 14% shares to SIMEST SPA, an Italian financial institution. SIMEST was the beneficiary of a put option whereby it could require Terruzzi Fercalx, another Italian company to purchase its shares in Vulcan Engineers after a predetermined time. The informal guidance had been sought as a matter of interpretation under the SEBI (Substantial Acquisition of Shares and Takeovers) Regulations, 1997. In response, SEBI stated that the transaction under this arrangement would not qualify as spot delivery.

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5 Reena Zachariah, SEBI ruling on Cairn deal may hit M&As of listed companies, The Economic Times, April 20, 2011.
delivery contract as defined in § 2(i) of SCRA. Therefore, the pre-agreed buyback of VEL shares from SIMEST through put/call option was told not to be valid under SCRA.6

Contrary to the aforementioned instances, there have been instances where options have been successfully enforced in India without being labelled as legally invalid. In April, 2011, Essar had a put option over 22 per cent of Vodafone Essar Limited (VEL) with Vodafone and the same option was also successfully exercised by Essar to sell its 22 per cent to Vodafone. Similarly Vodafone also had a call option over the remaining 11 per cent of VEL owned by the Essar Group. This call option was also exercised by Vodafone and by the virtue of maturity of both these options Vodafone acquired 33% shares of VEL owned by Essar and its group companies for a consideration of $ 5 Billion. Prior to the same, the Punjab and Haryana High Court had held a similar clause to be valid in the case of Rama Petrochemicals Ltd v Punjab State Development Industrial Corporation7. It observed that the provisions of the SCRA 1956 will be excluded from application to the Financial Collaboration Agreement by virtue of the 1961 notification issued by the Central Government. Consequently, Clause 22 of the agreement, stating that Rama has to purchase (buy back) the shares of PSIDC in its company in two equal instalments before the expiry of third and fourth years after the commencement of commercial production, was found to legal and enforceable.

Significantly, in a recent development, the SEBI order, which denied permission to MCX Stock Exchange Ltd. to trade in securities, was set aside by the Bombay High Court clarifying that ‘option contracts’ differ from ‘forward contracts’, which are prohibited under the SCRA.8 However, the Court made no observations as to whether such contracts are in the nature of ‘contract in derivatives.’ This is of significance since Section18A 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.9

Interestingly, the Special Leave Petition filed by SEBI before the Supreme Court of India, challenging the decision of the Bombay High Court, was disposed of by the apex court under consent terms. It now makes 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 to operate as a stock exchange in light of the amended MIMPS Regulations.10 “The bench, however, asked SEBI not to be influenced by various observations made by the Bombay High Court in its judgement, setting aside the SEBI's order.”11

9 Securities Contracts (Regulation) Act, § 18A (1956).
11 PTI, Supreme Court asks SEBI to reconsider MCX-SX plea in 3 months, The Economic Times, April 11, 2012.
Consequently, we are yet to witness a definite legal stance by the apex court as to the legality of options. SEBI, contrary to its initial stance, “has granted MCX-SX permission to deal in equity and equity futures & options, interest rate futures and wholesale debt segments subject to a few conditions.” However, this clearance comes without any clarification as to the legal validity of options in India. Thus, the administrative decision by SEBI can also not act as a judicial precedent for future instances. In light of the prevailing uncertainty, the paper intends to put forth a view that differs from the opinion of SEBI; while simultaneously adopting a line of reasoning not considered by the Bombay High Court in making its recent observations.

II. OPTIONS AND SECURITIES

A. MEANING OF ‘SECURITIES’

§ 2 of the SCRA defines the term ‘securities’ to include, *inter alia*,

i) Shares, scrips, stocks, bonds, debenture stock debenture stock or other marketable securities of a like nature in or of any incorporated company or other body corporate;

ii) Derivatives;

iii) Government securities;

iv) Such other instruments as may be declared by the Central Government to be securities; and

v) Rights or interest in securities.

‘Securities’ refers to “an instrument that evidences the holder’s ownership rights in a firm, e.g., a stock; the holder’s creditor relationship with a firm or government, e.g., a bond; or the holder’s other rights, e.g., an option.”

The term ‘securities’ has been inclusively defined within the Act. Any right or interest created in any share, stock, bonds etc., or any other form of securities defined under § 2(h), would also amount to ‘securities’ under the Act. The last meaning attributed to the term – rights or interest in securities - is of special relevance to the given paper. As evident, the definition of ‘securities’ creates a distinction between two kinds of securities. First, securities that are capable of being physically possessed through the possession of the ownership documents. These are the securities in which a specific right or interest can be created, and include shares, stocks, debentures, government securities. For the sake of convenience, it is preferred to refer to these kind of securities as ‘physical securities’, though the usage may not be completely accurate. The second kind involves ‘notional’ or ‘constructive’ securities, which are primarily the rights or interest created in the former kind of securities. Such securities can be possessed via acquiring control, as well as be transferred, but are incapable of physical possession.

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13 Securities Contracts (Regulation) Act, § 2(h) (1956).
14 BLACK’S LAW DICTIONARY® 4226 (Bryan A. Garner ed., 2009).
The Securities Appellate Tribunal (SAT) had upheld the same distinction in *Alok Khetan*,¹⁵ albeit through the use of different words. It was held that a letter of allotment created a right in the shares, and this right could be transferred. A transfer of this right, and not merely a letter of allotment, was treated as a transfer of securities. The letter of allotment is a mere representation of the intangible right. “Rights so embodied may conveniently be termed ‘documentary intangibles’, and their significance lies in the fact that the document which manifests them is to most intents and purposes equated with goods and is susceptible to the same remedies of specific delivery, damages for conversion and the like.”¹⁶

In *Alok Khetan*, a company had allotted, through a letter, certain preferential shares to the appellants, amongst others, without the payment of allotment money at the time of allotment. The appellants had then immediately sold the same shares to a third party to manipulate the market in the scrip of the company; in a manner that was violative of the provisions of the SCRA. One of the many questions involved was whether such a transfer of shares, through only a letter of allotment, could be treated as a transfer of securities. The Tribunal had observed in response that,

“The appellant had not received the shares in the physical form but surely the letter of allotment that he received created a right in him and his interest in the specific shares which had actually been allotted... therefore, the letter of allotment by itself was a security which was traded by the appellant.”¹⁷

However, the transaction was found to be illegal as there was no payment of price on the same day as that of the contract, or the next day.

**B. OPTION IN SECURITIES**

An “‘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.”¹⁸ The essentials of an option in securities are that - firstly, subject matter must be a right – either to buy; or sell; or buy and sell – certain physical securities. Secondly, the transaction of the physical ‘securities’ involved must be in future. An option, therefore, creates a right in securities that can be documented like shares, stocks etc.; the right itself amounting to constructive securities under the SCRA.¹⁹ Therefore, the subject matter of any option must necessarily be a right *ad rem*, and not any other form of physical securities like shares, stocks, debentures etc.

To summarize, an “option gives the holder the right to buy or sell an underlying asset at a future date at a predetermined price... A put option is the right to sell. The buyer of a put option has the right, but not the obligation to sell an agreed quantity of a particular

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¹⁸ Securities Contracts (Regulation) Act, § 2(d) (1956).
¹⁹ Securities Contracts (Regulation) Act, § 2(h)(iii) (1956).
commodity or financial instrument, to the seller at a certain time for a certain price called strike price.”

C. RIGHTS AS CONSIDERATION

Subject to certain statutory exceptions, any agreement made without consideration is void. Agreements are also void, if their consideration is unlawful. Accordingly, the existence of a lawful consideration is central to the legal validity of any agreement. The subject matter of a Put Option is necessarily a right to buy securities in the future, at a pre-determined strike price. Thus, while the consideration for one party to such an agreement is the payment of price, the other party’s consideration is the granting of the specified right to buy in securities.

Rights are recognized to be a valid consideration. The Indian Contract Act provides that “[w]hen, at the desire of the promisor, the promisee or any other person has done or abstained from doing, or does or abstains from doing, or promises to do or to abstain from doing, something, such act or abstinence or promise is called a consideration for the promise.” “Right’ means a legally enforceable claim that another will do or will not do a given act; a recognized and protected interest the violation of which is a wrong.” It also means “the interest, claim or ownership that one has in tangible or intangible property”

The Supreme Court of India had clarified in Chidambara Iyer v PS Rangaiyer that a valuable consideration in the sense of law may consist of some right, interest, profit or benefit accruing to the one party, or some forbearance, detriment, loss or responsibility given, suffered or undertaken by the other. However, whether the consideration involved does in fact benefit the promisor is immaterial; it suffices that it was undertaken at his request.

Moreover, “personal property divides broadly into two groups: tangible movables and intangibles... These are rights to money, goods, or securities, which are locked up in a document to the extent that the document is considered to represent the right, which thus become transferable by transfer of the document itself.” Therefore, it is well accepted that ‘rights’ have been recognized to be a valid consideration irrespective of their nature, or the benefit they accrue to the promisor. After all, “an invisible right notionally embodied in a document or instrument may, miraculously, become the object of a pledge, or a possessory security. A person who disposes outright of a debt, apparently retaining nothing in his hands, physical or metaphysical, yet has power in certain conditions to make an effective transfer of the same debt to a second transferee.”

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20 The Commissioner of Income Tax v Bharat R Ruia, 199 Taxman 265 (Bom. H.C. 2010).
21 The Indian Contract Act, § 25 (1872).
22 The Indian Contract Act, § 24 (1872).
23 The Indian Contract Act, § 2(d) (1872).
III. SPOT DELIVERY CONTRACT

‘Spot Delivery Contract’ means a contract which, *inter alia*, provides for “... 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 despatch 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.”

In order to qualify as a spot delivery contract, the contract for sale of securities must provide for actual delivery of securities and the payment of price either on the same day as the date of the contract or on the next day, etc.

Accordingly, a spot delivery contract has three essentials:

i) Actual Delivery of Securities;

ii) Payment of a price;

iii) Both either,
    a. On the same day as the date of contract, or
    b. On the next day.

It has already been put forth that the subject matter of an option, in this regard a put option, must always be a right in securities. This right in securities is itself to be construed as a constructive security.

The question of legality of options arises out of the concern that in the absence of an actual delivery of securities involved, such a transaction would be speculative in nature, and not considered legal under the SCRA. However, the premise on which the argument is based overlooks the nature of securities involved in an option. Since a put option is a transaction of constructive securities, as opposed to physical securities, there is indeed an actual delivery of the securities involved.

‘A put option is the right to sell. The buyer of a put option has the right, but not the obligation to sell an agreed quantity of a particular commodity or financial instrument, to the seller at a certain time for a certain price called strike price.’ The right to sell to an assured a buyer at a pre-determined strike price gets transferred to the buyer of a put option the moment the agreement comes into force. Such a right, amounting to constructive securities, therefore, gets actually delivered on the same day as that of making the contract. Consequently, as long as the payment of price is made on the same day, a put option ought to be considered as a spot delivery contract. The distinction between actual and physical delivery is also a matter of discussion; however, the same is reserved for later heads.

It must also be realized that a spot delivery contract does not necessitate that the physical securities in which the right has been created by the put option be also delivered on the same day.

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30 Securities Contracts (Regulation) Act, § 2(i)(a) (1956).
day as that of the contract or the next day. Such securities in which the right has been created are not the subject matter of the put option. The subject matter of an option, as discussed earlier, must only be a right in securities. Thus, any assumption to the contrary, mandating an actual delivery of physical securities through an option is in direct contradiction to the very nature of an ‘option in securities’. Such assumptions are not envisaged by the SCRA. As far as the legality of a put option is concerned, it is irrelevant when do the securities in which the right has been created actually get delivered, or if they get delivered at all.

There might be certain situations wherein the put option, despite being bought, is never exercised. The legality of the option would then be contingent upon its exercise. This proposition not only defies reason, but also reflects what can be described as an erroneous and incomplete understanding of ‘options’. It has already been discussed that rights are valid consideration in the sense of law. Moreover, the legality of any contractual clause must be pre-determined, and not rest upon the performance of either of the party. It shall indeed be an absurd assertion that a specific contractual clause is legally valid if exercised immediately, but invalid in case of delay. Hence, since a put option does involve an actual delivery of the constructive securities involved on the same day as that of the contract, it amounts to a Spot Delivery Contract, irrespective of its exercise.

A. LEGALITY OF SPOT DELIVERY CONTRACTS

“The Central Government may, by order published in the Official Gazette, direct that the powers (except the power under § 30) exercisable by it under any provision of this Act shall, in relation to such matters and subject to such conditions, if any, as may be specified in the order, be exercisable also by the Securities and Exchange Board of India or the Reserve Bank of India.”33 In the exercise of the same, the Central Government has directed that certain powers under, inter alia, § 16 of SCRA 1956 shall be exercisable by SEBI.34

The power delegated states that,

“[i]f the Central Government is of opinion that it is necessary to prevent undesirable speculation in specified securities in any State or area, it may, by notification in the Official Gazette, declare that no person in the State or area specified in the notification shall, save with the permission of the Central Government, enter into any contract for the sale or purchase of any security specified in the notification except to the extent and in the manner, if any, specified therein.”35

Moreover, “[a]ll contracts in contravention of the provisions of sub-§ (1) entered into after the date of notification issued there under shall be illegal.”36 The Securities and Exchange Board of India has thereby, in exercise of the said power, duly notified that,

33 Securities Contracts (Regulation) Act, § 29A (1956).
35 Securities Contracts (Regulation) Act, § 16(1) (1956).
36 Securities Contracts (Regulation) Act, § 16(2) (1956).
“[N]o person... shall, save with the permission of the Board, enter into any contract for sale or purchase of securities other than such spot delivery contract or contract for cash or hand delivery or special delivery or contract in derivatives as is permissible under the said Act...”\textsuperscript{37}

In light of the same, any Spot Delivery Contract for the sale or purchase of securities is enforceable under the Indian law. Since Put Option satisfies the essentials of a Spot Delivery Contract as defined under the SCRA, it must be considered as valid and enforceable in India.

**IV. DELIVERY AND POSSESSION**

**A. THEORETICAL MEANING**

Delivery refers to “the formal act of transferring something; the giving or yielding... control of something to another.”\textsuperscript{38} In terms of delivery of goods, “delivery means voluntary transfer of possession from one person to another.”\textsuperscript{39} Actual delivery is “the act of giving real and immediate possession to the buyer or the buyer’s agent.”\textsuperscript{40} Ideally, “the use of the words ‘actual delivery’... would rule out the possibility of constructive or symbolic delivery. It means real delivery as opposed to notional delivery.”\textsuperscript{41}

The statutory definition of ‘delivery’, given in the Sale of Goods Act, 1930, is capable of a number of different meanings and is not confined to the transfer of physical possession. The use of words ‘delivery’ and ‘possession’ encompasses all forms - physical and constructive. Constructive delivery ‘denotes the transfer of control of the goods to the buyer without physical possession’\textsuperscript{42}. The co-relation between ‘delivery’ and ‘possession’ is of immense importance here.

Possession of an asset can be defined “as control, directly or through another, either on the asset itself or of some larger object in which it is contained, or of land or buildings on or beneath which it is situated, with the intention of asserting such control against others, whether temporarily or permanently.”\textsuperscript{43} However, like ‘delivery’, meaning of ‘possession’ also varies according to the nature of issue in which the question is raised. For example, in the case of \textit{Re Atlantic Computer Systems plc}\textsuperscript{44}, the United Kingdom Court of Appeal held that a company which took computers under an equipment lease and let them to the intended end-user under a sub-lease nevertheless continued to hold possession as between itself and the head lessor.

Accordingly, the concept of possession has three essentials:

\textsuperscript{37} SEBI, SO 184(E) (March 1, 2000), \url{http://www.sebi.gov.in/acts/ html}.

\textsuperscript{38} BLACK’S LAW DICTIONARY® 494 (Bryan A. Garner ed., 2009).

\textsuperscript{39} The Sale of Goods Act, § 2(2) (1930).

\textsuperscript{40} BLACK’S LAW DICTIONARY® 494 (Bryan A. Garner ed., 2009).


\textsuperscript{42} ROY GOODE, COMMERCIAL LAW 265 (Penguin Books 2004).

\textsuperscript{43} ROY GOODE, COMMERCIAL LAW 42 (Penguin Books 2004).

\textsuperscript{44} Re Atlantic Computer Systems plc, (1990) BCC 859 (Court of Appeal).
i) Existence of an asset;
   a. Tangible, or
   b. Intangible

ii) Control over the asset;
   a. Direct, or
   b. Indirect

iii) Intention of asserting such control against others;
   a. Temporarily, or
   b. Permanently

Possession, therefore, exists in terms of control over the asset and the intention to assert the same, independent of the capability of an asset to be physically possessed or not.

The Supreme Court of India had made similar observations in *Tata Consultancy Services v. State Of Andhra Pradesh*, wherein it held the information technology within a floppy, or a disk to amount to ‘goods’ under the Andhra Pradesh General Sales Tax Act, 1957 since ‘it was capable of being transmitted, transferred, delivered, stored, possessed etc.’ The decision was most recently upheld by the Madras High Court in *Infotech Software Dealers v. Union of India*.

“The common law concept of possession is, thus, much broader that it is under French law or civil law systems based on French law, where a person holding goods for another is considered to be a mere *detenteur*, having custody but not possession of the goods.”

**B. DELIVERY AND POSSESSION AS LEGAL CONCEPTS**

The term ‘actual’ delivery has often been used interchangeable with ‘physical’ delivery. More often than not, any distinction existing between the same has not been recognized. By actual delivery, it is often “meant the transfer of physical possession to the buyer or his agent.” Various examples of a similar interpretation can be found in the Indian legal system as well. The Negotiable Instruments Act, 1881 stipulates that, “the making, acceptance or endorsement of a promissory note, bill of exchange or cheque is completed by delivery, actual or constructive...” The Transfer of Property Act, 1882 upholds the same while interpreting the term ‘actionable claim’.
“[A]ctionable claim means a claim to any debt, other than a debt secured by mortgage of immoveable property... or to any beneficial interest in moveable property not in the possession, either actual or constructive, of the claimant...”51

The relevant point here is that there does not appear to be any distinction made between ‘actual’ and ‘physical’ delivery. Indeed, it is tedious task to interpret actual as being separate from physical. An attempt to provide a clear meaning had been made by the Supreme Court of India in Jute Investment Co. Ltd. v. Commissioner of Income-tax52, while elaborating upon the interpretation of a ‘speculative transaction’. A similar opinion was shared by the Madhya Pradesh High Court as well in Thakurlal Shivprakash Poddar v Commissioner of Income Tax.53 Speculative transaction means a transaction in which a contract for the purchase or sale of any commodity, including stocks and shares, is periodically or ultimately settled otherwise than by the actual delivery or transfer of the commodity or scrips.54 The apex court had observed that the use of the words actual delivery in the definition of the speculative transaction would rule out the possibility of notional or constructive delivery.

The observation was based on the landmark judgment of the Supreme Court in a separate case of Davenport & Co Pvt Ltd v Commissioner Of Income Tax.55 Therein, the appellant had contracted to purchase certain goods from a third person. The appellant, however, did not take actual delivery of the goods, as it had no go-downs for keeping the goods. The aforesaid transactions resulted in a substantial loss to the appellant, which was sought to be adjusted as a trading loss in the assessment year 1959-60. The question that fell for consideration was whether the transaction referred to above entered into by the appellant was a ‘speculative transaction’ within the meaning of The Income Tax Act, 1922. The legal position is that any ordinary trading loss incurred by a person could be deducted from his Income Tax returns, unless it arose from a speculative transaction.56 Moreover, the condition of actual delivery of goods contemplated to be sold must be satisfied for it to be eligible for deduction.

It was contended by the appellant that there was an actual delivery of goods through the exchange of delivery orders. Accordingly, the loss sustained by the appellant would not be a loss of speculative transaction. In response, it was contended that actual delivery cannot be constructive in nature. Since there was no actual delivery in the given case, any corresponding deduction made shall be invalid. The apex court, while ruling against the Appellant, upheld the distinction between ‘actual’ and ‘constructive’ delivery. It noted that there cannot be an actual delivery of goods through the delivery bonds, and the necessary conditions for a valid tax deduction have not been satisfied. Accordingly, ‘actual’ and ‘physical’ deliveries have been made interchangeable aspects of law by denoting them a similar, if not completely identical, meaning.

51 The Transfer of Property Act, § 3(c) (1882).
52 (1980) 121 ITR 56.
53 (1979) 116 ITR 190
Under the next head, an attempt shall be made to distinguish the mentioned judicial instances from those of possession of securities. The author does not dispute the legal findings of the Apex Court, but differentiates them on the basis of the subject matter of an option, that is, constructive securities.

C. Actual Delivery of Securities

The inherent co-relation between delivery and possession becomes essential to prevalent discussion regarding the actual delivery of securities. It may be restated that any commodity is said to be actually delivered if there is an actual transfer of possession from one person to another.

The judicial understanding of the word ‘actual delivery’ reflects a slightly rigid and orthodox manner of interpretation that creates no distinction between ‘actual’ and ‘physical’ securities. While it is not disputed, it is put forth that the same interpretation must not have any significant bearing on the current discussion. The lack of significance is due to two primary reasons. Firstly, the observations made by the Supreme Court of India are apt as far as the goods are tangible in nature. In each of the discussed cases, the goods involved were capable of being physically held and possessed. However, applying the same yardstick universally to the possession and delivery of intangible commodities would be erroneous. It would imply that any commodity that cannot be physically held is not capable of being actually delivered. In a world dominated by numerous intangible rights pertaining to intellectual property, as well as other transferrable contractual rights of a similar nature, such a conclusion would be inherently flawed and easily disputable.

Secondly, the observations of the apex court must not be understood and applied out of context. The decisions cited were pertaining to the deductions permissible under the Income Tax Act, 1961 and tax evasion. As the Supreme Court of India itself has observed,

“[T]he general rule of construction is not only to look at the words but to look at the context, the collocation and the object of such words relating to such matter and interpret the meaning according to what would appear to be the meaning intended to be conveyed by the use of the words under the circumstances.”

The issue involved here, on the other hand, is with respect to the legal validity of Put Options in India, being governed by the SCRA. The only definitions and interpretations relevant to the discussion must also be either with reference to the SCRA itself, or the Companies Act, 1956. As has been rightly put,

“[P]arliament would legislate to little purpose if the objects of its care might supplement or undo the work of legislation by making a definition clause of their

58 Securities Contracts (Regulation) Act, § 2A (1956).
own. People cannot escape from the obligation of a statute by putting a private interpretation on its language.”

It has already been discussed that securities, under the SCRA, are of two kinds – physical and constructive. While the former includes shares, stocks etc. in which rights or interest can be created, the latter includes those very rights or interest created in the former. Such constructive securities are, therefore, capable of being actually delivered, as envisaged by the SCRA. The actual delivery, however, cannot rest upon the notion of physical delivery of the securities involved.

Rights are not tangible commodities that can be held in hand. However, their existence is contingent upon the possibility of its exercise. A right exists if it can be exercised at any point of time by any person possessing the right, subject to the various Constitutional or contractual restrictions. Thus, a person possesses a right in securities if the three essentials of possession are satisfied, namely – existence of the right, control over the right, and an intention assert such control against others. Any instance, in which, such a right, along with the control over it, is transferred from one person to another, must be construed as an ‘actual delivery’ of the right. Put Option, hence, is a perfect example of the above instance wherein, the right to sell certain physical securities,

i) At a future point of time;
ii) To an assured buyer;
iii) For a fixed strike price;

is actually delivered from one person to another.

D. CONDITIONALITY OF RIGHTS

The legal validity of Put Option can also be challenged on the pretext that any delay in the delivery of the ‘right in securities’ would render it void.

Typically, contracts involving Put Options are stipulated in such a manner that there may appear to be a prima facie delay in the actual delivery of the constructive securities, nullifying the entire argument put forth. A contractual clause, more often than not, is not independent, but subject to various contractual restrictions.

The following hypothetical contract shall illustrate the concern raised,

COMPANY # 2 acquires Z % shares of the issued and paid-up equity share capital of a Private Limited COMPANY # 3 (‘Z Shares’), subsidiary to COMPANY # 1.

Clause X: “Exit Event” means any date on which the market price of COMPANY # 1 quoted on the Bombay Stock Exchange falls below Rs. 100/- per share.

59 Netherseal Co. v. Bourne, (1889) 14 AC 228.
Clause Y: COMPANY # 1 hereby grants to COMPANY # 2 the option to sell any or all of the Z Shares to Mr. ABC, if,

i) Any time after the expiry of two (2) years from the date hereof;
ii) An Exit Event occurs;
iii) At the stipulated strike price;
iv) Provided that such Put-Option is exercised within 60 days of the relevant Exit Event.

Such a contractual arrangement may raise concerns in the light of opposing arguments that there is not actual delivery of the right taking place on the same day as that of the contract, or the next day since the delivery is delayed for two years after the contract. Any such concerns, however, have a weak footing. SCRA defines ‘securities’ to include ‘rights or interest in securities’, 60 and does not dwell upon the nature of the right. Rights in securities need not be absolute rights, but may also be conditional in nature wherein their exercise is subject to contractual restrictions, like in the given case. The principle of conditionality of rights explicitly recognizes the non-absolute character of rights by providing that one may lose or reduce them due to his own right-altering conduct, for example, by consent. There exist many instances of creation of legally valid conditional rights in common law.

In the case of In re: Welsbach Incandescent Gas Light Co., Ltd. 61, it was stipulated that the rights and privileges of the various shareholders could validly be changed by the resolution as provided in the memorandum and articles and that such resolution did not require the sanction of the Court. Upon alteration of certain shareholder rights, in accordance with the procedure laid down in the memorandum and articles of association, the matter had gone to court. The Court recognized the rights incorporated to be conditional in nature, and perfectly valid. It observed,

“To vary the conditional rights and privileges given to various classes of shares by the memorandum does not amount to an alteration of the conditions contained in the memorandum, because one of three conditions in the memorandum is that the rights and privileges are subject to variation. To hold otherwise would be to ignore the condition in the memorandum providing for variation in the rights for the time being attaching to particular classes of shares.” 62

Similar observations were made by the Allahabad High Court in a factually similar case of British India Corporation Ltd. Vs. Shanti Narain 63.

“In the case before us, however we find that the rights and privileges of the ordinary and deferred shareholders were conditionally stated in the memorandum and could... be varied, abrogated, or affected... The exercise of the power vested did not amount to an alteration of those rights and privileges, as those rights and

60 Securities Contracts (Regulation) Act, § 2 (h)(iii) (1956).
61 In re: Welsbach Incandescent Gas Light Co., Ltd. (1904) 1 Ch. D. 87.
62 In re: Welsbach Incandescent Gas Light Co., Ltd. (1904) 1 Ch. D. 87.
privileges were subject to this important condition that they could at any time be altered... They were not unconditional rights of the shareholders, but rights subject to variation from time to time by special procedure laid down in the memorandu-and Articles.”

Accordingly, any right in securities, even if conditional in nature, shall be considered as a constructive security, since the SCRA does not mandate that such right be absolute in nature to amount to securities. The existence of contractual restrictions does not negate the actual delivery of the securities on the same day as that of the contract, or the next day.

V. LEGISLATIVE INTENT

A. PURPOSE OF ENACTMENT

It is a well known principle that that interpretation is best which makes the textual interpretation match the contextual. “A statute is best interpreted when we know why it was enacted.” Therefore, “it would be permissible to look into the legislative intent, and the conditions prevalent prior to the enactment of the ... act can certainly be referred to for the purpose of construing the provisions of law.”

The SCRA was passed with an intention to prevent undesirable speculations. Speculation means “a position in an asset designed to perform well if some random variable, such as the asset’s price, achieves a certain value.” Prior to the enactment of SCRA, a Committee known as the Gorwalla Committee had been constituted for suggesting ways and means of preventing and controlling speculation in shares of public limited companies. The SCRA came to be enacted on the basis of the recommendations made by the said committee.

The Statement of Objects and Reasons of the SCRA also shows “that the object of the Act was to provide for regulation of stock exchanges and of transactions in securities dealt in on them with a view to preventing undesirable speculation in them.” “Speculative transaction means a transaction in which a contract for the purchase or sale of any commodity, including stocks and shares, is periodically or ultimately settled otherwise than by the actual delivery or transfer of the commodity or scrips.” “A transaction in which a contract for the purchase or sale of any commodity, including stocks and shares, is settled otherwise than by the actual delivery or transfer of the commodity or scrips is a speculation transaction.”

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67 P. RAMANATHAN AIYAR, ADVANCED LAW LEXICON 4433(2009).
69 Mysore Fruit Products Ltd. & Ors. v. The Custodian& Ors., (2005) 107 BOMLR 955 (Bom. H.C.)
The same intent is visible even within the provisions of the SCRA. The Securities Contract Regulation Act, 1956 gives the Central Government the power to declare certain contracts illegal in order to avoid undesirable speculation. Initially, options were considered to be highly speculative in nature and were indeed intended to be prohibited. § 20(1) of the SCRA originally stated that “notwithstanding anything contained in this act or in other law for the time being in force, all options in securities entered into after the commencement of this act shall be illegal.”

B. AMENDMENT TO THE LEGISLATIVE INTENT

No legislative intention can be assumed to be continuous and conclusive over a stretch of time. Legislative intent is always with respect to the law in force. Any amendment made to a statute is an amendment made to the legislative intent. It signifies a change in the intention behind its enactment. Further, the economic conditions in the country have undergone an enormous change since those that were prevalent in 1956. Options, which were earlier considered to be speculative in nature, are now seen more as a necessary instrument to secure transactions in securities.

The period of transition began with the advent of the New Economic Policy in India in 1991. “India’s recent progress toward economic growth stems from reforms undertaken after the 1991 fiscal crisis, which lifted India from decades of slow growth under socialist rule and offered an opportunity to improve living conditions in the immense, poor country.” As a part of the liberalization strategy, “the governments of India, both at the central and state government levels, had initiated divestment programs to sell government equity in several public-sector enterprises.” “Having moved from barring foreign ownership in a wide swath of industries to encouraging foreign investment, India has made significant progress in opening its economy.”

Prior to 1991, “although foreign ownership in some Indian companies was permitted, investors faced complications that included a subjective licensing process, high regulation upon approval, and equity-holding caps. In fact, until recently Indians had only one television program and had to settle for locally-produced Thumbs Up instead of Coca-Cola.” Such restrictions which dominated the license-raj have now been entirely removed, or at least made flexible. Probably, the biggest step in this direction was the replacement of the Foreign Exchange Regulation Act, 1973 by the Foreign Exchange Management Act, 2000. The shift from the draconian ‘regulation’ regime to the more encouraging ‘management’ strategy exemplifies the change in the political and economic circumstances in the country.

72 Securities Contracts (Regulation) Act, § 16 (1956).
73 Securities Contracts (Regulation) Act, § 20(1) (1956). (Now Omitted)
The relevant point here is that the process of liberalization, initiated in the 1991, paved way for an increased amount of Foreign Direct Investment in the country. The same was supplemented by the ongoing disinvestment strategies that invited bulk investments by the Private Sector as well. The sudden increase in large scale investment in the Indian economy mandated an improvement in various risk management tools. The very purpose of Options was to provide security for large scale monetary transactions. The need for providing ample market security to encourage and sustain investors over a period of time was realized. Consequently, the arguments in favour of legalization of Options gathered momentum.

Mr. M S Sahoo, Director, SEBI shares a similar opinion, when he observes,

“In the recent past, there have been substantial improvements in the functioning of the securities market. However, there were inadequate advanced risk management tools. In order to provide such tools and to deepen and strengthen the cash market, a need was felt for trading of derivatives like futures and options.”

Considering the same, the enactment of Securities Laws (Amendment) Act 1995 was no surprise. The said Act omitted the phrase ‘by prohibiting options and’ from the long title of the SCRA, mentioned in its preamble. § 20 of the SCRA, which prohibited ‘all options in securities’, was also repealed.

Moreover, SEBI notification in the year 2000 allowed ‘contract for derivatives as is permissible under the SCRA’; signifying its intent to give legal recognition to ‘options’. Derivative includes either “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” or “a contract which derives its value from the prices, or index of prices, of underlying securities.” Accordingly, options, being contracts in derivatives, will also be legal, in accordance with §.18A of the SCRA, as long as they are “traded on a recognised stock exchange” or “settled on the clearing house of the recognised stock exchange”, both in accordance with the rules and bye-laws of such stock exchange.

The mentioned amendments are to be construed as being indicative of the legislative intent behind the SCRA. The amendments made to the act, viewed in the backdrop of the more liberal New Economic Policy, reflect a gradual and visible shift away from the legislative intent behind the enactment of SCRA prevalent in 1956. While the initial focus was solely on the prevention of undesirable speculations, the need to address the ever increasing demand for a secure market is now being felt.

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83 Securities Contracts (Regulation) Act, § 18A(a) (1956).
84 Securities Contracts (Regulation) Act, § 18A(b) (1956).
It is pertinent to note here that Options are increasingly being recognized as necessary advanced risk management instruments. This is precisely why trading in options in securities was introduced both on the National Stock Exchange and the Bombay Stock Exchange in 2001.\textsuperscript{85} Even SEBI, while issuing to cease notifications to certain brokers who were entering into non-genuine transactions without any intention to transfer the shares, described options as unique trading instruments, and stressed on the multiple important purposes performed by them.\textsuperscript{86} In light of the same, declaring such transactions, which satisfy the legal pre-requisites laid down in the SCRA, as illegal solely on the basis of them being speculative in nature would be a step backwards as far as liberalization is concerned. Such a backward step is neither preferable, nor desired by the market forces.

VI. CONCLUSION

Options, by transferring a right to purchase or sell securities in future, at a pre-determined strike price, reduce the amount of risk that comes with any investment. Their necessity becomes all the more pertinent when it is realized that such investments, in nine cases out of ten, range in millions of dollars.

The legality of Put Option is advocated by identifying and defining the subject matter of such transactions. The subject matter of a Put Option is not shares, stocks, debentures etc. but necessarily the right to purchase the same at a future point of time, for a fixed strike price. These rights are to be considered as ‘securities’ themselves within the ambit of the SCRA. The issue of legality, therefore, rests upon the question as to whether or not there is an actual delivery of securities involved taking place when any Put Option is purchased.

As elaborated earlier, there is an actual delivery of securities taking place in a Put Option. The possession of the rights involved gets ‘actually’ delivered to the purchaser of such Option at the very instant an agreement to the same comes into force. The actual delivery is immediate, subject to the conditions of the contract, and takes place the moment the dotted line is signed by both the parties. Actual delivery of such ‘constructive securities’ must not be confused with their physical delivery. As evident, rights are not tangible commodities that can be held in hand. Therefore, as far as intangibles are concerned, there exists no concept of physical delivery. The actual delivery of such intangibles can only take place through the delivery of the relevant documents, and is signified by a change in possession of the right. Therefore, assuming that there is no delay in the payment of price, a Put Option satisfies all the requisites of a Spot Delivery Contract. Accordingly, Put Options are legally valid transactions of securities within the scope and meaning of the SCRA.

India is an economy that is growing at an alarmingly encouraging rate. The basis of such consistent growth over the past two decades has been heavy investments from all across the world. It comes as no surprise that India is being primed as one of the most lucrative markets for investors – foreign and domestic. However, the same is accompanied by an increasing

\textsuperscript{85} A SARKAR, Indian Derivative Markets in THE OXFORD COMPANION TO ECONOMICS IN INDIA 56 (Kaushik Basu ed., 2006).

desire for the market to be structured in a secure manner so as to encourage more of the same. The amendments made to the SCRA provide an adequate reflection of a similar need. Under such circumstances, the necessity of options cannot be ignored. Options are one of the most appealing advanced risk management tools, which encourage continuous investment by providing a safer framework for all investors.

A put option provides ample security in an uncertain market, and investments are of a high monetary value. Such a security is, therefore, a valuable economic asset in itself, minimizing the risk associated with every investment. The economy is, as a consequence, portrayed as a safer market to the current and potential investors, thereby, receiving the continuous benefits of further investments.

As has been rightly exclaimed by Milton Friedman,

“The most important single central fact about a free market is that no exchange takes place unless both parties benefit.”

Appreciating the statement, it may not be a herculean task to identify and acknowledge that the ultimate beneficiaries in the proposed scenario are not only the plethora of investors purchasing a Put Option, but the market itself. It is only growth, if it is continuous.