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Pledges in context of insider trading regulations

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10th September, 2015

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<http://india-financing.com/staff-publications.html>

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There are several lurking questions in context of insider trading regulations. The Securities and Exchange Board of India (hereinafter referred to as “SEBI”) had recently issued a Guidance Note on SEBI (Prohibition of Insider Trading) Regulations, 2015 on 24th August, 2015¹ (hereinafter referred to as “Guidance Note”), about employee stock option plans (ESOPs), and in that guidance, some questions pertaining to pledges were also answered. However, there was no generic clarity on matters pertaining to pledges. This article seeks to examine pledges in context of SEBI (Prohibition of Insider Trading) Regulations, 2015² (hereinafter referred to as “Regulations”) and particularly to answer questions as to what are the compliances required in respect of each stage of a pledge.

There are four aspects of a pledge, in respect of which the question, as to whether there is a “trade”, the meaning of which as construed from the definition of “trading” as per Para 2(l) of the Securities and Exchange Board of India (Prohibition of Insider Trading) Regulations, 2015 (hereinafter referred to as “Regulations”), may be considered. These are (a) creation of a pledge; (b) invocation of a pledge; (c) sale of pledged property by the pawnee; (d) release of a pledge.

Meaning of “trading”

The term “trading” has been defined in Para 2(l) of the Regulations, in the following manner –

(l) "trading" means and includes subscribing, buying, selling, dealing, or agreeing to subscribe, buy, sell, deal in any securities, and "trade" shall be construed accordingly;

The definition is clearly an exhaustive definition, which is apparent from the use of the expression “means” – therefore, the definition cannot be extended to cover what is not explicitly covered in it.

The definition may be analysed as follows, trading means –

- (a) Either of these
 - a. Buying
 - b. Selling
 - c. Dealing, or
- (b) Agreeing to either of these
 - a. Buying
 - b. Selling

¹ http://www.sebi.gov.in/cms/sebi_data/attachdocs/1440413398668.pdf

² http://203.199.247.102/cms/sebi_data/attachdocs/1421319519608.pdf



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c. Dealing

The words “buying” and “selling” are generally clean and unambiguous. In case of “sale”, there is an involvement of transfer of property, along with other features. According to Benjamin³, to constitute a valid “sale”, there must be a concurrence of the following elements –

1. Parties competent to contract;
2. Mutual assent;
3. A thing, the absolute or general property which is transferred from the seller to the buyer;
4. A price in money is paid or promised.

Some of the other authoritative text books define “sale” in the following manner:

- Blackstone⁴ defines sale as –

"sale or exchange is a transmutation of property from one man to another, in consideration of some price or recompense in value."

- Halsbury's Laws of England⁵ defines sale as –

"Sale is the transfer of the ownership of a thing from one person to another for a money price. Where the consideration for the transfer consists of other goods, or some other valuable consideration, not being money, the transaction is called exchange or barter; but in certain circumstances it may be treated as one of sale. The law relating to contracts of exchange or barter is undeveloped, but the courts seem inclined to follow the maxim of civil law, permutatio vicina est emptio, and to deal with such contracts as analogous to contracts of sale. It is clear, however, that statutes relating to sale would have no application to transactions by way of barter."

- Williston on Sales⁶ defines "sale of goods" as –

"an agreement whereby the seller transfers the property in goods to the buyer for a consideration called the price."

³ Lease Financing and Hire Purchase, by Vinod Kothari, Chapter – 19, Page 874

⁴ <http://indiankanoon.org/doc/1425329/>

⁵ Halsbury's Laws of England, Second Edn., Vol. 29, p. 5, Para. I,

⁶ Williston on Sales, 1948 Edn



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As is evident from the definition of the “sale”, by the various authoritative books, quoted above, a sale involves – (i) transfer of property; and (ii) consideration in money.

“Buying” on the other hand is the reciprocal of “selling” – hence, the meaning of “buying” has each of the elements of sale discussed above.

It is the word “deal” which is broad, and may stretch itself to different dimensions based on requirements. The meaning of “deal” as per Black’s Law Dictionary⁷ is as follows:

To traffic; to transact business; to trade.

Therefore, the word “deal” may include any form of a transaction which parties may conduct in course of trade practices. Thus, the expression “deal” gets a contemporaneous meaning, including within its sweep each of the different types of ways in which parties may, in course of trade, “deal” with a particular object. For example, the context in the present case is securities. So, securities may be sold, pledged, mortgaged, or may be subject matter of a securities lending transaction, or securities ready-forward trade, etc.

Meaning of a pledge:

The term “pledge” has been defined in Section 172 of the Indian Contracts Act, 1872 in the following manner –

172. "Pledge" "pawnor", and "pawnee" defined. - The bailment of goods as security for payment of a debt or performance of a promise is called "pledge". The bailor is in this case called the "pawnor". The bailee is called the "pawnee".

A pledge is certainly a form of security interest; however, unlike mere lien, a pledge is possessory interest as well. That is, the pledgee acquires the bailment of goods. Further, Section 176 of the Indian Contract Act, 1872, the pawnee has the right to cause a sale of the pledged article where the pawnor makes a default.

Pledge and mortgage:

A mortgage is defined in Section 58 of the Transfer of Property Act, 1881 to mean the following –

(a) A mortgage is the transfer of an interest in specific immoveable property for the purpose of securing the payment of money advanced or to be advanced by way of

⁷<http://www.nationallibertyalliance.org/files/docs/Books/Black's%20Law%204th%20edition,%201891.pdf>



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loan, an existing or future debt, or the performance of an engagement which may give rise to a pecuniary liability.

The transferor is called a mortgagor, the transferee a mortgagee; the principal money and interest of which payment is secured for the time being are called the mortgage-money, and the instrument (if any) by which the transfer is effected is called a mortgage-deed.

There is a transfer of specific interest in property in case of a mortgage. The mortgagor is the transferor, and the mortgagee is the transferee. The mortgagor vests specific interest in the property in favour of the mortgagee, thereby making the mortgagee the holder of a specific interest. The specific interest may be limited to (a) such interest, for example, usufructuary interest as may be passed by the mortgagor; (b) right to cause a sale or cause a transfer of property in terms of the mortgage deed; (c) right to become absolute owner by foreclosure of the mortgagor's right of redemption, etc.

Whereas in case of pledge, there is, no doubt, a right of sale, conferred by Section 176 of the Indian Contracts Act, 1872. There is also a right of possession, as pledge is essentially a possessory interest. Hence, a pledge may be considered transfer of specific interest in property.

Whether a pledge is a case of “dealing”?

As discussed above, the use of the term “deal” or “dealings” in the definition of the term “trading” has actually expanded its meaning beyond the usually understood meaning of “trading”. Further, SEBI's legislative Note to the definition of “trading”, as stated below, makes it even clearer –

*Under the parliamentary mandate, since the Section 12A (e) and Section 15G of the Act employs the term 'dealing in securities', it is intended to widely define the term “trading” to include dealing. **Such a construction is intended to curb the activities based on unpublished price sensitive information which are strictly not buying, selling or subscribing, such as pledging etc when in possession of unpublished price sensitive information.***

Not only has the Note expanded the meaning of the term “dealing”, but has also clarified that for the purpose of the Regulations, dealing in securities would also include pledging of securities.

Further, the same has been dealt with in the Answer to Question 6 of the Guidance Note, as stated below –



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6. (a) *Whether SEBI's intent is to prohibit creation of pledge or invocation of pledge for enforcement of security while in possession of UPSI?*

(b) *Whether creation of pledge or invocation of pledge is allowed when trading window is closed?*

Guidance: Yes. However, the pledgor or pledgee may demonstrate that the creation of pledge or invocation of pledge was bona fide and prove their innocence under proviso to sub-regulation (1) of regulation 4 of the Regulations.

In the above guidance, SEBI has very clearly expressed its intent to curb the practice of pledging of securities/ invocation of pledge on securities while in possession of UPSI as well.

What, in case of a pledge, is “dealing”?

Given that, as we discussed above, a pledge is a transfer of specific interest in goods, a pledge may be regarded as a form of “trading”, the question is, which of the several aspects of a pledge will be regarded as “trading”.

(a) Creation of a pledge:

As stated in the Note to the definition of “trading”, dealing includes pledging of shares. So, there is no ambiguity to the fact that creation of pledge will be regarded as “trading” for the purpose of these Regulations.

Now let us understand as to why be SEBI so interested in controlling the pledge of securities. Assuming a case, where a promoter has access to UPSI and expects the price of the shares of the company to fall on publication of the UPSI. In all likelihood, he would like to pledge the shares before the publication of the UPSI and raise money from the market. It is as sensitive an issue as buying and selling of securities at based on UPSI.

Thus, it is very logical to include pledging of securities in the definition of “trading”.

(b) Invocation of a pledge and sale of property by the pledge:

Here, at the very outset, we must understand that the right to invoke a pledge remains with the pawnee of the property and a pledge can be invoked only when there is a default on the part of the pawnor. On invocation of the pledge, the pawnee attains the right to cause a sale of the property, as per Section 176 of the Contract Act, 1872. Note, that generically, under the law of pledges, the pawnee does not become absolute owner of the property on invocation of the pledge – he simply acquires the right to cause a sale of the pledged article.



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Such a sale, caused by the pawnee, is certainly a sale in normal parlance, and is hence, a “trading”. One has to see whether the pawnee (and not the pawnor) is in possession of UPSI at this stage. If the pawnee has an UPSI, the sale by the pawnee will attract the provisions of the Regulations. If the pawnor is an insider, and the pawnee is not, but the pawnee is causing the sale at the instructions of the pawnor, once again, there is a use of UPSI, and therefore, the pawnee may also be regarded as “insider” within the meaning of Para 2(g) of the Regulations.

(c) Invocation of a pledge and assumption of ownership interest by the pledgee:

In furtherance to the discussion in point (b) above, where the terms of the pledge empower the pawnee to acquire title to the goods on invocation of the pledge, and the pawnee decides to acquire the ownership of the pledged securities, there is a change in the designation of the pawnee, i.e, from being a mere holder of a security interest over a property, it is becoming an owner of the property. This is undoubtedly a transaction, where the outstanding debt is being settled in exchange of the ownership. This is also a case of a “trading”. Actual sale of the pledged article by the pawnee at a subsequent stage will also be a trading.

Therefore, meaning of the term “deal” is being satisfied, so is the term “trading” for the purpose of these Regulations.

(d) Release of a pledge

Release of the pledge is, truly speaking, a satisfaction of the pledge. The specific property that the pawnee had expires on satisfaction of the purpose for which the pledge was created. Neither does the pawnee, on satisfaction, have the right to retain the goods (Section 174 of the Contract Act, 1872) nor does he have any right to cause a sale. Hence, this amounts to an automatic termination of the rights contractually conferred by the pawnor. One cannot contend that on release of the pledge, there is a retransfer of the specific property back to the pledgor. To begin with, the property was specific and not absolute – it was granted for the purpose of securing a debt. When that purpose becomes extinct, the specific property expires by redemption of the purpose or debt. Therefore, it is wrong to contend that at this stage, there is a “trading” of any kind.

However, SEBI, in its Guidance to Question 7 of the Guidance Note, has expressed the view that revocation of pledge also amounts to a trade. While the use of the word “revocation” is, humbly, incorrect and inappropriate, even if this is taken to refer to a release of the pledge, it is wrong to contend that there is any transfer back of property, and therefore, there is no question of any “trading” at this stage. More so in context of the Regulations, because the Regulations are not intended to provide for a generalised public record of pledges, as in case of registration of charges under the Companies Act. The purpose of the Regulations is to ensure that there is no insider taking advantage of UPSI.



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Surely enough, if the pawnor is releasing his property by satisfying the debt, he cannot be intending to do so to gain an advantage merely by release. If he at all were to cause a sale of the released securities, that in any case will constitute a trade, but it is wrong to contend that a mere release is a trade at all.

Conclusion

SEBI's Guidance Note creates an unwarranted confusion about pledges this article has tried to align understanding pertaining to pledges in different scenarios. We hope that readers and practitioners will find this article useful.