



BENEFICIAL OWNERSHIP, PLEDGE ENFORCEMENT AND REGULATORY CONFLICTS: A RE-EXAMINATION OF THE SUPREME COURT'S RULING IN PTC INDIA FINANCIAL SERVICES LTD. V. VENKATESWARLU KARI (CA NO. 5443 OF 2019)

DR. NANDITA S JHA ¹

¹ ASSISTANT PROFESSOR, CHANAKYA NATIONAL LAW UNIVERSITY, PATNA.

ABSTRACT:

Having recently settled a difficult and long-standing question on the treatment of pledged dematerialised securities is the Supreme Court of India's decision in PTC India Financial Services Ltd. v. Venkateswarlu Kari. The Court ruled that on invocation under the Depositories Act, 1996, the recording of a pledgee as "beneficial owner" is a procedural duty which allows for sale, not transfer of title. Such a clarification has major implications for the Takeover Regulations, Insider Trading Regulations and the contractual pledge doctrine which is governed by the Indian Contract Act, 1872. The intention of this paper is to show that there is little room for confusion in the interpretation of the law, even if regulation would be guided by contract law in theory which requires a significant harmonisation between the law and the actual contracts.

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INTRODUCTION

The growth of dematerialised securities in India has re-instigated the preoccupation with the interface between conventional understandings enshrined in the Indian Contract Act, 1872 (ICA) and regulation of securities. The most enduring question is about whether an invocation under such a pledge in respect of dematerialised shares becomes a change of ownership resulting in an acquisition of title in the depository. In PTC India Financial Services Ltd. v. Venkateswarlu Kari (2023-24), the Supreme Court has unequivocally decided in this judgment that this entry does not indicate ownership transfer and is only a mechanism that can be accessed by the pledgee in order to sell the security in order to recoup unpaid dues. This clarification causes the earlier jurisprudence to be re-evaluated, specifically that of the Securities Appellate Tribunal (SAT) in Liquid Holdings Pvt. Ltd v. SEBI, where invocation and open offer obligations were defined as acquisitions.² The case also obliges us to reconsider the application of the SEBI (Substantial Acquisition of Shares and Takeovers) Regulations, 2011 (Takeover Regulations) and the SEBI (Prohibition of Insider Trading) Regulations, 2015 (PIT Regulations) to pledges. This paper evaluates the Court's reasoning and assesses its doctrinal and regulatory implications. It contends that the dematerialised context does not change or impact what is intrinsic to the pledge a security interest without transfer of title and that India's regulatory framework needs to be realigned.

RECONCEPTUALISING THE PLEDGE: THE CONTRACTUAL FOUNDATION

ICA provides the law regarding the characteristics and incidents of a pledge in Sections 172-179. A pledge conveys possession, not ownership, and the pledgee's remedy is limited: to keep the goods as security, to sue for a debt while retaining them as collateral, or to sell the pledged property after giving reasonable notice.³ The pledgee is never a complete owner and can never appropriate the goods for himself. Such principles are applicable to intangible securities, the Supreme Court of India in PTC India reiterated. The difficulty is that dematerialised shares cannot physically change hands. Possession is replaced instead by the entry into a depository account.⁴ Through its reliance on the ICA as a foundation for this analysis, the Court stressed that no regulation of securities could create a proprietary transfer where the contract law was made to disallow that transfer.

DEPOSITORY LAW AND THE MOVEMENT OF SECURITIES

According to Regulation 79 of the SEBI (Depositories and Participants) Regulations, 2018, a pledge is created when the securities in the pledgor's account are frozen over dematerialised securities.⁵ No transfer, in legal or beneficial sense takes place; the depository simply records the encumbrance. Upon satisfaction of dues, the encumbrance is stripped away, and the securities lapse back to the "free balance" of the pledgor. At creation, no transfer transpires so, the release also does not amount to a transfer. Invocation of the pledge would be the subject of Section 176 ICA in which reasonable notice must be given

to the pledgor prior to the sale. For dematerialised securities, Regulation 79(8) requires that the pledgee be listed as “beneficial owner” before a sale can take place. This entry was held by the Supreme Court as:

- does not grant ownership,
- is merely a procedural move for sale,
- does not transform the pledgee into an acquirer of shares.⁶

The judgment thus dismisses the argument that invocation constitutes acquisition. Section 177 ICA provides redemption until the actual sale of the pledged property. It is further confirmed in the decision that redemption does not divest the pledgor of title, even when invocation is given.⁷ Hence, returning a share to the pledgor is not a new “acquisition.” A true transfer happens only when the pledgee sells the shares to a third party purchaser. At this point, ownership passes and where disclosures on securities law obligations and potential triggers for an open offer may emerge.

THE TAKEOVER CODE: RE-EVALUATING TRIGGER POINTS

The Takeover Regulations Regulations 29 and 31 treat pledges as encumbrances, which must be disclosed. Earlier, SEBI and SAT interpreted invocation as an “acquisition” stating that invocation had the potential to activate the 25% open-offer threshold, or 5% creeping acquisition limit. The Liquid Holdings decision epitomizes this reasoning.² The PTC India judgment definitively negates that position by stipulating that invocation does not constitute acquisition.⁶ Because no proprietary interest passes at invocation, such an open-offer obligation at this point violates ICA rules. Post-judgment, the only event that counts as an “acquisition” under the Takeover Code is sale by the pledgee to a third party. Obligations to make disclosures are in place throughout the cycle of the pledge and are there, although open-offer obligations can be obtained only through real transfer of title. An Analysis of PIT Regulations That Follows the Principles of the Contract. Earlier SEBI (Prohibition of Insider Trading) Regulations, passed in 1993, barred any possessing Unpublished Price Sensitive Information (UPSI) from “dealing” in securities. But pledges were not set out as part of the definition of “dealing.”

At the time that the new PIT framework was being developed, the N.K. Sodhi Committee observed that an overly broad term including “dealing” could accidentally prevent normal and legitimate financial transactions. The Committee noted that many of the most important shareholders regularly pledge their shareholdings as collateral for borrowings either for personal or corporate. Facing such pledges as banned transactions each time UPSI is held would stop customary lending without contributing to insider-trading prevention. Simultaneously, the committee recognized that, in the event that a pledge could be misused as mere a framing device, SEBI’s broad powers under Section 12A of the SEBI Act for insider trading restrictions would provide for enforcement. It was

suggested on draft PIT Regulations that enforcement of a pledge by a lender would be within an exemption from enforcement, extending to trades made by another authorised person acting independently from the insider, as well as acting independently of and without access to UPSI. The aim of this carve-out was to shield inside persons from the responsibility when a lender or trustee, in the exercise of their security enforcement rights, has acted in the exercise of their security interest. The PIT Regulations announced in the final iteration did not hold the same view. A legislative note regarding the definition of “trade” indicated that the term was meant to include activities, such as pledges, that are not traditional buy/sell/subscription activities but which can still be conducted whilst the insider retains UPSI.

Further to these, SEBI’s Guidance Note for 2015, in conjunction with Comprehensive FAQs, confirmed that the creation, invocation, and revocation of a pledge amounted to “trades” under the PIT Regulations. Consequently, any and all compliance obligations under Trade Directive for Designated Person (DP) transactions which fall to pre-clearance, disclosure, contra-trade restrictions, and trading-window rules and to trade with the DP for good cause was applied to the pledges subject to a very narrow exclusion allowing pledges for bona fide fund-raising purposes with prior pre-clearance. The pledgor, or pledgee, is responsible to prove bona fide intent. After the PTC judgement in India there have been some contradictions that have begun to emerge. Under the Takeover Regime, the encumbrance of shares is defined as an acquisition by the pledgee and release of encumbrance as a disposal, but solely for disclosure purposes. By contrast, SEBI’s view in terms of the PIT Regulations is that the same acts are considered actual “trades” as part of their totality, with a pledge being treated as a disposal and a release as an acquisition by the DP.

This logic leads to the interpretation’s practical difficulties, particularly as it relates to contra-trade restrictions. If a DP pledges shares, listed entities tend to interpret these rules as the only legal prohibition for the same DP to say that the DP has not permitted that same DP to release the pledge for six months. The ICSI Guidance Note also indicates that changes of lender to one person could result in de-pledging and re-pledging and a subsequent six months of restriction, the same as is discussed in the previous section. These kinds of outcomes are commercially impossible to see at first blush, because repayments and releases of pledged shares by borrowers are typically accelerated and soon recourses of such share releases take place within much shorter periods of time. From a legal perspective, however, it is also conceptually wrong to consider the release of a pledge as a trade. These problems have already been discussed in commentary on the PIT Regulations by industry professionals.

PIT RULES TO STAGES OF A PLEDGE (POST-PTC INDIA DECISION).

The process and handling of pledges in the SEBI

(Prohibition of Insider Trading) Regulations, 2015 (PIT Regulations) has been controversial, and this has significantly been exacerbated by the determination in the PTC India Financial Services Ltd v. Venkateswarlu Kari ruling (2015), which clarified the character of pledged securities in Indian law. The 1993 Insider Trading Regulations have outlawed trading while possessing Unpublished Price Sensitive Information (UPSI), and "dealing" was defined in this way without reference to pledges. In crafting the 2015 framework, the N.K. Sodhi Committee indicated explicitly that a broad definition could inadvertently stymie legitimate financial activity because promoters and major shareholders routinely pledge their shares as collateral to obtain individual or corporate loans that are a fundamental and habitual economic activity. Hence, the Committee warned of a need to take care: pledges undertaken in the ordinary course of lending cannot be automatically treated as insider trading, but SEBI should still remain an option for intervention when a pledge structure is used as a cover to trade on UPSI. While the draft regulations attempted to treat enforcement of the pledge by a lender as a legitimate transaction when it was done independently of the insider, the final regulations changed the perspective. A legislative statement that included "trade" clarified that even transactions not technically in the category of buy/sell related actions like pledges would be within the permissible bounds if implemented while taking possession of UPSI.

This makes commercially unworkable choices: given that the pledge is a disposal, the contra-trade norm means that the pledgor cannot de-pledge the same securities for six months, a presumption that differs from secured lending principles in which pledged securities are routinely released and repeatedly re-pledged in a short period. Others have even gone up the ladder to view a change in lender as a fresh pledge and de-pledge, which would again set a six-month restriction circle into motion, rendering common refinancing operations unfeasible. The logic to treat release of a pledge as an "acquisition" goes both ways: release is only the repayment of the debt and the reversion of the security, not a trade undertaken for gain. It is a more nuanced understanding of each part of the pledge cycle post PTC India.

PLEDGE

Creation of a pledge does not result in the transfer of title or beneficial ownership of securities; the pledged securities are in pledgor's demat account only and are locked to prevent a sale. There would be no "sale" or "purchase" of value. Thus the application of contra-trade restrictions or provision of pre-clearance for pledges seem conceptually unsound, especially when trading-window closures do not suppress pledge creation. Release of a pledge is not a trade in a similar manner; once the pledgee fulfills the underlying obligation, his special property in the securities ceases to exist, and the securities return to the pledgor's free status. There is not a transaction intention consistent with its regulatory philosophy at the

core of insider-trading control. The offer of a notice of invocation likewise requires no transfer or dealing. Invocation is an act only through lender's control itself, and induced only upon default. It is too harsh and unreasonable to expect pre-clearance or contra-trade obligations for the pledgor for any act they perform without any control.

The pledgee's status as "beneficial owner" in the depository system, even when invoked, merely serves as a procedural step to facilitate its sale and does not convey actual ownership, in the words of the Supreme Court. Redemption after invocation is allowed under Section 177 of the Contract Act until the securities are sold, which just makes the pledgor appear once again in his position (this is not a trade, it is a statutory right). A true disposal happens only when the lender sells the pledged shares eventually. Even here, the decision-maker is usually not in possession of the UPSI of the pledgor, highlighting the question whether PIT limitation on the pledgor is applicable. Ideally, disclosures will be triggered on sale, given that disposal is the point at which the pledge is actually sold, and the interim transfer into the pledgee's account is still a procedural prerequisite for enforcement.

These inconsistencies highlight the necessity of harmonising between the PIT Regulations, the Takeover Regulations, and the legal characterisation of pledges under the Contract Act in order to ensure obligations fall within the constraints of an appropriate understanding of a pledge's true nature, free from disruption to legitimate financing structures vital to market function.⁸ Such an approach included such protections against the following:

- pre-clearance requirements,
- contra-trade restrictions,
- trading-window closures. The Supreme Court's decision clarifies that these stages do not reflect trading behaviour:
- Creation is just an encumbrance, not disposal.
- Invocation is not a voluntary activity that leads to acquisition.
- Redemption reverses the original status.
- Only sale by the pledgee results in transfer of ownership.

Therefore, to put insider-trading compliance mechanisms into use at non-trading events is in contradiction with our objective of preventing misappropriation of unpublished price sensitive information (UPSI).

A distinction between the two produces noncompliance anomalies and unwarranted litigation. For banks and financial institutions, operational difficulties arise from the treatment of non-transfer events as trades, which is a significant deterrent to the operations of banks when trading-window closures occur or the regulatory environment is compliant with contra-trade restrictions. A ruling by the Supreme Court provides a chance to simplify compliance times and lower transaction friction.

CONCLUSION

The PTC India judgment serves as a fundamental clarification on Indian securities law to differentiate between procedural meaning of “beneficial ownership” under depository law, as opposed to substantive ownership under contract law. Invocation of a pledge is not the purchase; the ownership cannot be transferred but only upon sale, after the pledge has been called. The finding calls for a redoing of the Takeover Regulations and PIT Regulations to incorporate this principle and eliminate an undue stress on compliance. Harmonisation of legal systems Contract law, depository law, takeovers regulation and insider trading Rules is critical if we aim to reintegrate doctrinal consistency and predictability into the Indian securities markets.

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