
Prelims and Mains focus: about the move; benefits and significance; about share pledging

News: The Securities and Exchange Board of India (SEBI) has amended the SEBI (Depositories and Participants) Regulations by including an additional explanation that states that ‘pledge’ would also refer to ‘re-pledge of securities for margin or settlement obligations.’

Why?

A minor tweak in the manner ‘pledge’ is defined in the regulatory laws is expected to go a long way in minimising instances where stock brokers misuse client securities by pledging such shares for their own benefit in terms of meeting their margin requirements.

Background

- This assumes significance as the recent past has seen few instances of brokers pledging client securities to raise funds from banks and non-banking finance companies (NBFCs). More importantly, this was done without the clients being aware that their securities were being misused in such a manner.

- The most high-profile matter in the recent past was of Karvy Stock Broking in which the Hyderabad-based firm raised funds from entities such as Bajaj Finance, ICICI Bank, HDFC Bank and IndusInd Bank by pledging client securities.

- Further, according to the lenders — as stated in an order by the Securities Appellate Tribunal — Karvy Stock Broking had even given an undertaking that the securities that were being pledged were its own
and that they did not belong to clients.

**Changes made**

- Onus of bonafide pledge created from margin account of a stock broker will now lie with the depository following the SEBI amendment.

- In the past, pledge from the margin account was directly routed by the stock broker **using the power of attorney route, without the active consent or approval of the beneficiary holder of shares. Now consent of beneficial owner will be necessary.**

**Likely benefits**

- Instances where a client’s funds/securities were diverted or misutilised by brokers toward margin or settlement obligations of itself, or for some third party, or for raising loans against shares on its own account, will be **minimised.**

- With the insertion of this explanation, depository participants of both the pledger and the pledgee will **have to inform the pledger and the pledgee respectively of the entry of creation of the re-pledge.**

The latest SEBI move comes close on the heels of the regulator developing an in-house system to track the movement of client securities that are collected as collateral by the brokers.

**What is a pledged share?**

Simply put, it is taking loan against the shares one holds. It can be done by both investors and promoters.

**Why do promoters pledge shares?**
One of the methods promoters use to raise finance is to **take loans against their holding in their company from banks or non-banking financial companies.** For these financial institutions, these **shares are collateral.** Promoters can raise funds for various reasons—for meeting requirements of the business or personal needs.

### Can banks sell the shares pledged by promoters?

- Banks can sell the pledged shares **if the price of the stock falls closer to the value agreed in the contract** between them and the company. Typically, the **amount that is lent by banks/NBFCs to promoters is less than the market value of the shares.**

  - This shortfall is the margin is the amount that these lenders retain as security. **In case the stock price falls, lenders ask the promoter to provide more cash or shares to top up this margin.** If the promoters are not able to top up the collateral, the lenders can sell the shares to maintain this margin. Conversely, **revoking of pledged shares by promoters is seen as a positive sign.**

### What is the risk for retail investors in this?

High promoter pledged shares can **wreak havoc in a stock if price continues to fall and lenders sell these shares in the market.** The sudden supply of shares can lead to further price fall and is a risk for retail investors who may have to sell the shares for a significant loss.

### What should be the approach of retail investors in stocks with high pledged promoter holding?

- Shares of companies with high pledged promoter holding tend to witness higher volatility. The risk is assessed on the basis of the amount of pledged shares as a percentage of the total shareholding.

  - A stock is considered a risky bet if pledged shares are more than 50% of the total shares in the company so ideally, retail investors should avoid such stocks.