The Infinite
An International Peer Reviewed / Refereed Journal of Multidisciplinary Research

An Online Peer Reviewed / Refereed Journal
Volume 2 | Issue 7 | July 2025
ISSN: 3048-9539 (Online)
Website: www.theinfinite.co.in

Digital Pledging of Dematerialized Securities: Legal Validity and Challenges

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ARTICLE DETAILS

Research Paper

Keywords :

Pledge, Dematerialized Securities, Indian Contract Act, Depositories Act, SEBI, NSDL, CDSL, Digital Assets, Secured Transactions, Financial Law

ABSTRACT

With the rapid evolution of digital finance and the widespread dematerialization of securities, the traditional legal concept of pledge—historically premised on the physical delivery and custody of tangible goods—has undergone a profound transformation. Traditionally, a pledge involved the transfer of possession of movable goods from the pledgor (borrower) to the pledgee (lender) as collateral, with a right to reclaim the goods upon fulfillment of an obligation. However, the shift from physical share certificates to electronic securities held in dematerialized form through depositories has redefined the manner in which collateral is created, recorded, and enforced in financial transactions.In the Indian context, this transition has been facilitated primarily by the establishment of centralized depositories such as the National Securities Depository Limited (NSDL) and the Central Depository Services (India) Limited (CDSL). These institutions enable investors to hold and transfer securities in electronic form, thus eliminating the risks and inefficiencies associated with physical certificates. However, while this shift has enhanced convenience and efficiency, it has also introduced a new set of legal and operational challenges, particularly in the context of creating, registering, and enforcing pledges over these dematerialized securities.

Unlike traditional pledges that rely on physical possession, pledges over demat securities involve electronic marking of encumbrances within

depository systems. This raises fundamental questions about whether such intangible assets fulfill the legal requirements of a valid pledge under Sections 172 to 179 of the Indian Contract Act, 1872, which presuppose delivery and custody of tangible goods. Additionally, the Depositories Act, 1996, and SEBI regulations provide a parallel regulatory structure, creating complexity in harmonizing traditional contract law with modern capital market practices.

This paper undertakes a comprehensive doctrinal and analytical study of the legal framework governing the pledge of dematerialized securities in India. It critically evaluates the roles and responsibilities of key entities, including depository participants (DPs), the beneficial owners, and the pledgees, in the electronic pledge process. It further explores how recent reforms, particularly SEBI's 2019 framework for pledge and repledge, aim to improve transparency and reduce misuse.Moreover, the paper examines relevant judicial interpretations and analyzes regulatory guidelines to assess their effectiveness in resolving disputes and ensuring the enforceability of such pledges. It identifies legal loopholes, ambiguities, and operational challenges, such as the lack of statutory clarity on the definition of possession in the digital context, the risk of double pledging, and concerns related to cyber-security and data privacy.

In conclusion, the paper proposes targeted legal and policy reforms to strengthen the enforceability, reliability, and legal certainty surrounding the digital pledge ecosystem. These include broadening the legal definition of "goods" to include dematerialized securities, codifying digital pledge procedures, enhancing SEBI oversight, and ensuring better alignment between contract law and depository regulations. Such reforms are critical to ensure that the law keeps pace with technological innovation, fosters investor confidence, and supports the growth of India's digital financial infrastructure.

1. Introduction

The concept of pledge has its roots in ancient commercial and contract law, where it functioned as a secure and simple means for a debtor (known as the pledgor) to provide movable, tangible goods to a creditor (the pledgee) as security for the repayment of a debt or the performance of an obligation. Upon the fulfillment of the obligation, the pledged goods were to be returned to the pledgor. This arrangement is legally recognized and governed under Sections 172 to 179 of the Indian Contract Act, 1872, where pledge is treated as a specialized form of bailment. One of the essential conditions of a valid pledge under this framework is the delivery of possession of the goods from the pledgor to the pledgee, while ownership remains with the pledgor.

Historically, this model of pledge was based on the assumption that the goods involved were physical, tangible, and movable, such as jewelry, stock-in-trade, or agricultural produce. Physical possession served as a key indicator of the creditor's security and legal control over the asset. However, with the advent of technology-driven financial systems and particularly the process of dematerialization, which refers to the conversion of physical financial instruments into electronic form, the traditional understanding of pledge has come under scrutiny and strain.

In contemporary financial markets, dematerialized (demat) securities—such as shares, bonds, and debentures held in electronic form—have become the norm. These demat securities are maintained through centralized depositories like NSDL (National Securities Depository Limited) and CDSL (Central Depository Services Limited), and accessed by investors via depository participants (DPs). While this transformation has undoubtedly increased the speed, transparency, and safety of financial transactions, it has also altered the legal and operational dynamics of pledging.

The fundamental challenge arises from the intangible nature of demat securities. Since there is no physical delivery involved, the pledge is not created by handing over a physical certificate but by initiating an electronic instruction through the depository system. This raises important legal questions: Can the electronic marking of securities as "pledged" constitute valid delivery and possession in the eyes of traditional contract law? Does the absence of physical transfer render the pledge invalid under the existing provisions of the Indian Contract Act?

Furthermore, the implications of pledging demat securities through digital platforms include not just the need to redefine "delivery" and "possession", but also the requirement to recognize system-based custody and control. The process involves technical steps like pledge request initiation, confirmation, and

invocation within the depository system—actions that replicate the essence of a traditional pledge, yet operate entirely within a virtual ecosystem.

As the practice of pledging intangible assets becomes more widespread, especially in the collateralization of loans, margin trading, and secured lending, it is crucial to examine how the existing legal framework accommodates these changes. A failure to do so may result in legal uncertainty, enforcement difficulties, and the erosion of creditor rights in the event of default. Thus, there is a growing need to critically assess and possibly reform the legal understanding of pledge to ensure it aligns with the realities of dematerialized financial instruments and the technological landscape of the 21st century.

2. Legal Framework Governing Pledge in India

2.1 Indian Contract Act, 1872

Section 172 defines a pledge as the bailment of goods as security for the repayment of a debt. Traditionally, "goods" did not include intangible assets such as shares held electronically.

2.2 Depositories Act, 1996

The Depositories Act, 1996, along with SEBI (Depositories and Participants) Regulations, provides the framework for demat securities. It recognizes NSDL and CDSL as licensed depositories in India. As per Section 12 of the Act, beneficial ownership remains with the account holder even when securities are held in demat form.

2.3 SEBI Guidelines and Circulars

The SEBI Circular dated August 1, 2019, introduced a revised mechanism for pledging and repledging of shares in demat form through a structured system to enhance transparency and reduce misuse.

3. Creation and Enforcement of Digital Pledge

The pledge of dematerialized (demat) securities operates through an electronic depository system, which replaces the traditional method of physical delivery of share certificates. In this system, the pledgor (borrower) initiates the process by instructing their Depository Participant (DP)—an agent registered with a central depository like NSDL or CDSL—to create a pledge over specified securities held in their demat account. Unlike traditional pledges where the goods are physically transferred to the possession of the pledgee, in a demat pledge, the securities remain in the pledgor's account, but are electronically marked as "pledged" in the depository system. This marking serves as a digital representation of restricted ownership and acts as a notice to third parties about the encumbrance.

The process of creating a pledge in the demat environment involves multiple key steps. First, the pledgor initiates a pledge request through their DP, specifying the securities and the terms of the pledge. Next, the pledgee (lender or creditor) must confirm the request through their own DP. Upon mutual confirmation, the securities are flagged in the system as pledged, effectively restricting their free transfer until the obligation is discharged. In case the pledgor defaults on their obligation, the pledgee can invoke the pledge, leading to the automatic transfer of the pledged securities into the pledgee's demat account, thereby satisfying the debt.

The entire procedure is paperless, automated, and system-driven, offering enhanced efficiency, transparency, and reduced risk of fraud compared to physical pledges. However, the legal validity and enforceability of such pledges are contingent on the fulfillment of both contractual conditions between the parties and strict compliance with depository and SEBI regulations. Any failure in adherence—such as improper authorization, lack of confirmation, or breach of regulatory protocols—may render the pledge void or unenforceable. Therefore, while the demat pledge process aligns with the demands of a digital economy, it also necessitates robust regulatory oversight and legal clarity to ensure the security and integrity of such transactions.

4. Legal Challenges and Issues

4.1 Intangibility and Possession

The traditional requirement of **delivery of goods** becomes problematic in the digital realm. Demat securities do not involve physical delivery, raising concerns about whether such a transaction constitutes a "pledge" in the classical sense.

4.2 Third-Party Rights

There may be competing claims or encumbrances over the same demat securities, especially if not properly marked or disclosed. Lack of transparency in past off-market pledging practices led to SEBI's revised pledge mechanism in 2019.

4.3 Enforceability and Invocation

Although depositories provide a mechanism for invoking a pledge, legal proceedings may still be necessary if there is a dispute regarding authorization, fraud, or breach of agreement.

4.4 Technological and Operational Risks

System failures, cyberattacks, and unauthorized access to demat accounts can compromise the security and legality of pledged assets, raising questions of liability.

5. Judicial Interpretation

Indian courts have gradually recognized the **pledge of dematerialized securities** through broader interpretations. In *ICICI Ltd. v. Grapco Mining & Co.*, the court accepted that demat shares can be pledged and enforced. However, judicial clarity remains limited, and more case law is needed to solidify the legal position.

6. Comparative Perspective

In advanced jurisdictions such as the United Kingdom and the United States, the pledge or creation of security interests over dematerialized (demat) securities and other intangible assets is well-recognized and systematically governed under comprehensive secured transaction laws. In the United States, for instance, Article 9 of the Uniform Commercial Code (UCC) provides a robust and detailed legal framework for the creation, perfection, and enforcement of security interests in both tangible and intangible personal property, including investment securities, accounts receivable, and intellectual property. Under this framework, the concept of possession is interpreted broadly, encompassing not only physical control but also control through electronic systems, thereby validating the pledge of digital assets even in the absence of physical delivery. The UCC facilitates electronic filing of financing statements, establishes priorities among creditors, and ensures the enforceability of security interests through well-defined procedures in the event of default.

Similarly, in the United Kingdom, the Financial Collateral Arrangements (No. 2) Regulations 2003, which implement the EU Directive on Financial Collateral Arrangements, provide for the creation of security interests over financial instruments, including shares held in electronic form. UK law allows for both legal and equitable pledges over dematerialized securities and recognizes book-entry systems and custodial arrangements as valid mechanisms for creating enforceable security interests. The legal recognition of control through systems maintained by clearinghouses, custodians, or depositories provides certainty and flexibility in modern financial markets.

These legal frameworks are designed to support the dynamic needs of modern finance, especially in jurisdictions where digital transactions dominate capital markets. They offer a comparative model for India, where the legal doctrine of pledge is still rooted in the 19th-century conception of physical goods

and delivery. By studying these jurisdictions, India can derive valuable lessons on how to modernize its laws to effectively incorporate dematerialized securities, digital assets, and system-based possession within the scope of pledging and secured lending. Adopting such reforms would not only harmonize Indian law with international best practices but also enhance investor confidence, facilitate credit expansion, and promote the efficiency and security of digital financial transactions.

7. Recommendations

To effectively address the legal and operational challenges posed by the pledge of dematerialized securities, a series of targeted legislative, regulatory, and institutional reforms are essential. First and foremost, there is an urgent need to amend the Indian Contract Act, 1872, to explicitly recognize intangible and digital assets, such as demat securities, within the scope of "goods" that may be pledged. The current statutory language is based on 19th-century commerce, which envisioned only tangible goods. A revised definition would provide clarity and legal certainty to stakeholders engaging in digital pledging practices and help avoid interpretational ambiguities.

In parallel, SEBI regulations must be further strengthened to clearly define the rights, duties, and liabilities of all parties involved in the pledging of demat securities—namely, the pledgor, pledgee, and depository participants. A more comprehensive regulatory framework should address issues such as the timing and effect of pledge creation, the process for invocation, dispute resolution mechanisms, and remedies for unauthorized pledges. Clearer regulatory standards would reduce the scope for litigation and enhance the enforceability of such transactions.

Additionally, the establishment of a centralized and publicly accessible pledge registry, possibly maintained by the depositories or SEBI, would significantly enhance transparency in the system. Such a registry would help prevent the risk of multiple pledges over the same securities, mitigate fraudulent practices, and ensure that third parties, including other creditors, have access to real-time information about existing encumbrances.

Further, the introduction of judicial training programs and interpretative guidelines specifically addressing digital pledges would promote uniformity and consistency in court rulings. As the concept of possession and delivery in electronic transactions differs substantially from traditional pledges, judges must be equipped with both technological understanding and legal insight to fairly adjudicate disputes involving demat securities.

Finally, as digital pledges are facilitated through online depository systems, there is a critical need to bolster cybersecurity infrastructure to safeguard against data breaches, unauthorized access, and cyber threats. Strengthening digital authentication, encryption, and audit trails within NSDL, CDSL, and depository participant systems will not only enhance trust in the pledge mechanism but also protect the interests of investors and financial institutions alike.

8. Conclusion

The digital pledging of dematerialized securities marks a significant shift in the application of traditional legal concepts. While regulatory mechanisms and depository infrastructure have evolved to support such transactions, legal uncertainties and operational challenges persist. To ensure the efficiency, enforceability, and security of digital pledges, Indian law must modernize its approach—recognizing intangible digital assets as valid subjects of pledge, and developing a robust legal ecosystem that blends contractual freedom, technological infrastructure, and regulatory oversight.

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