

To Be or Not To Be Included: Whether ‘Trading’ Includes ‘Pledging’ Under the Purview of the Prohibition of Insider Trading Regulations

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Abstract

The dynamic nature of Securities law which seeks to protect the interests of the investor and develop the market has raised an intriguing question of whether the term ‘trading’ under the Prohibition of Insider Trading Regulations of 2015 includes within its purview ‘pledging’, brought to the forefront by the Satyam scam ruling. This research article endeavors to argue both sides of the ensuing debate considering the tenets of rules of interpretation, use or mere possession of unpublished price sensitive information (UPSI), presence of unlawful motive and the requirement of disclosures of such transactions with the aim of displaying that the law requires not merely definitional clarity but also additions in order to be equipped to prevent the illegitimacy of such transactions as compared to those which are conducted in the ordinary course of business with bonafide intentions. Neither a blanket prohibition of such transactions could be the intent of the authorities as that would draw the market to a standstill nor can allowing a clear loophole which acts as a device of deviance be permissible and thus, there is a need to draw a balance between the arguments put forth on both ends of the debate, to allow for the regulations to be triggered but on a certain test being met with and with caveats accounting for the nature of such transactions.

Keywords: Dealing, Pledging, UPSI, Unlawful Motive, Satyam Scam, Disclosures

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INTRODUCTION

The Prohibition of Insider Trading Regulations of 2015 (and erstwhile 1992) raises several debatable questions, and the jurisprudence of SEBI through its instruments such as Legislative Intent and Guidance Notes as well as decisions of the Tribunals has been geared towards clarifying these doubts while expanding definitions and the interpretable scope of powers in tandem with the interests of the securities market, investors and stock exchanges. However, the question of whether the term ‘trading’ includes ‘pledging’ is one which has no definite answer and this research article seeks to evaluate the possible contentions on both ends of such interpretation while highlighting the implications of the same.

To begin with, we first need to understand the definition of ‘trading’ under the PIT Regulations, which is under S. 2(1) and has been defined as, “trading” means and includes subscribing, buying, selling, dealing, or

agreeing to subscribe, buy, sell, deal in any securities, and “trade” shall be construed accordingly” [1]. Not only this, but the definition of trading, under the SEBI note attached to the legislation states that the term ‘dealing’ as used in S. 12A and S. 15G would be included within ‘trading’ in order to curb activities which do not strictly fall within the purview of buying, selling or subscribing but are attempts to transact in a favourable manner for oneself when in possession of unpublished price sensitive information.

The question of whether ‘pledging’ is included arises from one of the questions raised in the **Satyam scam** ruling, wherein the sale of shares (Promoter’s) under pledge being sold by institutions ahead of the disclosures as well as the fall in prices resulted in public outrage and it was to be determined whether the pledge was included under ‘dealing’ and whether it was bonafide and excepted from the purview of dealing [2].

The question holds importance not only because it widens the definition of trading and hence, the transactions which fall under scrutiny but also because it represents an amendment in the law that would be necessitated for disclosures of such pledge transactions. Further, the more the law expands, the greater is the requirement for clarity over the caveats created such as bonafide transactions as well as over whether mental element of unlawful gain is essential.

THE CASE TO NOT INCLUDE PLEDGING IN THE PURVIEW OF THE DEFINITION

We commence this segment of the research article by first focusing on S. 2(l) of the Regulations itself which employs the word 'means' to explain the definition. As per the cases of *P. Kasilingam v. P.S.G. College of Technology* [3] and *Punjab Land Development and Reclamation Corporation Ltd. v. Presiding Officer, Labour Court* [4], it has been held that the term is a hard and fast term which would imply that no other meaning than that put forth in the expression can fall under the definition. This allows us to argue that while the definition of 'selling, buying and subscribing' is unambiguous and pledging is none of these activities nor is it an agreement to do any of these in the future [5]; the only possibility for pledging to fall under the definition is if it falls under 'dealing'. The definition of 'dealing' as per the Black's Law Dictionary is 'to transact business, to traffic, to trade' [6]. However, this is where a difference lies between the two terms.

This difference was expounded upon in the case of *MTZ Polyfilms Ltd.* wherein it was held that the intent of the regulations is to prevent insiders from transacting or dealing with securities prior to material disclosures at a point in time which is favorable to them in terms of the price vis-à-vis what it could be if disclosures were made [7]. However, in pledging, the risks and rewards in the shares are held by the borrower only such that the lender is the one who chooses to sell the shares and if he does so at a time when the prices have fallen, the loss is borne by the borrower. It is stated in that case law that, "*He would be credited obviously only to the extent of the*

amount realized by sale. If the borrower bears the risk of such fall, then this goes against the very concept of Insider Trading where the dealer profits from a fall in price that may be the result of adverse information published later [8]".

Further, where such a transaction would not have yielded a profit or gain to the transacting individual, it could not be said to be against the interest of the investors, and motive though not expressly brought to the fore by the regulations could not be ignored either as held in the case of *Rakesh Aggarwal v. SEBI* [9].

It can further be argued that the decision of the Whole Time Member in the *Satyam Scam* ruling does not follow the rule of *ejusdem generis* which has been held in the case of *Uttar Pradesh State Electricity Board v. Hari Shanker Jain* to state that general words follow particular words, they are not to be given the widest meaning but rather are to be construed in the same kind and class as the particular words mentioned [10]. While all the other transactions mentioned in the definition under S. 2(l) involve a transfer of shares, pledging does not per se involve such a transfer, it is only a possessory security which is physically delivered to the beneficiary of the pledge and an entry is recorded evidencing such a transaction, and hence, it should not fall under the purview of the definition, which is exhaustive.

This is in tandem with the definition of an 'acquirer' under the SEBI (Substantial Acquisition of Shares and Takeovers) Regulations, 1997 [11] who has been defined as any person, who either by himself or with any person acting in concert with him, whether directly or indirectly, acquires or agrees to acquire the shares or voting rights in the specified target company or to acquire control over the target company. In pledging, there is only conditional parting to provide security for a loan and is not akin to acquisition for the purpose of 'dealing in securities'.

Pledging should also not fall under the definition of 'dealing' and consequently 'trading' until and unless it satisfies use of unpublished price sensitive information. This

essentially means that while a sale does constitute trading, it will only constitute insider trading if it is motivated by the UPSI which is possessed by the person transaction. This then means that either the pawnee at the time of the sale is required to be acting on the UPSI to gain favorable outcomes or should be acting on the instructions of the pawnor who is an insider. If neither of these criteria are met, the transaction would be considered bonafide and not motivated by the triggers for the PIT Regulations [12].

It has also been noted by the recent report of the Reserve Bank of India that pledging is a major source through which funds are raised for the company and it was noted that out of the 56.3% promoter holding of major industries and sectors, about 14.2% were pledged and the presumption should thus be of bonafide transactions in this regard [13].

In this regard itself, it may also be put forth that the transactions of pledging are those which are carried out in the normal or usual course of business and the SAT has often opined that the nature of the information pertaining to such activities which a business may reasonably be expected to carry out will not be considered price sensitive and such activities will not be considered for the purpose of violations of PIT Regulations unless they denote action on possession of UPSI for gain as held in the case of **Gujarat Mineral Resources NRE v. SEBI** [14].

Further, the motive of insider trading is usually to seek a financial and unlawful gain for oneself. This requires the presence of mental element apart from the UPSI which allows for an unfair advantage to the transacting individual. In the case of **Mrs. Chandrakala v. Assessing Officer, SEBI** [15] it was put forth in this context that where the transaction is reasonable and was on a basis other than possession of UPSI, then it cannot be treated as a wrongful act which mirrored the recommendation of the Report of the High Level Committee to Review the SEBI (PIT Regulations), 1992 [16].

The SAT had held in the case of **Ramalinga Raju v SEBI** [17] that pledging of securities

cannot be prohibited under the PIT Regulations 1992 without any proof of illegal gain. The SEBI has extensively referred to the US law on insider trading in interpreting the PIT Regulations [18]. The SEC had in the matter of **Cady Roberts & Co.** held that the prohibition on trading on undisclosed information is triggered only when the information is used for personal benefit [19].

Further, the interpretation of a subordinate legislation [20] such as the PIT Regulations, 2015 enacted under the SEBI Act should be within the four corners of the Act [21] and should not be derogatory to the intents of the broader legislation and as held in the case of **Rakesh Agarwal**, the Act never intended to ban all related activities, but only specific activities actually constituting insider trading [22].

It is also important to argue the implications of such scrutiny for pledging under the Regulations and the same were deliberated by the Sodhi Committee which had deliberated as to whether pledges and encumbrances could be created as a device for circumventing the prohibition. It had concluded that such a mischief was unrealistic and impractical and would not anyway go scot-free owing to Section 12A of the SEBI Act. A prohibition on pledging would bring the activity to a standstill for the banking and finance industry with no real corresponding benefit to the market [23].

THE CASE FOR INCLUSION OF PLEDGING WITHIN THE PURVIEW OF THE DEFINITION

This segment of the research article shall focus on the arguments that can be put forth in order to include the term 'pledging' within the definition of 'dealing' under S. 2(1) of the Regulations and we begin by citing the case laws such as **The Executive Engineer and Anr. v. Sri Seetaram Rice Mill** and **Tinsukhia Electric Supply Company Ltd. v. State of Assam** which have held that the construction of such regulations should be purposive [24] in order to make them effective and operative wherein citing Black's Law Dictionary would yield that where a pledge creates an interest or right, it is included under the purview of

dealing in securities on reading the regulations alongside the Securities Contract Regulation Act [25].

It is further to be argued that a widely worded inclusive definition should not be attributed a limited scope and this has been held in the case of **Hood-Barrs v. Internal Revenue** [26]. In India, it has been held that in interpreting the provisions of a beneficial enactment, the Court should adopt that construction which advances, fulfils and furthers the object of the Act rather than the one which would defeat the same and render the protection illusory as held in the case of **Chinnamarkathian v. Ayyovoo** by the Supreme Court of India [27].

This broad definition that has been argued above was employed in the **Satyam scam** ruling [28] where the SAT held that dealing includes within its purview pledging and this was due to the object of the act being to regulate the interests of the investors [29]. The WTM held that pledging of shares is within the definition of 'dealing in securities' as the term would include all commercial dealings in relation to the securities which involve not only transfer of securities or but also any rights or interests therein. In **Tanuja Aerospace & Aviation Ltd.** also the ruling held that any device which has the ability to influence the investment decisions of the investors should be disallowed, though a caveat is created stating that such device has to be employed fraudulently [30].

In this wide interpretation of the term 'dealing' we may make use of the Mischief rule of interpretation wherein in the case of **Glaxo Laboratories (I) Ltd. v. Presiding Officer, Labour Court, Meerut and Ors.** [31], it was observed that the purpose of interpretation is to give effect to the intention underlying the statute, and therefore, if two constructions are possible, that construction which advances the intention of the legislation and remedies the mischief should be accepted. This was mirrored by the Report of the High level Committee where they opined that, "*it is a settled law that such regulations ought to be purposively construed and if two views were possible, the view that furthers the legislative object would need to be adopted over a view*

that makes a mockery of the legal provisions [32]". This would imply that pledging, when done in the possession of UPSI, would further the intent of the legislation more effectively if it fell within the purview of the regulations.

Further, the High level Committee was of the view that the term 'trading' should be used instead of 'dealing' because "*each and every act of doing something with securities would constitute dealing* [33]". The committee categorically observed that "*a prohibition in dealing when in possession of UPSI would result in a prohibition on pledging of shares by any person in possession of UPSI* [34]".

Further, possession of UPSI can be considered sufficient for the purpose of a transaction to fall within the purview of the Act and there is no additional requirement of proving that there was use of the same as per the order in **Kemefs Specialties (P) Ltd. v. SEBI** [35]. This stance of SEBI and the Securities Tribunals has undergone developments such that while in the case of **Rajiv B. Gandhi v. SEBI** [36], it had been held that action 'on the basis of the UPSI' was an essential criteria, the SAT concluded in the case of **Laurel Energetics Ltd. v. SEBI** [37] that post the 2002 Amendment in the regulations under S. 3, there was mere possession requirement to alert and trigger the regulations [38].

Even more explicit intentions to include stem from the SEBI guidance notes wherein under the answer to question 6 of the Guidance Note, SEBI had laid down as per the following, "*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* [39]". This indicates that while pledging should in most transactions be included within the purview of the Regulations, the same is excepted when the transaction is bonafide, or within the ordinary course of business.

In addition to the above arguments, it is also imperative to put forth from this end of the debate that the motive to secure unlawful gains is irrelevant for the purposes of determining whether the Regulations are triggered or not such that it was held in the case of ***Sterlite Industries v. SEBI*** that the imposition of penalty by SEBI is undertaken for a breach of civil obligation and not as a component of criminal or quasi-criminal proceedings that it should require the evidence of a mental element [40]. The argument that making of profit is essential for proving of a charge of insider trading was negated by Securities Appellate Tribunal in the case of ***Hindustan Lever Limited v. SEBI*** [41] which held that 15J of the SEBI Act will have no bearing on the violation of Regulation 3 of PIT. Further, in the case of ***SEBI v. Shriram Mutual Funds***, ‘intention’ or ‘mens rea’ was held to be non-essential and insignificant under the SEBI Act and its Regulations [42].

Not only this, but transactions of such a nature where action is taken on the basis of UPSI cannot be differentiated into legitimate and illegitimate actions and this has been held in the case of ***SEC v. David E. Lipson*** [43] where it was stated that merely because an insider had two purposes pursuant to which he dealt in securities, one being legitimate, and the other merely for the purpose of making unlawful gains, the existence of the legitimate purpose would not have the effect of ‘sanitizing’ the illegitimate one. This would imply that if the action of pledging was with possession of UPSI, then that transaction would not be differentiated from the transactions of other transfers which were conducted post this possession of UPSI even if they were not to secure profits as the individual would stand to have the probability of securing a benefit or providing benefit to another such as the pawnee for consideration. From the perspective of implications, if there is no inclusion of the term ‘pledging’ within the meaning of trading and dealing, it provides an escape route to the insiders and connected persons amounting to the same under the Regulations to engage in such transactions and allow deviation from the central goal of the protection of investors. Several of the above

judgements and guidance notes or legislative intent notes have created exceptions for legitimate purposes or for the purposes of ordinary course of business or required fraud; however, these are not clearly delineated in the relevant statutes or judicial decisions. That alone should not allow the securities market to be hampered in the endeavor of protection.

THE ROAD AHEAD

The debate regarding whether ‘pledging’ should be included within the purview of the definition of ‘trading’ goes far beyond mere definitional change, it encompasses within it several other implications and the conclusion of this debate does not appear to be a simple affirmation or exclusion of the term from the definition, but rather appears to require legislative focus accompanied by judicial criteria outlined to allow for pledging to be included within the purview of the regulations to trigger it but with caveats such as legitimate purposes, bona fide transactions, ordinary course of business etc. which are provided at present as well but hold little meaning due to the lack of any elaboration on what these caveats entail. Not only this, but there are conflicting views that have been presented by the authorities over the requirement of motive or mental element and trigger on use or mere possession of UPSI and this would need to be clarified as a precursor to specifically dealing with pledging of securities as these issues are common even to other transactions which involve securities. Further, guidance notes and legislative comments are merely persuasive and do not carry within them the weight of concrete law and there is thus a need for the authorities to either insert explanations within the statute or for the Judiciary to provide certain thresholds which can be used to understand the point of trigger.

Further, with regards to disclosures of the Promoters, the idea itself is a sensible one which allows for the public to be aware of the vulnerability and real stake of a Promoter of a company and guides the market and the shareholder. This disclosure does not have to carry with it the taint that it is because the transaction itself is a contentious one, rather, it should be accepted that pledging is done in the

ordinary course of business more often than not to raise funds, but at the same time, disclosures would make the trigger point that should be outlined by the legislature and the judiciary easier to identify [44].

The SEBI should be interested in the regulation of pledging as the power to pledge would usually be possessed by important personnel of a company such as the promoter who would usually possess UPSI and have the power to conduct transactions which have implications for the market as a whole. However, the SEBI should categorize the different stages of a pledge apart from considering the points raised in the debate to draw a balance.

For instance, presumptions should not be raised when a sale is caused by the pawnee at a point which appears favorable and rather, it is essential for investigations to be pointed at whether UPSI was directly or at second measure, as above explained, possessed by him to trigger the Regulations. Similarly, when the pawnee becomes the owner by transfer, there is a similar course which should be followed. However, when the pawnor receives the property back on repayment and termination, it should not fall under the purview of trading in the first place as the purpose had been specific and not absolute in the first place.

The *Satyam ruling* being devoid of reason does not provide adequate position of law in the country and neither do persuasive instruments such as guidance answers in notes, and the treatment of the question as being isolated from questions of UPSI and mental element disallows the answers till date to be wholly satisfactory. The SEBI at this hour, on this debate, thus needs to align ideas to provide an authoritative solution, which should follow the above pointers, while not treating this as an answer capable of being linear, but rather requiring elaborate definitions, trigger points as well as disclosure requirements apart from categorization of the stages of the transaction, with a focus on the precursor questions and all the while keeping

in mind the endeavour to protect the investors and develop the market.

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Cite this Article

Sanskriti Sanghi. To Be or Not To Be Included: Whether 'Trading' Includes 'Pledging' Under the Purview of the Prohibition of Insider Trading Regulations. *Journal of Corporate Governance and International Business Law*. May 2018; 1(1): 1–8p.