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Share pledges and margin call pressure☆

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ABSTRACT

It is common practice worldwide for corporate insiders to put up stock as collateral for personal loans. We highlight a potential problem in such pledging. When controlling shareholders face a margin call threat if stock prices fall below the required level for a loan, they have an incentive to use corporate resources for their private benefit. We develop and test a margin call hypothesis that controlling shareholders may initiate share repurchases to fend off potential margin calls associated with pledged stocks in order to maintain their control rights. Investors seem to recognize such behavior and discount the potential benefits of repurchase programs. However, share pledges are not reliably related to repurchases when control rights are not a concern. We further show that regulatory restrictions of control rights on pledging effectively reduce the likelihood of firms' repurchasing. Overall, our results shed light on the impact of share pledges on corporate decisions.

1. Introduction

It is not uncommon for company officers or directors to put up stock as collateral for a personal loan. According to a recent survey, 982 directors or officers in the United States reported pledging stock in 2006–2009 proxy statements; the average pledge amounted to 44% of total holdings (Larcker and Tayan, 2010). In India, insiders in more than 20% of listed companies pledged part of their holdings; in 2013 the pledges had a market value of US$25.8 billion (Press Trust of India, 2013). Given these nontrivial collateral amounts, stock pledges have attracted the attention of regulators and participants worldwide.[1] Yet, the personal share pledging by insiders, especially by controlling shareholders who control the firm and make important corporate decisions (La Porta et al., 1999),

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[1] Several markets, including India, Singapore, the United States, and the United Kingdom, started to require the disclosure of pledges by company insiders recently (U.S. Securities and Exchange Commission, 2006; U.K. Financial Services Authority, 2009; Securities and Exchange Board of India, 2009; Singapore Exchange, 2011).

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is underexplored. The academic literature is largely silent regarding how share pledges can alter controlling shareholders' incentives and subsequently affect corporate decisions. Our paper fills this void. In particular, our research proposes that controlling shareholders have incentives to initiate buyback programs for private benefits when they pledge stock.[2]

Controlling shareholders are prevalent in many countries. Anderson et al. (2009) find that 47.6% of the 2000 largest U.S. firms are controlled by founders or their heirs. Faccio and Lang (2002) find that 44.29% of publicly traded Western European corporations have an individual or a family that owns more than 20% of the outstanding shares. In East Asian economies, more than two-thirds of firms were controlled by a single shareholder in 1996 (Claessens et al., 2000). As the controlling shareholders dominate the corporate decision process and have a sufficiently large ownership (Claessens et al., 2002; Faccio and Lang, 2002), the pledging behavior of controlling shareholders may have a significant impact on corporate activities. Given that controlling shareholders are common in many countries, our paper is relevant for other economies.

Our motivation in examining the impact of share pledging stems from cases of forced sales that drew unfavorable publicity. For example, in May 2012, Robert Stiller, the founder and chair of a Nasdaq company, Green Mountain Coffee Roasters, was forced to sell 3.2% of his outstanding shares to cover margin calls on loans collateralized by his stock (Fontevecchia, 2012). He has since been removed as the board chair and lost his control over the firm.[3] Forced sales are driven by margin calls when the stock price falls below a certain level. In a margin call, if the borrowers do not deposit more funds or repay the loan, the lender can sell the pledged shares. If the amount of pledged shares sold is high enough, controlling shareholders could lose their control of the firm. Given the dire consequences of a forced sale of pledged shares, controlling shareholders may have strong incentives to use corporate resources in an attempt to avoid the margin call.

While controlling shareholders could avoid margin calls and forced sales in various ways, a company could buy back shares to provide price support or to prevent a further price drop.[4] One such example is Swift Transportation, one of the largest trucking firms in the United States. Its founder, CEO, and controlling shareholder, Jerry Moyes, pledged more than $600 million of shares (60% of his and family's holdings)—about a quarter of the outstanding Swift shares. Swift stock price tumbled 52% in 2015, creating enormous pressure in margin calls. The company thus announced consecutive stock buyback programs that totaled $250 million in late 2015 and early 2016 (Mann et al., 2016; Whelan, 2016) to relieve price pressure.[5] Swift's repurchasing activity is consistent with the view in the academic literature. For example, it is generally believed that open-market repurchases can be helpful to support a falling stock price (Cook et al., 2004; Ginglinger and Hamon, 2007). Managers tend to carry out repurchases when the stock price is low (Brav et al., 2005). Moreover, repurchase programs generally signal positive corporate information, such as undervaluation, and evoke positive market reactions (e.g., Ikenberry et al., 1995; Chan et al., 2004). Taking advantage of the positive market reactions to repurchases, some firms under enormous price pressure might initiate a buyback program only to send a false signal (Chan et al., 2010).

By linking personal share pledges to corporate repurchases, we propose a margin call hypothesis that controlling shareholders may initiate an open-market repurchase program in response to potential margin calls associated with share pledges to absorb the selling pressure. Controlling shareholders who face great margin call pressure would be more likely to buy back shares. Yet, as repurchases are used merely to support prices rather than to signal favorable information to the market, investors are less likely to revise their view of the stock in a positive way. As a result, the market reaction to pledge-related repurchase announcements, unlike the positive effects generally observed in repurchases, will be less favorable.

To test the margin call hypothesis, we employ a unique Taiwanese data set of share pledges by controlling shareholders from 2000 to 2015. In Taiwan, insiders in listed companies have been required to file information on shares owned and shares pledged on a monthly basis since 1997. More than 30% of controlling shareholders in Taiwanese firms have share pledges. As a result, we have sufficient share pledge data across the board to conduct empirical tests. We know of no other country with such comprehensive pledge data. The lack of data explains why academic research on pledging is limited.[6]

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[2] While it would be interesting to understand why controlling shareholders put up such collateral in the first place, testing the reasons shareholders pledge shares would require personal or demographic data that we cannot access.

[3] Similar cases of forced sales include ABC Learning Centers (listed in Australia) in February 2008, Carphone Warehouse (listed in the United Kingdom) in December 2008, Satyam Computer Services (listed in India) in January 2009, Sino-Environment Technology Group (listed in Singapore) in March 2009, and Achem Technology Corporation (listed in Taiwan) in 2009. A recent survey from Institutional Shareholder Services (ISS) shows that 49% of institutional shareholders thought that "any pledging of shares by executives or directors is significantly problematic" (Institutional Shareholder Services, 2012). The CFA Institute recommends the disclosure of share pledges by controlling shareholders and directors (CFA Institute, 2009).

[4] There are also alternative but indirect methods, such as earnings management or dividend increases, that might alleviate margin call pressure. We will discuss these alternatives in Section 5.

[5] Investors questioned whether the stock buyback plan was intended primarily to increase the value of Moyes's stake in Swift. Analysts also argue that the financial decisions made by Moyes contributed to the fact that, compared to its peers, Swift stock is often traded at a discount (Sirtori-Cortina, 2017).

[6] The prevalence of share pledging is also observed in developed countries, such as the United States. We hand- collect share pledge information from DEF 14A filings of S&P 1500 firms in 2012. Our search result shows that 19% of S&P 1500 firms had insider share pledging in 2012. More important, the average insider pledging across S&P 1500 firms is 7.1%, and 9.1% of these firms have insider pledging of more than 0.3 (i.e., high share pledging). These numbers are very close to the average share pledging of 7.6% in Taiwan and 9.3% of Taiwanese firms with high share pledging, respectively (see Table 1, Panel A). We also find that the average share pledging amounts to 37% for U.S. firms with insider pledging. As a result, even in the United States, many firms have share pledging by insiders, and the average pledging amount is quite significant for affected firms.