

Share Pledge Disclosures by Directors and Controlling Shareholders

A review of existing regulations and policy recommendations

by the Asia Pacific Office of the CFA Institute Centre for Financial Market Integrity

September 2009

In the past year, Asian markets have witnessed several cases of dramatic share price declines in companies where controlling shareholders and directors had pledged their shares to banks for margin loans. The practice of pledged shares and margin loans tends to be more prevalent in small and mid cap companies, in which founders and senior executives typically hold large stakes and free float is limited. Sometimes these parties utilize these loans for personal investments unrelated to the company's business. In a number of instances, pledged shares were forcibly sold into the market in order to meet margin calls, resulting in large share price declines, and at times resulting in a change in control of the company.

The disclosure of shares pledged and margin loans by directors and major shareholders ("pledgor") and by the parties providing the loans ("pledgee") is one area where disclosure requirements vary across the different jurisdictions in the Asia Pacific region. There are no requirements to disclose trigger points where shares pledged can be sold by the lender.

However, all markets are subject to continuous disclosure requirements and disclosure of material, price sensitive information. The directors of the company are responsible for determining whether information is price sensitive and then disclose it by making an announcement to the relevant stock exchange. In the case of pledged shares by directors, this can occur when the share price approaches the trigger point where lenders can exercise their right to sell the shares pledged for margin loans. This may result in further sell down of the shares by traders and investors.

This paper attempts to address the disclosure requirements in cases where directors and controlling shareholders have pledged their equity stakes in publicly listed companies as collateral for personal loans. If CFA Institute members are interested in this subject matter and would like to provide their input please contact us via email at cfacentre@cfainstitute.org.

Recent Cases in Asia Pacific

The following are summaries of three recent cases in Asia Pacific where the issue of pledged shares and margin calls had been widely reported:

Sino-Environment Technology Group (Singapore)¹

Sino-Environment Technology Group is listed on the SGX main board. The CEO, Sun Jiangrong, had secured loans against his entire stake (56.3 percent) but this information was not disclosed to shareholders until his loan default was announced in March 2009. His stake was reduced from 56 percent to 6 percent, and the share price fell more than 70 percent over the course of almost two months, from 29 cents to 8.5 cents (in Singapore currency). The forced sale led to a change in control at the company, as bondholders exercised their right to redeem a large outstanding bond from the company.

Satyam Computer (India)²

Satyam Computer is an Indian computer outsourcing company listed on the BSE and NSE in India, with ADRs listed on NYSE. B. Ramalinga Raju, 54, was the chairman of Satyam Computer and founded the company in 1987. On 16 December 2008, the directors of Satyam approved a proposal to buy two related companies - Maytas Infrastructure and Maytas Properties - for US\$1.6 billion cash consideration. After an analyst briefing on the same day, investors reacted by selling down shares in the US market; Satyam's share price fell 55 percent within a few hours of the announcement. According to filings with the US SEC, foreign investors owned 52 percent of Satyam as of March 2008. The deal was called off by the board of directors the next day.

Over the next 10 days, additional bad news drove the share price down further. The World Bank announced it had blacklisted Satyam and banned it from bidding for projects for 8 years. A non-executive director and an independent non-executive director of Satyam both resigned. Unknown to investors, Chairman Raju had pledged his stake in the company (about 8.6 percent in September 2008) to secure funding from a number of banks. Regulations in India at that time did not require making such disclosures. The lenders began to sell the pledged shares to meet margin calls and drove the price down further. As of 6 January 2009, Raju's stake was reduced to 3.6 percent.

The Satyam scandal took a further twist on 7 January 2009, when the chairman admitted to falsifying the company's accounts and mis-reporting profits and resigned. The company had reported US\$1.1 billion cash in September 2008 but actually only had US\$66 million at that time. SEBI responded to the Satyam episode by introducing regulations that require disclosure of pledged shares.

ABC Learning Centres (Australia)³

ABC Learning Centres was the world's largest childcare service provider and listed on the ASX. It was founded by Eddy Groves in 1988 when he opened a child learning centre in Brisbane. He then expanded throughout Australia and by 2008 also had a substantial presence in USA with over 1,000 child learning centres. At the start of November 2007, the share price was around A\$6.50. In February 2008, ABC released its half year results and announced a 42 percent drop in earnings, due to one-off charges and seasonal earnings. The CEO, Eddy Groves, owned 20 million shares at the time, or 4.3 percent. His wife owned another 3.5 percent stake. One other director, Martin Kemp, held another 10.4 million shares. The total shareholdings by directors amount to 50 million shares or 10.5 percent of shares outstanding. Institutional shareholders included Temasek with a 12 percent stake and Lazard Asset Management with about 11 percent.

In the February 2008 results release, the company also announced that it has secured a 3 year syndicated loan facility of A\$1.43 billion. However, ABC did not disclose that the loan had a debt covenant that required minimum shareholders funds of A\$2 billion. In order to fund their shares in ABC, some directors of ABC had also pledged their shares in ABC to secure margin lending arrangements.

Soon after the February announcement, another company, Allco Finance Group, announced that it had a market capitalization requirement attached to its bank debt, and it had breached this covenant. Rumors then spread that ABC Learning also had a similar debt covenant with a minimum of A\$2 billion market capitalization, and it may have breached this covenant. On 27 February 2008, the price of ABC Shares plunged 43 percent to close at A\$2.14, triggering a rush of margin calls on directors' holdings. Hedge funds, short sellers and day traders all got into the act and a massive 157 million shares changed hands that day. ABC Learning directors were forced to dump 26 million shares to meet margin calls. The shares were suspended at the end of the day. The company made an announcement that the directors still

beneficially owned 21.86 million shares, of which 21 million were held pursuant to margin lending arrangements.

ABC Learning went into receivership in August 2008.

Disclosure requirements for selected jurisdictions

The following table summarizes the various disclosure rules across different jurisdictions:

Disclosure Rules in Different Jurisdictions

Jurisdiction	Disclosure Requirements
SEC (US)	<p>Under section 229.403⁴</p> <ul style="list-style-type: none"> • <i>Security ownership of management.</i> Disclose shares beneficially owned by all directors. Show the total number of shares beneficially owned. Also calculate the percent of the class so owned if it is above 1 per cent. Indicate the amount of shares that are pledged as security • <i>Changes in control.</i> Describe any arrangements, including any pledge by any person of securities of the registrant or any of its parents, the operation of which may at a subsequent date result in a change in control of the registrant
Main Market, London Stock Exchange (UK)	<p>Under the Model Code⁵</p> <ul style="list-style-type: none"> • Prohibits dealings in company's shares by directors and other persons discharging managerial responsibility ("PDMR") during close periods (i.e. periods leading up to financial reporting) and other times when they have inside information • Director must get prior clearance from chairman or other designated director regarding share pledge <p>Under Disclosure and Transparency Rules ("DTR")⁶</p> <ul style="list-style-type: none"> • Director or PDMR must disclose transactions in company's shares in own account • On 9 January 2009, the Financial Services Authority ("FSA") confirmed that PDMRs must notify companies of transactions conducted on their own account such as pledges on shares⁷ • Company must inform the market (no later than end of business day following receipt of information by company) • FSA gave companies until 23 January 2009 to comply with this rule. No retroactive actions in respect of past failure to disclose⁸
Alternative Investment Market, London Stock Exchange (UK)	<p>Under AIM rules⁹</p> <ul style="list-style-type: none"> • Director must not enter into a share pledge during close period • Director must disclose to the company details of share pledges and the company must then disclose to the market
ASX (Australia)	<p>Under listing rule 3.1- Continuing Obligations¹⁰</p> <ul style="list-style-type: none"> • Disclose information that a reasonable person would expect to have a material effect on value of shares

	<ul style="list-style-type: none"> Listed entities must disclose the existence of any finance arrangements that may be in place in relation to directors' shareholdings (eg. margin loans) Disclose key terms of finance arrangements – not specified but can include number of securities involved, trigger points, right of lender to sell unilaterally, etc.
HKEX (HK)	<p>Under listing rule 13.17 – Continuing Obligations¹¹</p> <ul style="list-style-type: none"> Disclose if controlling shareholder¹² (30 percent or greater stake) has pledged shares to secure debts or guarantees of issuer. Must disclose <ul style="list-style-type: none"> Number and class of shares being pledged Amount of debts, guarantees or other support for which the pledge is made Any other details that are considered necessary for an understanding of the arrangements
SFO (HK)	<p>Under part XV¹³</p> <ul style="list-style-type: none"> Disclose interests of 5 percent or greater in shares of a listed company, including security interests Disclosure exemption if security interest held with qualified lenders (eg. banks or licensed brokers) Qualified lender must make disclosure when <ul style="list-style-type: none"> It becomes entitled to exercise voting rights in respect of the security interest as a result of a default; or The power of sale becomes exercisable and it offers the shares for sale
SGX (Singapore)	No specific rules under SGX listing rules or Securities and Futures Act
SEBI (India)	<p>Under SEBI Takeover Code regulation 8A (in effect from 28 January 2009)¹⁴</p> <ul style="list-style-type: none"> Promoter must disclose to company details of shares pledged within 7 working days Company must disclose to stock exchange if shares pledged exceeds 25,000 shares or 1 percent of the total shareholding or voting rights of the company, whichever is lower, on a quarterly basis.

Summary of disclosure standards

The current disclosure requirements in Asia Pacific are summarized below:

1. No specific regulations but companies are required to disclose if information deemed to be material and price sensitive under continuous disclosure requirements. This is the case in Australia. Under this scenario directors have the responsibility to decide if the information is material and needs to be disclosed to investors. They will then have to make an announcement to the stock exchange.
2. Specific regulations but only for controlling shareholders. This is the case in Hong Kong where controlling shareholders with an interest of at least 30 percent are required to disclose when shares are pledged to secure debts or guarantees. Details include the amount of debt against which the pledge is made, the number of shares pledged and information regarding debt arrangements.
3. Share pledgees (i.e. the institutions providing the loans) are required to make disclosure regarding their exercise of voting rights or power of sale upon loan default. This is the case in Hong Kong.
4. Specific regulations for promoters that are “event based”, i.e. at time of pledge; and periodic disclosures. This is required in India and the threshold is 25,000 shares or 1 percent of the total outstanding shares issued, whichever is lower. Aggregate information is also released on a quarterly basis.
5. There are no specific rules requiring the disclosure of trigger points for margin loans in any jurisdiction.
6. Requirements in USA are stricter than what is practiced in Asia. They require all directors to disclose details of shares owned, and number of shares pledged.

Recommendations and Policy Considerations

1. The Centre believes that continuous obligations under listing rules that require the directors to make a judgment call is inadequate given the number of small and medium sized companies in APAC that undertake the practice of share pledges for loans. These companies typically have a controlling shareholder who will decide when the information should be made known to the market. Secondly, as seen in a number of cases in Australia in 2008, the issue becomes material not when share prices are going up but rather when they plummet. As share prices reach trigger points, directors will have to disclose relevant information to investors which will drive the share prices down even further. Therefore, there should be specific regulations that require disclosure of share pledges at the time the shares were pledged, i.e. on an event basis.
2. The Centre recommends that there should be specific regulations in the listing rules for controlling shareholders and directors to disclose details of the shares pledged on an “event basis”. This will at least allow investors to make informed decisions and price in risk. In India, the threshold for such disclosure is 1 percent or 25,000 shares; whichever is lower. In Hong Kong disclosure only applies to a controlling shareholder. A controlling shareholder is one with 30 percent or greater voting power at a general meeting, or someone who is in a position to control the composition of majority of the board of directors.

The threshold for disclosure should consider the amount of shares pledged against the total issued shares of that class. Below are some examples.

- i. A director who owns 30 percent of the total shareholdings and pledges 100 percent of his shares would be considered material information for an investor as the director has 30 percent of issued capital at risk.
- ii. A director who owns 30 per cent and pledges 10 percent of his shares, effective has only 3 per cent of issued capital at risk.
- iii. A director who owns 3 percent and pledges 100 percent of his shares will also have only 3 percent of the issued share capital at risk.

Therefore the threshold should be based on the number of shares pledged as a percentage of the total issued shares. The information should then include number of shares pledged and number of shares pledged as a percentage of total issued capital. The Centre recommends a threshold of between 3 – 5 percent.

In addition there should also be disclosure of the amount of shares owned by the shareholder, director or controlling shareholder, and percentage of shares owned to total issued capital. Most jurisdictions would however already have a requirement to disclose shareholdings above a certain percentage; in Hong Kong and Singapore it is 5 percent.

We believe that a threshold of 1 percent might be onerous and burdensome for companies to comply with, and investors might not consider that this information would have a significant impact on share price even if it reaches the trigger point.

3. More detailed information such as trigger points for margin calls is important yet controversial. Certain traders and hedge funds might make use of the information at times of depressed market conditions and deliberately force the share prices down to trigger margin calls and benefit from the decline in prices. The Centre proposes against disclosing trigger points as part of shares pledge disclosure requirements. However, under continuous disclosure requirements, the board of directors of the company will have to make a judgment call under “material price sensitive information” and make an announcement as the share prices reach the trigger point and one of the directors has a substantial shareholding.
4. There are also default covenants and other relevant information to disclose that is being debated. The case of ABC Learning is a good example. In Hong Kong, controlling shareholders are required to disclose the amount of debts and guarantees for which the pledge is made. The CFA Centre does not have a prescriptive view of what additional information needs to be disclosed as part of regulatory requirements. This will have to be tailored to each market and CFA Centre will in cooperation with local societies determine what is appropriate in each jurisdiction. Companies should however, voluntarily disclose default covenants and other information that would be relevant to investors.

Endnotes

¹ Goh Eng Yeow, “S-chip firms in big trouble,” *The Straits Times* (9 May 2009)

² http://en.wikipedia.org/wiki/Mahindra_Satyam

³ http://en.wikipedia.org/wiki/ABC_Learning

⁴ <http://ecfr.gpoaccess.gov/cgi/t/text/text->

[idx?c=ecfr&sid=20c66c74f60c4bb8392bcf9ad6fcca3&rgn=div5&view=text&node=17:2.0.1.1.1.11&idno=17#17:2.0.1.1.11.5.31.1](http://ecfr.gpoaccess.gov/cgi/t/text/text-idx?c=ecfr&sid=20c66c74f60c4bb8392bcf9ad6fcca3&rgn=div5&view=text&node=17:2.0.1.1.1.11&idno=17#17:2.0.1.1.11.5.31.1)

⁵ FSA (<http://fsahandbook.info/FSA/html/handbook/LR/9/Annex1#D593>)

⁶ FSA (<http://fsahandbook.info/FSA/html/handbook/DTR>)

⁷ “Stop Press – disclosure of pledges over shares by directors and PDMRs of listed companies,” *Withers Worldwide* (26 January 2009) (<http://www.withersworldwide.com/news-publications/457/stop-press-disclosure-pledges-over-shares-by-directors-pdmrs-listed-companies.aspx>)

⁸ *Ibid.*

⁹ AIM Rules, LSE (<http://www.londonstockexchange.com/companies-and-advisors/aim/advisers/rules/aim-rules-for-companies.pdf>)

¹⁰ ASX Listing Rules (<http://www.asx.com.au/ListingRules/chapters/Chapter03.pdf>)

¹¹ HKEX, Rules Governing the Listing of Securities on the Stock Exchange of Hong Kong (http://www.hkex.com.hk/rule/listrules/Chapter_13.pdf)

¹² As defined in HKEX glossary (<http://www.hkex.com.hk/issuer/listhk/glossary.htm>)

¹³ Securities and Futures Commission, Legislation & Regulatory Handbook, Part XV Disclosure of Interests (<http://www.sfc.hk/sfcRegulatoryHandbook/EN/displayFileServlet?docno=H339>)

¹⁴ <http://www.sebi.gov.in/acts/sast28jan09.pdf>