Pledge or Not Pledge?
Shares Owned by Insiders Pledged for Collateral

Angela L.J. Hwang
Yu Qiao
Department of Accounting and Finance
Eastern Michigan University, Ypsilanti MI 48197, U.S.A.

Catherina Ku
College of Business
California State University-Monterey Bay, Seaside CA 93955, U.S.A.

Corresponding author: Angela L.J. Hwang, ahwang@emich.edu

ABSTRCT

In 2010, The Dodd–Frank Wall Street Reform and Consumer Protection Act directed the SEC to provide guidance in reporting pledging on shares that are owned by corporate insiders as collateral for a personal marginal account or loan. While the SEC has not made progress on the issue, the Institutional Shareholder Services (ISS) began in 2012 to encourage shareholders to vote "no" on directors if they pledge their corporate stock ownership as collateral. However, many constituents and other proxy advisory firms have voiced their concerns on ISS' anti-pledging recommendation. In the 2013 policy, the ISS modified its recommendation. This seemingly simple task on reporting shares pledged by insiders is not so straightforward after all.

This paper contributes to better understand the insider share-pledging issue and aims to provide objective and relevant information for policy makers such as the SEC, corporate board of directors, and management. Firstly, it summarizes massive amount of online publications and discusses pros and cons to educate the business community on this controversial issue. Secondly, it compares the insider share-pledging policy factors considered by major proxy advisory organizations and further synthesizes these factors into four groups: pledging policy, trading limit, risk monitoring, and regulation compliance. Firms can utilize the grouped list to develop a policy or to benchmark with their existing one. Thirdly, it analyzes surveys conducted by two major executive compensation and corporate governance consulting firms in order to understand corporate reaction on the issue and current business practices. Furthermore, FedEx's pledged shares disclosures and policies in its 2014 proxy statement are included in Appendixes as an example because it has elaborate discussions due to its the controversial nature and media's attention. Lastly, the paper compares the SEC's current pledging regulations in the U.S. with those of countries such as U.K., Australia, and China-Hong Kong and attempts to make policy recommendations to the U.S. SEC.

Keywords: Corporate governance, Insider pledged shares, Insider share-pledging, Collateral, Margin accounts

HEADLINES

Reading excerpts from the stories drawn from the major business media below, it is natural that readers conclude that pledging shares by insiders should be prohibited. Below are several examples of the consequences of pledging.

The first example from the *Wall Street Journal* (Bryan 2001) focuses on the dramatic impact that falling stock prices and margin calls had on an executive's personal wealth when the dot.com bubble burst.

> At a growing list of technology firms, executives who had borrowed money against their holdings of company stock have faced margin calls as their once-highflying share prices nose-dived.
>
> Many executives have been unable to meet broker demands to come up with additional cash or stock to cover the loans, or margins. Adding to previously disclosed problems at other tech companies, some of the firms whose executives were in this predicament include Answerthink Inc., NetSol International Inc., Safeguard Scientifics Inc., Stamps.com Inc., MP3.com Inc., eToys Inc. and Daleen Technologies Inc.
>
> Like many average investors, executives were astounded at how far the stocks fell, and how fast. Ulysses Knotts III, director and executive vice president of sales and marketing for technology-consulting group Answerthink, borrowed against his company holdings to help finance the purchase of a house in Atlanta, a second home in Colorado and other investments.
>
> By Nov. 1 [2000] the stock was at $15, down from its $40 peak in January. The shares plunged another 70% in November. Despite his attempts to pay down the debt, the stock continued to fall. When it dropped below $3 in December, Mr. Knotts says he was forced to sell 325,000 shares, or 23% of his holdings, valued at about $950,000. That is a stark contrast to the roughly $13 million he would have received had he sold those shares at their peak.

The second example from the *New York Times* (Abelson 2008) shows how sharp drops in the stock market during its collapse in 2008 led to disastrous margin calls for executives.

> When executives own big stakes in the companies they run, investors can rest a little more easily at night, knowing those managers have the shareholders' best interests at heart. Except when maybe they don't.
>
> As the staggering destruction of wealth in the stock market has recently revealed, executives can sometimes appear to own shares in a company, but have actually pledged them as collateral for a loan. And if there is a sharp drop in the stock's value, the executive may suddenly be forced to dump those shares, very likely adding to the stock's downdraft. And the other shareholders probably never saw it coming.
>
> As it turns out, while corporate insiders must disclose their comings and goings in their companies' shares, experts say there are no hard and fast rules requiring that the public be told when an executive has put a big block of shares at risk by borrowing against them.
>
> Already this month [October 2008], there have been about $1 billion in sales by company insiders dumping stock to meet margin calls, as

> lenders' demands for the stock sales are known. According to Equilar, an executive compensation research firm in Redwood Shores, Calif., executives at three dozen companies have disclosed such sales since October.

The third example from the *Wall Street Journal* (Casselman 2008) shows the impact of margin calls on a single individual insider stockholder that led to a disastrous drop in not just his wealth, but the company's overall capitalization.

> On Friday [Oct. 10, 2008], Chesapeake disclosed that Mr. McClendon, who is also chairman, had been forced to sell 31.5 million shares -- or 94% of his 5.8% stake -- to meet a margin call. Those shares, worth $2.2 billion when Chesapeake's stock hit $69.40 on July 2 [2008], were sold over three days last week for just $569 million. The stock closed at $16.52 Friday, down 76% from the July peak.

The final example from the *New York Time* (Eavis 2012) shows the impact of overzealous pledging not just on the executives' fortunes, but on their positions at the company as well as on the company's capitalization.

> Margin calls can be merciless, as the founder of Green Mountain Coffee Roasters has now found out. The founder, Robert P. Stiller, lost his post as chairman of the board on Tuesday after he sold five million shares, worth around $125.5 million, to pay off loans he had taken out against his sizable stock holdings in the company….Founders of companies often keep a large share of their wealth in the business that made them rich. But what's unusual about Mr. Stiller's case is the size of the loans he took out against his stake in Green Mountain. As of Jan. 26 [2012], 12.6 million of his shares, or 78 percent of his total personal holdings, were pledged as collateral against loans, according to a securities filing. At the time, the pledged shares would have been worth around $619 million.
>
> As the shares plunged, the banks have been able to force sales to ensure that their loans to Mr. Stiller stayed in line with the lower value of the shares. The selling weighed on the stock price, adding to the pain of other shareholders in the last week.
>
> The high level of loans taken out by Mr. Stiller raises important questions about how executives handle large stakes. Taking out loans against shares allows an executive to raise cash from a stake without actually selling it. But if the shares plunge, the resulting margin call may lead to an especially brutal wave of selling.

PLEDGING STATUS

Maxwell Murphy (2012), a senior editor at the *Wall Street Journal*, went through approximately 300 fillings on the SEC website and identified roughly 20 companies that disclosed that their executives or directors pledge their shares in margin accounts and dozens more companies that indicated their executives or directors pledge their shares for unexplained purposes.

According to Murphy's findings (see Exhibit 1) in 2012, Frederick Smith, founder and CEO of FedEx Corp., pledged $470 million of his shares, the largest amount disclosed among the reported, as collateral for a personal margin account. Cornelius Prior

Jr., founder and chairman of Atlantic Tele-Network Inc., had more than 20% of the company's total shares outstanding pledged to a personal margin account or as collateral for other loans. These individuals and other founders, CEOs, and directors listed below are the most impressive examples of people who put a large number of shares in their personal margin accounts or use them as collateral for other loans. It is not unlikely that many more unidentified company founders, co-founders, CEOs, and board members have at least some of their holding shares pledged in their personal margin accounts, probably many more than the public is aware of.

Exhibit 1: In from the Margin (Murphy 2012)

Company	Name	Role	Total shares owned	Shares pledged to margin or other loans	Value of shares pledged	Percentage of shares pledged	Shares pledged as a % of total shares outstanding
FedEx Corp.	Frederick W. Smith	Founder/Chairman/CEO	19,714,015	5,349,000	$469,642,200	27.10%	1.70%
Atlantic Tele-Network Inc.	Cornelius B. Prior Jr.	Founder/Chairman	4,485,070	3,121,611	$113,564,208	69.60%	20.12%
Discovery Communications Inc.	John S. Hendricks	Founder/Chairman	3,793,581	1,210,175	$62,190,893	31.90%	0.83%
Iron Mountain Inc.	Kent P. Dauten	Director	2,034,639	2,000,000	$61,880,000	98.30%	1.17%
Range Resources Corp.	John H. Pinkerton	Chairman	1,017,688	874,388	$58,618,972	85.90%	0.54%
Costco Wholesale Corp.	Jeffrey H. Brotman	Co-Founder/Chairman	721,718	626,702	$53,018,989	86.80%	0.14%
UnitedHealth Group Inc.	Douglas W. Leatherdale	Director	956,902	910,275	$50,247,180	95.10%	0.52%
CBRE Group Inc.	Brett White	CEO	1,547,452	555,310	$9,590,204	35.90%	0.17%
Dean Foods Co.	Gregg L. Engles	Chairman/CEO	2,717,867	629,338	$9,156,868	23.20%	0.34%
Perry Ellis International Inc.	George Feldenkreis	Chairman/CEO	2,328,226	459,600	$7,914,312	19.70%	2.92%
Marriott International Inc.	Arne M. Sorenson	CEO	1,722,825	195,221	$7,679,994	11.30%	0.06%
Eastman Chemical Co.	James P. Rogers	Chairman/CEO	748,106	150,398	$7,471,773	20.10%	0.11%

Sources: WSJ research; Securities and Exchange Commission.
Notes: *As of 5/11/2012 **Shares outstanding taken from latest 10-Q or 10-K

REGULATIONS AND PROXY ADVISORIES

It is common for companies to include equity in compensation packages to align the interests of management, directors, or employees with those of shareholders. These insiders may later want to pledge the company's shares that they own as collateral for a personal margin account or loan. Although title to these shares remains with the pledgor, the shares may be subject to sale if necessary to settle a margin call or the loan they collateralize. Among many reasons, pledging allows insiders who have a high concentration of wealth in their company stocks to purchase other assets and achieve financial diversification (Larcker & Tayan 2010). However, when the pledgors are the insiders, the situations can become tricky and potentially violate insider trading regulations.

Proxy advisors, consulting firms, and business media are very vocal about the issue and each has its own interest in forming an opinion. This section discusses the status of current regulation and views from major proxy advisory organizations. We then compares the insider share-pledging policy factors considered by these proxy advisors and synthesizes these factors into four groups: pledging policy, trading limit, risk monitoring, and regulation compliance. Firms can utilize the grouped list to develop a policy or to benchmark with their existing one.

SEC

Many companies may already have established policies to address the pledging of company stock. However, these policies are not be publicly disclosed because the SEC rules require disclosure only "to the extent these policies are material to an understanding of named executive officer compensation" (Gibson, Dunn & Crutcher LLP 2012). Currently, the SEC only require disclosures in the beneficial ownership table in the annual proxy statement about pledges by directors, director nominees, and named executive officers on a person-by-person basis, and by directors and executive officers as a group (SEC 2006). The SEC believed that these pledged shares "may be subject to material risk….These circumstances have the potential to influence management's performance and decisions. As a result, we [SEC] believe that the existence of these securities pledges could be material to shareholders." Appendix A presents a corporate reporting example in response to such a requirement. It is FedEx's (2014) pledged shares disclosures and policies published in its proxy statement. The elaborate discussions are due to its controversial nature and media attention.

Dodd-Frank Act

In the aftermath of the 2008 financial crisis, President Obama signed the Dodd–Frank Wall Street Reform and Consumer Protection Act into law in 2010 (U.S. Senate and House of Representatives 2010). The act requires the SEC provide rules for companies to disclose their policies related to hedging and pledging of company shares by employees and directors. However, the SEC has yet to propose rules in either area and the act does not prescribe deadlines for doing so (SEC n.d.).

Institutional Shareholder Services, Inc. (ISS)

While the reasons for the continued delays in the SEC's action are not clear, proxy advisors have been vocal about the issue. For example, Institutional Shareholder Services (ISS), a global company that provides advisories to corporations and updates to policies once every year, issued its initial recommendation in 2012 (but has since toned down its adamant recommendation).

ISS' *2012 U.S. Proxy Voting Summary Guidelines* stated that "Generally vote FOR proposals seeking a policy that ***prohibits*** [emphasis added] named executive officers from engaging in derivative or speculative transactions involving company stock, including hedging, holding stock in a margin account, or pledging stock as collateral for a loan" (ISS 2012, p. 52). ISS recommended companies to adopt the anti-pledging policy.

ISS continued to view pledging of company shares by executives or directors as "a problematic practice". However, in its *U.S. Corporate Governance Policy 2013 Updates,* ISS considered factors (summarized in Exhibit 2a along with those from other proxy advisors) in terms of its recommendations regarding the election of directors on companies which currently have executives or directors with pledged company stock (ISS 2013, pp. 4-5).

In its *2014 Updates,* the ISS was silent in the policy update regarding the pledging issue. Recently, its *2015 Updates* included only "significant pledging of company stock" in the footnote regarding material failure of risk oversight (ISS 2015, p. 3). Although ISS in general holds a negative view on pledging, its attitude towards the pledging of company share by executives and directors has softened greatly in recent years (Skroupa 2013).

Glass Lewis & Co.

Similar to ISS, Glass Lewis & Co., LLC is another leading proxy advisory firm. In it *2014 Proxy Voting Guideline*, Glass Lewis (2014, pp. 29-30) published its first recommendation on employee shares pledging, and repeated it in its 2015 publication. Perhaps it has benefited from learning different comments on the issue and has adopted a case-by-case approach that considers all relevant factors.

Towers Watson & Co.

While ISS and Glass Lewis specialize in corporate governance services, Towers Watson (TW), considered the world's largest employee-benefits consulting firm by revenue, consults on employee benefits (Wikipedia n.d.). TW does not publish annual proxy voting guidelines. Scott & Seelig (2013), two senior executive compensation experts at TW, rebutted ISS' initial 2012 "absolute" anti-pledging policies and countered with a list of factors to use when adopting "pledging policies that the board, shareholders and executives see as reasonable."

Insider Pledged Shares Policy Comparison among Proxy Advisors

We develop Exhibit 2a below to summarize the considering factors provided by the three proxy advisory firms or advisors. The numbers to the left of items in Exhibit 2a are the item orders listed in the original publications. In order to make a comparison, the exhibit uses ISS' factors as the benchmark. Across the same row, it then presents factors from the other two proxy advisors that share constructs similar to the ISS factor. As a result, we place all factors into the four groups indicated in the last column. Exhibit 2b presents the items included in each group, which can be used as a checklist when a company evaluates its pledging policy.

Group A can be labelled as the "pledging policy factor," containing qualitative attributes that are important for a clear policy on pledging. Group B can be considered as the "trading limit factor" to provide quantitative pledging assessment. Group C is the "risk monitoring factor" that keeps the pledging in check. Group D is the "regulation compliance factor" to ensure that the information provided in the Beneficial Ownership Table complies with the SEC's current regulation. Zions Bancorporation's proxy statement (2014, p. 36) in Exhibit 3 provides a good example that includes these four groups.

Exhibit 2a: Comparison of Considering Factors on Insider Pledged Shares Policy among Proxy Advisors

ISS (2013, pp. 4-5)	**Glass Lewis (2014, pp. 29-30)**	**Towers Watson (Scott & Seelig 2013)**	
1.* Presence in the company's proxy statement of an anti-pledging policy that prohibits future pledging activity	7. The company's current policies regarding pledging and any waiver from these policies for employees and executives	1. Reasonable limits on the purposes for which shares may be pledged (e.g., to purchase a home, pay children's educational expenses or help with medical or special nursing needs for aging parents)	A╪
2. The magnitude of aggregate pledged shares in terms of total common shares outstanding or market value or trading volume	6. The participation and eligibility of executives and employees in pledging	2. Reasonable limits on the amount of the stock that any one executive may pledge, set so that the total value of the shares all executives are allowed to pledge would be a small percentage of the market cap and daily trading value of the company's shares	B
3. Disclosure of progress or lack thereof in reducing the magnitude of aggregate pledged shares over time	4. The volatility of the company's stock (in order to determine the likelihood of a sudden stock price drop)	5. Pledging program oversight by the general counsel, who reports any infractions to the board.	C
4. Disclosure in the proxy statement that stock ownership and holding requirements do not include pledged shares	8. Disclosure of the extent of any pledging, particularly among senior executives	4. Excluding pledged shares from those counted toward satisfaction of the stock ownership guideline	D
5. Any other relevant factors	1. Whether there are different policies for purchased and granted shares	3. A prohibition on nonrecourse borrowing — the type of pledging most often seen in hedging activities	A
	2. Whether the granted shares were time-based or performance-based		A
	3. The overall governance profile of the company		A
	5. The nature and cyclicality, if applicable, of the company's industry		A

* Numbers indicate the orders listed in the original publications.
╪ Factor Groups, see Exhibit 2b.

Exhibit 2b: Factor Group on Insider Pledged Shares Policy among Proxy Advisors

A. Pledging Policy
ISS-1.* Presence in the company's proxy statement of an anti-pledging policy that prohibits future pledging activity
GL-1. Whether there are different policies for purchased and granted shares
GL-2. Whether the granted shares were time-based or performance-based
GL-3. The overall governance profile of the company
GL-5. The nature and cyclicality, if applicable, of the company's industry
GL-7. The company's current policies regarding pledging and any waiver from these policies for employees and executives
TW-1. Reasonable limits on the purposes for which shares may be pledged (e.g., to purchase a home, pay children's educational expenses or help with medical or special nursing needs for aging parents)
TW-3. A prohibition on nonrecourse borrowing — the type of pledging most often seen in hedging activities
B. Trading Limit
ISS-2. The magnitude of aggregate pledged shares in terms of total common shares outstanding or market value or trading volume
GL-6. The participation and eligibility of executives and employees in pledging
TW-2. Reasonable limits on the amount of the stock that any one executive may pledge, set so that the total value of the shares all executives are allowed to pledge would be a small percentage of the market cap and daily trading value of the company's shares
C. Risk Monitoring
ISS-3. Disclosure of progress or lack thereof in reducing the magnitude of aggregate pledged shares over time
GL-4. The volatility of the company's stock (in order to determine the likelihood of a sudden stock price drop)
TW-5. Pledging program oversight by the general counsel, who reports any infractions to the board.
D. Regulation Compliance
ISS-4. Disclosure in the proxy statement that stock ownership and holding requirements do not include pledged shares
GL-8. Disclosure of the extent of any pledging, particularly among senior executives
TW-4. Excluding pledged shares from those counted toward satisfaction of the stock ownership guideline

* Numbers indicate the orders listed in the original publications.

Exhibit 3: Zions Bancorporation 2014 Proxy Statement

SHARE OWNERSHIP AND RETENTION GUIDELINES
HEDGING AND PLEDGING POLICY

In 2009, we adopted share ownership and retention guidelines. These guidelines call for our executive officers either to hold common shares with an aggregate value equal to a multiple of their salaries, ranging from one to five depending on their position, or to retain shares equal to one-half of the net shares acquired through equity grants until they meet the ownership thresholds established in the guidelines.

In addition, our Insider Trading Policy was amended in 2013 to prohibit hedging and to place certain restrictions on pledging of Company stock by directors and executive officers. Under this policy, our directors and executive officers may ***pledge Company stock only with prior review and approval upon a demonstration that the pledge may be conducted prudently, without material risk to the pledgor or the Company*** [emphasis added]. The aggregate amount of securities pledged by all directors and executive officers may not exceed 5% of the total outstanding amount of the class of securities subject to the pledge. As of December 31, 2013, less than one-half percent of the Company's total outstanding common shares were subject to pledge by directors and executive officers. See the beneficial ownership table on page 57 of this Proxy Statement for additional information. The Compensation Committee reviews these pledging activities annually and may direct one or more pledgor to reduce their outstanding pledged positions if the committee believes it is necessary or advisable to reduce risk. Pledged stock is not included in amounts held by directors and officers to meet the Company's stock ownership and retention guidelines.

PROS AND CONS OVER PLEDGING

Unlike hedging, pledging may provide benefits. Perhaps, that is why the SEC is reluctant to make a black-and-white directive to outlaw pledging shares. *ISS Updates* tend to oppose share pledging. Those updates suggest the difficulty of implementing regulations of pledging shares. Pledging itself may not be simply defined as either good or bad since there are pros and cons concerning pledging discussed below.

Pros

Assets Diversification

Insiders can achieve financial diversification by pledging their shares for other investments and thus leveraging the outcome of their investment without changing the ownership of those shares. Pledging provides liquidity without having to sell the pledged shares. If the CEOs and directors need additional funds, pledging their company shares as collateral for a loan will be a better choice than selling them. When CEOs and directors need money and liquidate shares to raise it, they can cause the price of company shares to drop through stock dumping. By contrast, when CEOs and directors pledge their company shares as collateral instead of selling these shares when they need money, the action suggests the company shares may be undervalued (Larcker & Tayan 2010; Glass Lewis 2014).

Maintain Voting Rights

As title to pledged shares remains with the pledgor, insiders may need their shares to maintain control rights while taping into the liquidity provided by pledging shares (Chan et al. 2013).

Tax-Deferred Gain on Pledged Shares

Pledging can be a tax-planning tool because the tax on the gains from pledged shares is deferred. There are no tax charges when pledging shares to obtain additional funds since taxes on gains are due only upon sale of the shares (Larcker & Tayan 2010).

Tax-Effective Financing

Borrowing money through margin account by pledging shares as collateral is considered as a low cost and effective way for investors to get access to additional funds. Margin account holder can benefit from its flexibility and realize a tax deduction as well. A wealth management publication by Bingham, Osborn & Scarborough, LLC. (2004) states that:

> Margin borrowing can often serve as an extremely convenient and low-cost, tax deductible source of short term cash….Margin loans are floating rate loans, but without any specific maturity or due date, or minimum monthly payments….Margin interest is considered investment interest if it is incurred to either buy or hold investment securities, and as such may be taken as an itemized deduction for federal and state income tax.

Stimulate Economic Growth

Pledging shares into margin account as collateral increases the power of purchasing additional financial instruments or investing in new projects in general. Thus, capital mobility is higher when more money is borrowed and used to invest in new securities or projects. High capital mobility is one of the major ways to stimulate the economy growth. According to *Margin Trading and Misadjustment in the Open Economy*, the long term effects derived from trading on margin will be an increase in the domestic stock price and stimulation of the stock market (Huang n.d.).

Interest Alignment

Some argue that insiders' retention of shares they have been granted from compensation packages or insiders' further purchase of shares utilizing margin accounts align their interests with the interests of other shareholders and can maximize shareholder value to produce better returns (Scott & Seelig 2013).

Cons

Conflict of Interest

Glass Lewis (2014) indicates that the pledging of shares can present a risk: "An executive with significant pledged shares and limited other assets may have an incentive to take steps to avoid a forced sale of shares in the face of a rapid stock price decline. Therefore, to avoid substantial losses from a forced sale to meet the terms of the loan, the executive may have an incentive to boost the stock price in the short term in a manner that is unsustainable, thus hurting shareholders in the long-term."

Irresponsible Use of Company Equity

The examples of crises arising from margin calls discussed at the beginning of the paper show how a sudden forced sale of significant company stock may negatively impact the company's stock price, adversely affect other shareholders, and possibly contribute to market panic. In addition, selling the pledged shares outside the insider trading window may violate insider trading regulations (ISS 2013).

Increased Risk

Potential risks still exist depending on how the margin account holders are doing even when no margin call has been triggered. The risk increases when the number of pledged shares in the margin accounts goes up. Some investors may want to borrow more money from the brokerage company to purchase more stocks when they believe the stock prices are undervalued or they may irrationally want to increase their positions to make the phantom profits. The power of borrowing is unlimited as long as they keep pledging shares. Margin account holders such as chairpersons or CEOs who use their companies' shares as collateral might deposit more company shares they own when they borrow more from the broker. Although no damage to the stock market or the minority shareholders has happened yet, the public and retail investors unknowingly face the risk of prices dropping from the potential stock dumping (Skroupa 2013).

The margin account under this situation is much more price sensitive. A small percentage price drop may trigger a margin call because both the value of the holding position and collateral have decreased. If, unfortunately, these shares are forced to be sold because of a margin call, the multiplied selling can accelerate an overall price decline. This was the case with Chesapeake when Mr. McClendon, the CEO and chairman, was forced to sell almost all his pledged stock to meet margin calls leading to a price freefall in 2008 that wiped out more than half the company's market value (Carroll 2012). Anderson & Puleo (2015) and Chan et al. (2013) provide empirical evidence that insider pledging can increase firm risk.

BUSINESS PRACTICES

While the SEC has not issued the reporting rules required by the Dodd-Frank Act on hedging and pledging reporting, we try to understand corporate reaction to the issue and current practices by summarizing surveys conducted by two major executive compensation and corporate governance consulting firms: Meridian Compensation Partners LLC (Meridian 2014) and Compensation Advisory Partners (CAP 2014).

The surveys in Exhibit 4 provide some insight for 2011 through 2014. Although apples-to-apples comparison is challenging given different sample groups and the difficulty of deciphering the language, the surveys seem to suggest that the surveyed companies, by adopting pledging policies as a part of good governance, were responsive to the market information demand and anticipated regulation.

The <u>anti-hedging</u> policies have experienced an adoption rate above 90% in the most recent surveys suggesting that corporate America in general is on board with prohibiting employees to bet against their own companies. On the other hand, great strides have been made in ***pledging*** policy over the years. Meridian reported 54% of surveyed firms disclosed an anti-pledging policy in 2013 and the number increased to 66% for 2014. In particular, 88% among the 66% firms with disclosed anti-pledging policies further prohibited pledging shares, the remaining 12% permitted pledging of shares subject to approval by the board and/or management. We then further convert these numbers based on the entire Meridian 250 sample, 54.12% (= 66% × 82%) prohibited pledging shares and 11.28% (= 66% × 18%) required approval of pledging shares. Similarly, the 2013 survey by CAP reported 42.84% of its entire sample of 100 firms prohibited pledging shares and 12.60% required approval of pledging shares. Both survey data suggest that companies prefer to have their choice on the policy because only 54.12% (42.84%) of surveyed firms in Meridian (CAP) studies prohibited pledging of shares.

The implication for the SEC is that it is generally acceptable to ban insider hedging activities. However, it is appropriate to require firms to disclose their pledging policy instead of issuing a "one-size-fits-all" policy. In addition, Equilar (2013) provides more examples for firms with pledging practices that vary from "prohibited," to "permitted subject to approval," to "permitted without restriction." It also identifies some firms that did not discuss such a policy in their proxy statements. Equilar is a major provider of executive compensation data and shareholder engagement solutions.

Murphy (2012) from the *Wall Street Journal* has put FedEx under heat. FedEx has come a long way to discuss its pledging policy in its 2014 proxy statement shown in Appendices.

Appendix A: Beneficial ownership table and disclosures per SEC (2006) requirement
Appendix B: Hedging and pledging policy in Compensation Discussion & Analysis
Appendix C: Stockholder (Amalgamated Bank) proposal on hedging and pledging policy vs. the FedEx board's opposition to the proposal

Exhibit 4: Survey Summary of Pledging Practices by Meridian 250 and CAP 100

	Meridian	**CAP**
Last survey year	2014	2013
Number of firms surveyed	"Meridian 250"	100 of Fortune 500
Median revenues	$14.9 Billions	$32 Billions
Median market capitalization	$19.5 Billions	$52 Billions
Industry diversification	Yes	9 Industries
<u>Anti-hedging</u> policy disclosed	91% (2014) 82% (2013) 48% (2011)	95% (2013) 91% (2012)
Anti-Pledging policy disclosed	***66% (2014)*** 54% (2013)	***63% (2013)*** 59% (2012)
Prohibit pledging of shares in ***Anti-Pledging policy disclosed****	***82%***	***68%***
Prohibit pledging shares ***in the sample****	***54.12%***	***42.84%***
Required approval of shares in ***Anti-Pledging policy disclosed***	***18%***	***20%***
Required approval of shares ***in the sample***	***11.28%***	***12.60%***
Prohibit any shares subject to stock ownership guidelines to be pledged in ***Anti-Pledging policy disclosed***		***12%***
Prohibit any shares subject to stock ownership guidelines to be pledged ***in the sample***		***7.56%***

*Note: Meridian (2014) states that "Two-thirds (66%) of the Meridian 250 disclose that an anti-pledging policy is in place. Of these companies, 82% prohibit all pledging of shares, while 18% permit pledging of shares subject to approval by the board and/or management." Hence, in the entire sample of Meridian 250, firms which prohibit shares pledging is 54.12% (= 66% X 82%), in contrast to 11.28% (= 66% X 18%) require approval for pledging shares.

CAP (2014) states that "Anti-hedging and ***pledging*** [emphasis added] policies are in place at 95% and ***63%*** of companies studied, respectively…. Our analysis of pledging policies was broken down further to show that there are variations to prohibit ***pledging***. A company can ban all pledging (68% of companies with anti-pledging policies), prohibit pledging of shares unless an employee receives advance approval (20%) or prohibit any shares subject to stock ownership guidelines to be pledged (12%).” To compare the data with those of Meridian 250 above, we convert CAP’s percentages (68%-20%-12%) from the 63% of firms that disclosed an anti-pledging policy to 42.84% (= 63% X 68%), 12.16%, 7.56% respectively in terms of the entire CAP 100 sample.

Regulations in Other Countries

The pledged shares policies adopted by other countries discussed below show how the matter has been addressed elsewhere.

United Kingdom

The London Stock Exchange’s pledged shares disclosure regulations on top management’s transactions are much stricter than the SEC’s compensation amendment in the United States. The *Disclosure Rules and Transparency Rules* (DTR) issued by the Financial Conduct Authority (FCA n.d.), a financial regulatory body in the United Kingdom require an immediate and very detailed disclosure about any personal transactions with company shares.

DTR 3.1.2 states

> Persons discharging managerial responsibilities and their connected persons, must notify the issuer in writing of the occurrence of all transactions conducted on their own account in the shares of the issuer, or derivatives or any other financial instruments relating to those shares within four business days of the day on which the transaction occurred.

DTR 3.1.3 states

> The notification must contain the following information: (1) the name of the person discharging managerial responsibilities within the issuer, or, where applicable, the name of the_person connected with such a person; (2) the reason for responsibility to notify; (3) the name of the relevant issuer; (4) a description of the financial instrument; (5) the nature of the transaction (e.g. acquisition or disposal); (6) the date and place of the transaction; and (7) the price and volume of the transaction.

DTR 3.1.4 states

> An issuer must notify a RIS (Regulatory Information Service) of any information notified to it….The notification to a RIS must be made as soon as possible, and in any event by no later than the end of the business day following the receipt of the information by the issuer.

Alternative Investment Market (AIM) in the United Kingdom is an international stock exchange for smaller growing companies. According to AIM regulations, companies should disclose any non-public information that will cause the share price change if making the knowledge public without delay. Related party transactions including the name of the related party, the nature, the effect on the AIM company, and other related information, need to be disclosed to the public (AIM 2014). The highlight for the disclosure requirement is timely information dissemination.

Australia

Australia has listing company disclosure rules that concern top managers' funding arrangements, especially margin transactions that use company shares as collateral. The regulations require detailed information about the arrangements as well.

Listing rule 3.1 of the Australian Securities Exchange (ASX) requires companies to disclose immediately the information that "a reasonable person would expect to have a material effect on the price or value of the entity's securities." The *Companies Update* of listing rule 3.1 states (ASX 2008):

> Where a director has entered into margin loan or similar funding arrangements for a material number of securities, ASX advises that, listing rule 3.1, in appropriate circumstances, may operate to require the entity to disclose the key terms of the arrangements, including the number of securities involved, the trigger points, the right of the lender to sell unilaterally and any other material details.

The highlight for listing rule 3.1 is the disclosure of the trigger points for the arrangements. Hence, the public may be made aware of such risk and prepare for it.

China-Hong Kong

Chapter 13.17 of the *Main Board Listing Rules* of the Hong Kong Exchanges (HKEX 2014) states:

> Where the issuer's controlling shareholder has pledged all or part of its interest in the issuer's shares to secure the issuer's debts or to secure guarantees or other support of its obligations, the issuer must announce the following information as soon as reasonably practicable: (1) the number and class of shares being pledged; (2) the amounts of debts, guarantees or other support for which the pledge is made; and (3) any other details that are considered necessary for an understanding of the arrangements.

Although the rule does not have a clear list of what needs to be disclosed, it requires companies to ensure that the information be enough for the public to understand the arrangements for pledged shares.

Global Comparison

Exhibit 5 compares the rules and regulations for disclosing the shares pledged by a company's major shareholders in four countries—the United States, the United Kingdom, Australia, and China Hong Kong.

Obviously, the United Kingdom has the strictest rule on shares pledged by company executives. Compared with the United States, there are fewer problems caused by company shares being pledged by executives in the United Kingdom, which might be due to compliance with the regulation. However, two companies in the United Kingdom recently suffered from the news of executives pledging shares to margin accounts. Investors in the United Kingdom seem to have a negative view towards executives pledging company shares to margin accounts.

Exhibit 5: Global Comparison on Shares Pledging Disclosure

	U.S. SEC	London Stock Exchange	Australian Securities Exchange	Hong Kong Exchange
Name of the Insiders	X	X	X	
Position or Relationship	X	X		
Number of shares pledged	X	X	X	X
Financial Instrument description		X	X	X
Details of transaction		X	X	
Other important details			X	X
Disclosure within 1 business day		X		

IGas Energy Company's CEO pledged £10m of company shares as collateral for a personal loan. The public was afraid that the chief executive could be hit with a margin call and potentially sell all the shares; therefore, the stock price plummeted by 25% (Fortson 2014). The decreased stock price was not because the actual margin call, but the public's fear of the risk.

Quindell's board chairman and two directors used their company shares as collateral and borrowed money from Equities First Holdings to purchase more Quindell shares (Martin 2014). The stock price dropped 25.1% on the morning of Nov. 10th, 2014 after the company clarified the loan arrangement. The chairman missed the margin call and made the stock price decrease even further. In December, it is about $50 per share compared to the highest price of around $600 per share in April earlier in 2014. Again, the public's negative reaction caused the decrease in the share price, which triggered the margin call and led to the further decline of share price. Therefore, investors' potential reaction may be a factor that companies need to consider as well when deciding how and what to disclose in regards to the shares pledged by executives and board of directors.

In the United Kingdom, the London Stock Exchange posts news provided by Regulatory News Service (RNS) in regards to shares pledged by directors or executives. The news includes the name of the executive, the number of pledged shares, reasons for the loan, the potential payback time, and other detailed information if it is applicable (RNS 2014).

RECOMMENDATION

Several recommendations to the SEC flow logically from this review of share pledging.

Disclosure of Pledging Policy

Surveys have shown that companies are responsive to the market information demand and voluntarily disclose pledging policies as a good governance practice. However, pledging policies vary from "prohibited," to "permitted subject to approval," to "permitted without restriction." Instead of issuing a one-size-fits-all policy, the SEC could consider requiring companies to adopt a clear pledging policy disclosing whether they permit executives and directors to pledge company shares as collateral. If shares pledge is allowed, the following items (as suggested in Exhibit 2b) need to be disclosed as well:

- Which groups of employees are allowed to pledge
- Whether there is a upper limit on the total value of shares that can be pledged and what the limit is
- Whether the pledging needs to get the approval
- What types of the instrument are permitted or prohibited
- The frequency of updates

We believe the market would welcome the pledging policy disclosure mandate. However, firms discuss the policy in various places such as insider trading policy, corporate governance policy, and/or compensation discussion in analysis ("CD&A") in proxy statement. The SEC is also encouraged to provide specific guideline as to where the policy should be disclosed so that related information such as hedging policy and insider trading policy can be presented with consistency and coherence.

Expansion of Beneficial Ownership Table

The current compensation disclosure table under Item 403 of Regulation S-K (Security Ownership of Certain Beneficial Owners and Management) can be expanded to include the pledging information as summarized in Murphy (2012) and shown below:

Exhibit 6: Suggested Pledging Information

Name of beneficial owner	Role of the insider	Total number of shares owned	Total number of shares pledged	Shares pledged as % of holding shares	Total value of shares pledged	Shares pledged as % of total shares outstanding
Current Beneficial Ownership Table			**New** Pledging Information			

The note to the table can provide details of the margin accounts including the instruments' types and timeline, the time and place for the pledge, and other more-detailed information about the pledge. For example, the dollar value, the trigger point of the transaction, as well as potential exposure to liability that could result from pledges and sales of shares by the lender when margin calls go unsatisfied. However, if only few insiders are involved in pledging, the current footnote disclosure on the limited number of individuals should suffice.

Discussion of Material Pledging Status

In India, pledging shares that exceed 1% of total shares outstanding or pledging 25,000 shares (whichever is lower) is considered material. According to the Asia Pacific Office of the CFA Institute Centre for Financial Market Integrity, a total pledge of 3-5% of shares outstanding is the threshold (CFA 2009). Companies can disclose the implications should an individual executive or director pledge more than 1% of total shares outstanding or if the groups' total pledged shares go over 3%. However, companies can decide their own thresholds based on this by preparing a stockholder proposal for voting under proxy statement.

Frequency of Updates

Quarterly-Company can require the insiders to complete a questionnaire on a quarterly basis to collect the information about the pledged shares and discuss the issue on 10-Q.

Monthly-Insiders of listed companies in Taiwan are required to file monthly reports of the number of shares owned and shares pledged since 1997. Companies can be encouraged to provide monthly updates as in Taiwan's practice (Chan et al. 2013, page 11).

Timely Update-Similar to companies listed in the London Stock Exchange, insiders can be required to disclose within four business days any information on pledged shares that may affect the company's share price. Any urgent or material information in regard to the pledged shares, especially in the margin account, can be disclosed through a timely press release within one business day as soon as the company receives feedback from the insiders.

Companies can decide the frequency of the updates by releasing a proposal to the stockholders for voting. Whatever the frequency of updates the companies choose to follow, companies are encouraged to discuss it under the pledging policy.

CONCLUSION

Corporate insiders have long pledged their corporate stock ownerships as collateral for marginal accounts. This is the first academic paper examining the topic comprehensively in the hope of educating the business community on this seemingly simple yet controversial issue from an independent and objective perspective. It is understandable that business headlines tend to focus on the downfall when marginal calls force a sale, and this factor may or may not further cause the stock price to decline. However, there are also benefits when insiders pledge their personal corporate shares instead of selling them outright: the practice can increase liquidity and stimulate the economy at a macroeconomic level, it can align shareowners' interests at a microeconomic firm level, and can provide asset diversification and tax management at a personal level. For a market-directed economy like the U.S., the SEC understandably hesitates to outlaw the pledging practice. Proxy advisors, consulting firms, and business media are very vocal about the issue and each has its own interest in forming an opinion.

Expanding from the initial understanding of the pledging issue, the paper also synthesizes the recommendations that various constituents have made on pledging policies. With our critical evaluation and analysis, we find companies responsive to shareholder concerns and continue to progress by learning from best practices provided by a multitude of professional advisors without the SEC's regulatory intervention.

A chaotic market outburst in demanding the outlaw of pledge practices has moderated to a reporting equilibrium. It is uplifting to witness good business practices developed ahead of regulation mandates. Hence, we also synthesize pledging policies in other countries and make our policy recommendation to the SEC and corporate America to enhance current insider pledged shares reporting.

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