PRIME

Pledging of Shares by Promoters of Family Firms in India: Regulatory Concerns and Recommendations

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Introduction

The practice of pledging of shares has existed in the Indian financial system for a long time. However, it gained significant disrepute during the Satyam Corporate Governance scandal in 2009. Since then, the Securities and Exchange Board of India (SEBI) mandated the promoter shareholders of firms to declare their pledging activities to the stock exchanges within seven days.

Regulatory bodies such as SEBI and RBI have continually highlighted their concerns around pledging. As pledging-induced corporate governance scandals have seen stock prices plummet, investors too have called for pledging to be curtailed via the introduction of stringent regulations. Academics and corporate governance experts have associated share pledging with several detrimental firm-level outcomes. Some of these concerns are highlighted below.

Concerns

Health of the financial system: In India, financial institutions have seen a considerable rise in their exposure to debt backed by pledged shares in the past decade. Often, the asset cover set by lending institutions may be too small to cover the price risk associated with shares as collateral. Where pledging loans are non-recourse (i.e., the borrower is not personally liable for the loan apart from the provision of collateral), there is a possibility of the lender not recovering the principal amount in the event of a sudden downturn in the stock price and loan default.

Loss of control of the firm for controlling shareholders: In the hunt for wealth diversification and legacy building, controlling shareholders may be tempted to over-pledge their shares with a lack of provisions to repay the loan or answer margin calls. There have been numerous instances where margin calls have led to controlling shareholders losing control of the firm. These disruptions result in a significant loss in market capitalization of the firm and raise considerable doubt over its future.

Underinvestment in innovation and risk-aversion: While innovation is a strategic driver of long-term growth and firm value, investment in innovation is much riskier than the firm's *business-as-usual* activities. Post pledging, there may be a strong incentive for the promoters to underinvest in R&D activities to reduce the possibility of future margin calls.

Impact on accounting practices: To reduce the risk of a decline in the firm's share price and subsequent margin calls, promoters may attempt to falsely present a positive picture of the firm. Consequently, firms where controlling shareholders pledge shares have a higher propensity to indulge in inferior accounting practices such as earnings management and choose lower-quality auditors to continue earnings management and navigate through the regulatory requirement of a financial audit.

Decline in Firm Value: Following a share pledge by a controlling shareholder, increased risk-aversion and a rise in the firm's equity risk is likely to contribute to a decline in firm value in the longer term. Thus, while insiders pledging shares receive benefits in the form of a loan, outsiders must face a decline in firm value with no associated upsides, if the loan amount is not used for the same firm and with a judicious strategic plan.

Theoretically, there is a divergence in risks and rewards of the promoters who pledge their shares and other shareholders of a firm. This may act as an incentive for the promoters to pledge their shares despite all the concerns mentioned above. In the next section, the authors enumerate a few recommendations for the regulators that should help minimize the negative impact of pledging, while retaining the tool to access funds when in need.

Recommendations

Awareness and information dissemination: Despite concerns from all quarters over the negative implications of pledging, SEBI has indicated that it does not intend to prohibit the pledging of shares. SEBI believes that it should be the right of the owner of equity to decide the best possible way of utilizing it. Hence, given its positioning as a relatively accessible form of financing for shareholders, pledging of shares is expected to remain in the financial markets as a popular form of raising capital. Moving forward, it is critical for the regulators to create awareness and disseminate information about pledging of shares to all key stakeholders (including minority shareholders and financial institutions).

Integration and standardization: As of now, the disclosures on pledging by promoters to SEBI and the information available to RBI regarding the lending by financial institutions are not integrated. Both the regulators should jointly seek information from the promoters and disseminate the information in a consolidated manner to the investors. In addition, rules surrounding adequate cover for share pledges (and provision of the maintenance margin) must be standardized and ensured that they are implemented across all financial institutions uniformly.

End-use of pledging capital: SEBI has been considerably proactive in monitoring the pledging of shares and introducing stricter regulations around the same. We feel that these are steps in the correct direction. However, disclosure of the reasons for pledging must be mandated against all share pledges irrespective of the size of the pledge to further protect the interest of the minority shareholders. SEBI must actively mandate the precise destination of the funds obtained through pledging, as several promoters provide vague reasons for pledging in the disclosure reports.

Control and cash flows: In an ideal scenario, the associated risks, returns and control should be homogenous across the firm's shareholders. That is, the promotors, institutional investors and the retail investors should receive returns (in the form of capital gains and dividends), face risks and exercise control in accordance with the size of their shareholding in the firm. However, pledging may alter this homogeneity associated with stock ownership. While the shares are used as a collateral to raise funds, the promoters continue to enjoy all cash flows associated with those shares as well as their control and voting rights. In a way, this incentivizes the promoter to pledge their shares since there is no immediate negative consequence of doing so.

While, in a situation where the firm is close to default or needs immediate cash, the promoters might have no choice but to use pledging as a tool to access immediate capital, the promoters should have a plan to pay back the loan to the financial institution. Checks and balances are required to ensure that due to asymmetry of information, the promoters do not "cash out" of firms in distress leaving the financial institutions (lenders) and other shareholders to take the fall. A negative spiral in the stock price will most significantly impact the minority shareholders and leave the lenders with a collateral that may not cover the value of the loan extended. Such divergence can be checked by the SEBI by bringing in clauses such as deferred dividend payments until the shares are pledged or suspending the voting rights in proportion to the extent of shares pledged.

Guidance to the board: The role of the board of directors is critical in the event the promoters pledge their shares due to its far-reaching implications. The Ministry of Corporate Affairs may stress of the benefits of an empowered board of directors. It may also lay out the responsibilities of the board if a promoter wants to pledge its shares. The directors must caution the promoters from over pledging and should shield the firm from the promoters if they try to manage the margin calls by taking hasty or short-term view decisions in the firm. In addition, the board of directors should also evaluate if pledging is indeed the best option for the firm. Independent directors to be more vigilant and check that decision making at firm level is not impacted. In addition, they should be made more accountable for lack of carrying out their fiduciary duties.

Guidance to promoters: The Companies Act should also detail the expectations from the promoters when deciding to raise capital via pledging, viz. the promoters should be cognizant of the risks that this form of financing carries, the promoters should be reasonably confident of the cash-flow generation abilities of the investments made by them in the future. Overtly wishful and hopeful thinking by promoters without due diligence has indeed impacted many business barons in making over-optimistic bets. Also, the impact of variations in stock price of the firm observed in the short-term on the pledging contract should be manageable. The promoter should also have a contingency plan to answer margin calls made to the firm and they should disclose it to SEBI.

Compliance: Disclosure by the promoters and the companies should be monitored stringently with strict action for delays and non-compliance. For a better governed and efficient running of the market, there must not be any slip between the cup and the lip.

Conclusion

When we study individual cases of pledging of shares, we find that in conjunction with bad business decisions, pledging has had dire consequences for the promoters and other stakeholders. Such companies are many. They include Satyam, Future Group, and Zee Entertainment. However, there are also companies that have created long-term wealth for all shareholders by using pledging as a strategic tool to raise funds for expansion and growth. Examples include Apollo Hospitals and Granules Pharmaceuticals.

Therefore, all cases of pledging of shares should not be painted with the same stroke of negative. Rather, responsible pledging should be promoted, with appropriate checks and balances, transparent motivations to pledge, and a plan to revoke the pledge.