

Margin Trading Dangers Highlighted by Real Cases

Several high profile company share price collapses on the Australian Stock Exchange early in 2008 highlight the danger posed to ordinary shareholders from large scale margin trading of shares by directors of listed firms. So dramatic have been the consequences that no equities investor can afford to ignore the lessons.

Significant shareholdings by directors in a listed company have traditionally been viewed favourably as an alignment of executives' and other private shareholders' interests, but this ideal can be dramatically compromised in cases where those large shareholdings have been aggregated through, and remain security for, margin loans. Directors leveraging into positions well beyond their capacity to meet margin calls may create a known and acceptable risk for themselves but their actions inescapably also create a significant but hidden and usually unsuspected risk for other shareholders.

On exposure in a falling market, the consequences can be devastating to all concerned.

Basically margin trading involves borrowing through a brokerage to purchase shares on deposit with the shares purchased being held as collateral for the loan. As with all leveraged investments the potential for both amplified profits and losses exists, but particular additional risks attach to margin trading of shares.

Depending on the particular share being purchased and subject to other margin account criteria such as maintenance of a minimum balance, a private investor may be able to borrow, say, 50% of the purchase price with the margin agreement stating that the 50% loan to collateral value must be maintained at all times – hence a 50% margin applies. For the same share, a company director may be in a position to negotiate a higher loan to security value, say 80%, owing to the director's perceived influence on the company and the scale of business such a purchase will bring to the margin broker. Thus the director's margin is only 20%.

As with a used car buyer owing a finance company for the bulk of a purchase rather than the car dealer with whom the deal is done, the margin share trader actually remains ultimately beholden to a margin financier, quite likely a major bank, rather than the margin broker through whom the transaction is conducted.

While the director's purchase must be reported to the stock exchange under the listing rules, potentially devastating financial arrangements behind it can remain hidden from public view.

Let us now consider the case where a director borrows 80% of the purchase price of one million \$10 shares through a margin broker. Borrowings amount to \$8 million with \$2 million "equity" being put up by the director to complete the \$10 million purchase.

Furthermore, the margin trading agreement states that a minimum 80% loan to collateral value must be maintained at all times.

Initially the shares purchased provide all the security required by the broker and even excess security if the share price rises, possibly allowing a partial sale at profit by the director. However, even a modest share price decline of 10% to a market value of \$9 per share will reduce the director's holding of 1 million shares to a value of \$9 million, but still carrying the \$8 million debt and therefore breaching the 80% covenant. The director, having already sacrificed \$1 million of his original \$2 million stake (a 50% loss) will then be served with a "margin call" for a further \$1 million to re-establish the original loan/asset ratio. Failure to meet the call will invoke conditions allowing the margin broker to sell some of the holding to re-establish the required 80% figure.

In this case a sale of 333,333 shares at \$9 would see the loan reduced by \$3 million, to a total outstanding of \$5 million, against which the director's \$1 million remaining "equity" would restore the required 80/20 loan to asset value ratio. Importantly, the share price would now have to recover by \$1.50, to \$10.50, for the director to recover his initial investment.

A fall of just 20% in the \$10 share price to \$8 would see the director's initial \$2 million equity wiped out altogether and, in the absence of any margin call being met, the broker would very likely dump the entire holding at best price to minimise losses. Apart from sheer pressure of volume, attendant negative publicity through stock exchange disclosure requirements would probably see the company's share price devastated even though the company may remain as a viable enterprise. Any shortfall in recovery by the broker through sale of shares held as collateral would remain a liability against the director.

In this situation private shareholders become unsuspecting victims of a risk they didn't even know existed.

This scenario is far from academic. In a number of now salient Australian cases, dumping of directors', executives' and related party holdings have indeed seen share prices slashed, stock exchange listings suspended, directors and executives lose their jobs with their entire company shareholdings wiped out. Residual personal liabilities are suspected of being huge in some cases. Consequently, private investors have also suffered massive write downs in the value of their own holdings.

Needless to say, any company subject to such a fate will find it nearly impossible to raise fresh equity capital and will pay heavily for debt – particularly in today's credit crunched world. Assuming the enterprise can remain solvent, aggressive sale of assets becomes the most logical choice to fund a restructuring program.

Private investors engaged in margin trading the same company may well suffer a similar fate to the directors, albeit without a loss of employment.

A more detailed case study is available through the resource link.

As the case study points out, effects of a major margin call default can be widespread and devastating, seriously affecting even secured investors in related companies.

So how should the private investor guard against such an unwelcome outcome to a seemingly quite reasonable investment?

As we have discussed, potentially damaging margin trading by directors and executives can be difficult to detect, but some clues may be available through stock exchange announcements. Better still, just ask the Company Chairman through private correspondence or at the Shareholder's Annual General Meeting. Companies able to report a clean slate in respect of such activities are likely to be happy to do so. Investigate the others.

In one recent case it turns out that not only were directors purchasing shares on margin for their own accounts but were also margin trading other listed shares with shareholders' funds in the Company's name. Needless to say the Company and its shareholders soon lost many millions of dollars once markets suffered a modest reversal.

For the private investor, good advice is to avoid margin trading through a margin broker altogether. This, however, does not completely exclude the leveraged purchase of shares which remains a valid investment strategy under certain circumstances. It does, however, place vital separation between financier, sharebroker and shareholder.

In one recent Australian margin trading case, some private investors reportedly had their entire nominee-held share portfolios seized and sold to recompense the margin financier, a major bank. When the margin brokerage house collapsed, private investors were left as unsecured creditors of the failed broker. Prospects of recovery from this position would be dim indeed.

At a time when ever more complex means of trading traditional share markets are being developed, such as options, short selling, stock borrowing and margin trading, investors need to recognise that new opportunities for exceptional profit also bring exceptional new risks. Some may well be hidden behind a cloak of "immateriality" even though potential consequences could be disastrous.

In summary, private investors can minimise exposure to margin trading risk by taking a few precautions:

- Treat very fast growing companies with caution. These companies and their high profile directors seem most susceptible to the allure of big rewards offered by serious margin trading while overlooking the exceptional risks posed to both themselves and others.
- Examine available stock exchange announcements and news to unearth margin trading practices relating to major shareholdings, including those

of directors, executives and related parties. These may be difficult to find and interpret, but they do exist.

- Simply ask the Company Chairman if Directors and Executives or even the Company itself, is involved in margin trading the company's own shares – if the answer is yes, stay away.
- Also ask if shareholders' funds are being used to margin trade any other company's shares – hidden danger lurks there too.
- Avoid personal use of margin share trading accounts altogether – borrow elsewhere if you intend to use leverage for share purchases.
- Ensure any shares you purchase on leverage are registered in your own name to avoid the possibility of seizure by a higher ranking creditor should your sharebroker's business collapse.

Eventually disclosure of margin trading by company directors, executives and related parties may become mandatory under stock exchange listing rules, but until that time equity investors will need to include "margin trading risk" as yet another factor for their own determination.

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