Purchasing on Margin, Risks Involved with Trading in a Margin Account

We are issuing this investor guidance to provide some basic facts to investors about the practice of purchasing securities on margin, and to alert investors to the risks involved with trading securities in a margin account.

Use of Margin Accounts

A customer who purchases securities may pay for the securities in full or may borrow part of the purchase price from his or her securities firm. If the customer chooses to borrow funds from a firm, the customer will open a margin account with the firm. The portion of the purchase price that the customer must deposit is called margin and is the customer's initial equity in the account. The loan from the firm is secured by the securities that are purchased by the customer. A customer may also enter into a short sale through a margin account, which involves the customer borrowing stock from a firm in order to sell it, hoping that the price will decline. Customers generally use margin to leverage their investments and increase their purchasing power. At the same time, customers who trade securities on margin incur the potential for higher losses.

Margin Requirements

The terms on which firms can extend credit for securities transactions are governed by federal regulation and by the rules of FINRA and the securities exchanges. This investor guidance focuses on the requirements for marginable equity securities, which includes most stocks. Some securities cannot be purchased on margin, which means they must be purchased in a cash account, and the customer must deposit 100 percent of the purchase price. In general, under Federal Reserve Board Regulation T, firms can lend a customer up to 50 percent of the total purchase price of a stock for new, or initial, purchases. Assuming the customer does not already have cash or other equity in the account to cover its share of the purchase price, the customer will receive a margin call from the firm. As a result of the margin call, the customer will be required to deposit the other 50 percent of the purchase price.

The rules of FINRA and the exchanges supplement the requirements of Regulation T by placing "maintenance" margin requirements on customer accounts. Under the rules of FINRA and the exchanges, as a general matter, the customer's equity in the account must not fall below 25 percent of the current market value of the securities in the account. Otherwise, the customer may be required to deposit more funds or securities in order to maintain the equity at the 25 percent level. The failure to do so may cause the firm to force the sale of—or liquidate—the securities in the customer's account in order to bring the account's equity back up to the required level.

Margin Transaction—Example

For example, if a customer buys $100,000 of securities on Day 1, Regulation T would require the customer to deposit margin of 50 percent or $50,000 in payment for the securities. As a result, the customer's equity in the margin account is $50,000, and the customer has received a margin loan of $50,000 from the firm.

Assume that on Day 2 the market value of the securities falls to $60,000. Under this scenario, the customer's margin loan from the firm would remain at $50,000, and the customer's account equity would fall to $10,000 ($60,000 market value less $50,000 loan amount). However, the minimum maintenance margin requirement for the account is 25 percent, meaning that the customer's equity must not fall below $15,000 ($60,000 market value multiplied by 25 percent). Since the required equity is $15,000, the customer would receive a maintenance margin call for $5,000 ($15,000 less existing equity of $10,000). Because of the way the margin rules operate, if the firm liquidated securities in the account to meet the maintenance margin call, it would need to liquidate $20,000 of securities.

Firm Practices

Firms have the right to set their own margin requirements—often called "house" requirements—as long as they are higher than the margin requirements under Regulation T or the rules of FINRA and the exchanges. Firms can raise their maintenance margin requirements for specific volatile stocks to ensure there are sufficient funds in their customers' accounts to cover large price swings. These changes in firm policy often take effect immediately and may result in the issuance of a maintenance margin call. Again, a customer's failure to satisfy the call may cause the firm to liquidate a portion of the customer's account.

Margin Agreements and Disclosures

If a customer trades stocks in a margin account, the customer needs to carefully review the margin agreement provided by his or her firm. A firm charges interest for the money it lends its customers to purchase securities on margin, and a customer needs to understand the additional charges he or she may incur by opening a margin account. Under the federal securities laws, a firm that loans money to a customer to finance securities transactions is required to provide the customer with written disclosure of the terms of the loan, such as the rate of interest and the method for computing interest. The firm must also provide the customer with periodic disclosures informing the customer of transactions in the account and the interest charges to the customer.

Loans from Other Sources

In some cases, firms may arrange loans for customers from other sources, and there have been instances of customers making loans to other customers to finance securities trades. A customer that lends money to another customer should be careful to understand the significant additional risks that he or she faces as a result of the loan, and needs to carefully read any loan authorization forms. A lending customer should be aware that such a loan may be unsecured and may not be eligible for protection by the Securities Investor Protection Corporation (SIPC). The firm may not, without direction from the borrowing customer, transfer money from the borrowing customer's account to the lending customer's account to repay the loan.

Additional Risks Involved With Trading on Margin

There are a number of additional risks that all investors need to consider in deciding to trade securities on margin. These risks include the following:

- You can lose more funds than you deposit in the margin account. A decline in the value of securities that are purchased on margin may require you to provide additional funds to the firm that has made the loan to avoid the forced sale of those securities or other securities in your account.

- The firm can force the sale of securities in your account. If the equity in your account falls below the maintenance margin requirements under the law—or the firm's higher "house" requirements—the firm can sell the securities in your account to cover the margin deficiency. You will also be responsible for any short fall in the account after such a sale.
- The firm can sell your securities without contacting you. Some investors mistakenly believe that a firm must contact them for a margin call to be valid, and that the firm cannot liquidate securities in their accounts to meet the call unless the firm has contacted them first. This is not the case. As a matter of good customer relations, most firms will attempt to notify their customers of margin calls, but they are not required to do so.
- You are not entitled to an extension of time on a margin call. While an extension of time to meet initial margin requirements may be available to customers under certain conditions, a customer does not have a right to the extension. In addition, a customer does not have a right to an extension of time to meet a maintenance margin call.

It is important that investors take time to learn about the risks involved in trading securities on margin, and investors should consult their brokers regarding any concerns they may have with their margin accounts

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