

STOCK STRATEGIES

Margin Accounts: A Double-Edged Sword

By John Gannon

Every month, investors borrow considerable sums to purchase securities “on margin.” In January of 2005, the amount of debt taken on to buy securities exceeded \$200 billion.

The use of leverage magnifies an investor’s returns on the upside, but also magnifies losses on the downside.

NASD has written this article because we are concerned that many investors underestimate the risks of trading on margin and misunderstand the operation and reason for margin calls. Investors who cannot satisfy margin calls can have large portions of their accounts liquidated under unfavorable market conditions. These liquidations can create substantial losses for investors.

Before you decide to open a margin account, make sure you understand the following risks:

- Your brokerage firm can force the sale of securities in your accounts to meet a margin call;
- Your firm can sell your securities without contacting you;
- You are not entitled to choose which securities or other assets in your accounts are sold;
- Your firm can increase its margin requirements at any time and is not required to provide you with advance notice;
- You are not entitled to an extension of time on a margin call; and
- You can lose more money than you deposit in a margin account.

This article will explain these risks and provide you

with some basic facts about purchasing securities on margin.

How Margin Accounts Work

With a margin account, you can borrow money from your brokerage firm to purchase securities. The portion of the purchase price that you must deposit is called margin and is your initial equity or value in the account. The loan from the firm is secured by the securities you purchase. If the securities you’re using as collateral go down in price, your firm can issue a margin call, which is a demand that you repay all or part of the loan with cash, a deposit of securities from outside your account, or by selling some of the securities in your account.

Buying on margin amounts to getting a loan from your brokerage firm. When you buy on margin, you must repay both the amount you borrowed and interest, even if you lose money on your investment. Some brokerage firms automatically open margin accounts for investors. Make sure that you understand what type of account you are opening. If you don’t want to trade on margin, choose a cash account for your transactions.

Margin Costs

Buying on margin carries a cost. This cost is the interest you will pay on the amount you borrow until it is repaid. Margin interest rates generally vary based on the current “broker call rate,” or “call money rate,” and the amount you borrow. Rates also vary from firm to firm.

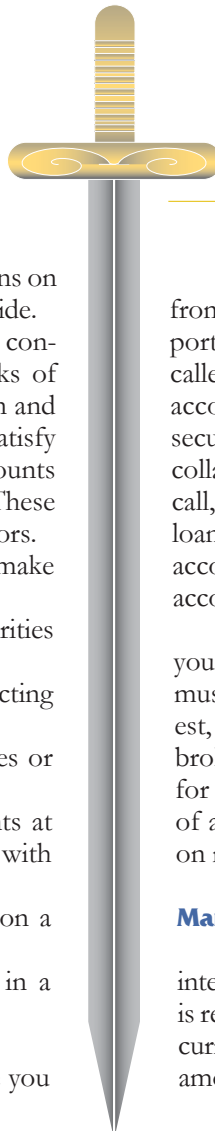


Table 1. How Margin Works: An Example

Initial Investment

Initial Investment: 1,000 shares of XYZ at \$100/share
 Total Investment Value: \$100,000
 Required Initial Margin: $\$100,000 \times 50\% = \$50,000$
 Margin Loan: $\$100,000 - \$50,000 = \$50,000$

What Happens When Share Prices Fluctuate

	Share	Total Investment Value	Margin	Shareholder's Equity	Minimum Maintenance Margin
	Price	(Price × Shares)	Loan	(Acct Val – Loan)	(Acct Val × 25%)
Day 1	\$100	\$100,000	\$50,000	\$50,000	\$25,000
Day 2	\$60	\$60,000	\$50,000	\$10,000	\$15,000

On Day 2, when the shareholder's equity in the account falls below the minimum maintenance margin, he will receive a maintenance margin call.

You can find the current call money rate in The Wall Street Journal listed under “Money Rates.” Most brokerage firms publish their current margin interest rates on their Web sites.

Margin Loans: Who Profits?

Margin loans can be highly profitable for your brokerage firm. They may also be highly profitable for your broker, who may receive fees based on the amount of your margin loans. This may take the form of a percentage of the interest you pay on an ongoing basis.

Margin Requirements

The Federal Reserve Board, NASD, and securities exchanges, including the New York Stock Exchange (NYSE), regulate margin trading. Most brokerage firms also establish their own more stringent margin requirements. This article focuses on the requirements for purchases of marginable equity securities, which include stocks traded in the U.S. Different requirements apply to day trading, short sales, securities futures, other types of securities, and certain foreign securities.

Minimum Margin

Before purchasing a security on

margin, NASD Rule 2520 and NYSE Rule 431 require that you deposit \$2,000 or 100% of the purchase price—which ever is less—in your account. This is called “minimum margin.” If you will be day trading, you are required to deposit \$25,000.

Initial Margin

In general, under Federal Reserve Board Regulation T, you can borrow up to 50% of the total purchase price of a stock for new, or initial, purchases. This is called “initial margin.” Assuming you do not already have cash or other securities in your account to cover your share of the purchase price, you will receive a margin call (or “Fed call”) from your firm that requires you to deposit the other 50% of the purchase price.

Maintenance Margin

After you purchase a stock on margin, NASD and NYSE rules supplement the requirements of Regulation T by placing “maintenance margin requirements” on your accounts. Under these rules, as a general matter, your equity in the account must not fall below 25% of the current market value of the securities in the account. If it does, you will receive a maintenance margin call that requires you to deposit more funds or securities in order to

maintain the equity at the 25% level. Failure to meet the maintenance margin call may cause your firm to force the sale of—or liquidate—the securities in your account to bring the account's equity back up to the required level.

Brokerage Firm Requirements

Your brokerage firm also has the right to set its own margin requirements—often called “house requirements”—as long as they are higher than the margin requirements under Regulation T or the rules of the NASD and the exchanges.

Some firms raise their maintenance margin requirements for certain volatile stocks, or a concentrated or large position in a single stock, to help ensure that there are sufficient funds in their customer accounts to cover the large swings in the prices of these securities.

In some cases, a firm may not even permit you to purchase or own certain securities on margin. These changes in firm policy often take effect immediately and may result in the issuance of a maintenance margin call (or “house call”). Again, if you fail to satisfy the call, your firm may liquidate a portion of your account.

Why Brokers Do What They Do

Many margin investors are familiar with the “routine” margin call, where the broker asks for additional funds when the equity in the customer’s account declines below certain required levels. Normally, the broker will allow from two to five days to meet the call. The broker’s calls are usually based upon the value of the account at market close since various securities regulations require an end-of-day valuation of customer accounts. The current “close” for most brokers is 4:00 p.m. Eastern time.

However, in volatile markets, a broker may calculate the account value at the close and then continue to calculate calls on subsequent days on a real-time basis. When this happens, the investor might experience something like the following:

Day 1 Close: A customer has 1,000 shares of XYZ in his account. The closing price is \$60—therefore, the market value of the account is \$60,000. If the broker’s equity requirement is 25%, the customer must maintain \$15,000 in equity in the account. If the customer has an outstanding margin loan against the securities of \$50,000, his equity will be \$10,000 ($\$60,000 - \$50,000 = \$10,000$). The broker determines the customer should receive a margin call for \$5,000 ($\$15,000 - \$10,000 = \$5,000$).

Day 2: At some point early in the day the broker contacts the customer (e.g., by an E-mail message) telling the customer he has “x” number of days to deposit \$5,000 in the account. Shortly thereafter, on Day 2, the broker sells the customer out without notice.

What happened here?

In many cases, brokers have computer-generated programs that

will issue an alarm (and/or take automatic action) in the event the equity in a customer’s account further declines. For example, assume the value of the XYZ stock in the customer’s account continues to decline during the morning of Day 2 by another \$6,000—that is, the shares are now worth only \$54,000. The customer still has a loan outstanding to the broker of \$50,000, but now the broker only has \$54,000 in market value securing that loan. So based upon the subsequent decline, the broker decided to sell shares of XYZ before they could decline even further in value.

Had the value of the securities stayed at about \$60,000, the broker probably would have allowed the customer the stated number of days to meet the margin call. Only because the market value continued to decline did the broker exercise its right to take further action and sell out the account.

What could the customer have done to avoid this?

The bottom line is that margin accounts require work on behalf of the customer. Information about the price of a stock is available from any number of sources. In fact, many investors check these prices on a daily basis, if not several times a day. An investor is free to deposit additional cash into a margin account at any time in an attempt to avoid a margin call. However, even if additional deposits are made, subsequent declines in the market value of securities in the account may result in additional margin calls. If an investor does not have access to funds to meet a margin call, he should probably not be using a margin account. While cash accounts do not provide the leverage that a margin account does, cash accounts are easier to maintain in that they do not require the vigilance that a margin account requires.

Partial Sell-Outs

In a partial sell-out some, but not

all, of the securities in a customer’s account will be sold out.

Here are two examples of how that can work against you.

Example 1: Mr. Jones has three stocks in his account totaling \$90,000 in market value: \$30,000 in ABC for which he has a substantial long-term (i.e., capital) gain, \$30,000 in DEF in which he has a large loss (which could be used to offset gains in stocks sold earlier in the year), and \$30,000 in GHI in which he has a short-term gain for tax purposes. Each stock has a 25% maintenance margin requirement. Mr. Jones has a \$6,000 unmet maintenance margin call, so the broker sells out some of his securities. The broker chooses to sell out GHI. Mr. Jones is in a very high tax bracket, so the sale results in a large tax bill for him. Mr. Jones is upset, since he would have preferred the broker sell out either of the other two securities.

Example 2: Ms. Young has \$10,000 each in stocks JKL, MNO, and PQR. JKL is a fairly stable stock so the broker requires only the standard 25% maintenance margin requirement on it. MNO is more volatile, so the broker set a 40% “house” requirement on the stock. Finally, PQR has been experiencing a lot of volatility in recent months, so the broker set a 75% “house” requirement for that stock. Ms. Young has a \$2,200 unmet maintenance margin call, so the broker sells out some of her securities. The broker chooses to sell out JKL. Ms. Young is upset because she thinks the broker should have sold out shares of PQR since it had the highest (i.e., 75%) maintenance margin requirement.

What happened in the above two examples?

It is important to remember that while customers borrow individually, brokers lend collectively. As such, brokers are concerned with overall financial exposure. In each example, the broker had numerous customers who had borrowed money against GHI and

How It Works: An Example

As an example of how margin works, let's assume you buy \$100,000 of securities on Day 1, but you do so using borrowed funds.

Regulation T would require you to deposit an initial margin of 50%, or \$50,000, in payment for the securities. As a result, your equity in the margin account is \$50,000, and you have received a margin loan of \$50,000 from the firm (see Table 1).

Let's assume that on Day 2 the market value of all of your securities falls to \$60,000. Under this scenario, your margin loan from the firm would remain at \$50,000, while your account equity would fall to \$10,000 (\$60,000 market value minus the \$50,000 loan amount). However, the minimum maintenance margin requirement for the account is 25%, meaning that your equity must not fall below \$15,000 (25% of the \$60,000 market value of the securities). Since the required maintenance equity is \$15,000 and your equity in the account is only \$10,000, you 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.

Margin Trading Risks

As the example above illustrates, there are a number of risks that you need to consider in deciding to trade securities on margin. These include:

- **Your firm can force the sale of securities in your accounts to meet a margin call.** If the equity in your account falls below the maintenance margin requirements under the law—or the firm's higher "house" requirements—your firm can sell the securities in your accounts to cover the margin deficiency. You will also be responsible for any

JKL. In order to reduce its exposure to "concentrated positions," where one or more securities support a large amount of customer debt, the broker's computers were programmed so that if sell outs were required, the securities sold would be those which represent the greatest financial risk to the broker.

What could customers Jones and Young have done to avoid this?

The way to avoid this is to understand that first and foremost a broker is an extender of credit and will act to limit its financial exposure in rapidly changing markets. The broker is not a "tax preparer" and is not required to base its actions on the customer's tax situation. Nor is the broker required to sell out securities of the customer's choosing. The only way to avoid sell-outs is to make sure you maintain a sufficient equity "cushion" in a margin account at all times, or to limit trades to cash accounts, where you must pay for the trade in full on a timely basis.

When \$2,000 Isn't \$2,000!

Mr. Smith has read investor education articles stating that the minimum requirement for a margin account is \$2,000. However, when he attempts to open a margin account with Broker S, that broker's clearing firm will not allow him to trade on margin at all. Mr. Smith then tries to open a margin account at Broker T, and is told it won't open a margin account for him unless he deposits \$20,000.

What might have happened here?

Brokers, like other lenders, have policies and procedures in place to protect themselves from market risk, or the decline in the value of securities collateral, as well as credit risk, where one or more investors cannot or refuse to meet their financial obligations to the broker. Among the options available to them, they have the right to increase their margin requirements or choose not to open margin accounts.

Margin is buying securities on credit

while using those same securities as collateral for the loan. Any residual loan balance is the responsibility of the borrower.

Assume that Mr. Smith recently bought \$36,000 in stock on margin from Broker R. He deposited \$18,000, and borrowed the remaining \$18,000 from Broker R. Shortly thereafter, the stock declined rapidly in value. Broker R sold out the stock for \$12,000 and kept the proceeds to repay part of the loan. However, since Mr. Smith had borrowed \$18,000, the \$12,000 in proceeds did not satisfy the loan. The broker asked Mr. Smith to send a check for the remaining \$6,000. Mr. Smith did not pay the \$6,000.

When Mr. Smith attempted to open accounts at Brokers S and T, each firm conducted its standard credit review process. They each made an inquiry to a securities industry data center and discovered that Mr. Smith had defaulted on a \$6,000 loan to Broker R. Broker S decided it did not want to do business with Mr. Smith at all, Broker T was only willing to retain his account with a substantial deposit.

What could a customer have done to avoid this?

Any obligation to a broker should be taken as seriously by an investor as an obligation to a bank or other lender. Failure to meet obligations to a broker may result in legal action against the customer and will almost certainly cause the broker to report the default to a data center. If you can't pay for a securities transaction, whether your order is placed in a cash or margin account, you should not place that order. Individuals should participate in the securities markets only when they have the financial ability to withstand the risks and meet their obligations.

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.

shortfall in the accounts after such a sale.

- **Your firm can sell your securities without contacting you.** Some investors mistakenly believe that a firm must contact them first for a margin call to be valid. This is not the case. Most firms will attempt to notify their customers of margin calls, but they are not required to do so. Even if you're contacted and provided with a specific date to meet a margin call, your firm may decide to sell some or all of your securities before that date without any further notice to you. For example, your firm may take this action because the market value of your securities has continued to decline in value.
- **You are not entitled to choose which securities or other assets in your accounts are sold.** There is no provision in the margin rules that gives you the right to control liquidation decisions. Your firm may decide to sell any of the securities that are collateral for your margin loan to protect its interests.
- **Your firm can increase its "house" maintenance requirements at any time and is not required to provide you with advance notice.** These changes in firm policy often take effect immediately and may cause a house

call. If you don't satisfy this call, your firm may liquidate or sell securities in your accounts.

- **You are not entitled to an extension of time on a margin call.** While an extension of time to meet a margin call may be available to you under certain conditions, you do not have a right to the extension.
- **You can lose more money than you deposit in a margin account.** A decline in the value of the securities you purchased on margin may require you to provide additional money to your firm to avoid the forced sale of those securities or other securities in your accounts.

Do Your Margin Homework

- **Make sure you fully understand how a margin account works.** If you don't, limit your investments to a cash account. Cash accounts are not subject to margin calls. It is important to take time to learn about the risks involved in trading securities on margin. Consult with your broker about any concerns you may have with your margin account.
- **Know the margin rules.** We've discussed some of the margin requirements in this article. To learn more, you can find NASD Rule

2520 and Federal Reserve Board Regulation T in the NASD Manual, located on the NASD Web site, www.nasd.com.

- **Know your firm's margin policies.** Read your firm's margin agreement and margin disclosure statement. Speak with your broker or check the firm's Web site for any changes in margin policies. Firms can make changes at their discretion and are more likely to do so in volatile markets.
- **If you use a margin account, you may not want to use all your available money to trade securities in your margin account.** For example, you may want to keep some money in a checking or savings account so that you can promptly meet a margin call.
- **Manage your margin account.** Margin accounts require work. Monitor the price of the securities in your margin account on a daily basis. If you see that the securities in your account are declining in value, you may want to consider depositing additional cash or securities to attempt to avoid a margin call. If you receive a margin call, act promptly to satisfy the margin call. By depositing cash or selling securities that you choose, you may be able to avoid your brokerage firm liquidating or selling securities it chooses. ▲

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