SEC

OFFICE of INVESTOR EDUCATION and ADVOCACY

INVESTOR BULLETIN

Understanding Margin Accounts

The SEC's Office of Investor Education and Advocacy is issuing this Investor Bulletin to help educate investors about the use of margin accounts.

The Difference Between Cash and Margin Accounts

A "cash account" is a type of brokerage account in which the investor must pay the full amount for securities purchased. An investor using a cash account is not allowed to borrow funds from his or her broker-dealer in order to pay for transactions in the account. A "margin account" is a type of brokerage account in which the broker-dealer lends the investor cash, using the account as collateral, to purchase securities. Margin increases investors' purchasing power, but also exposes investors to the potential for larger losses. Here's what you need to know about margin.

Understand How Margin Works

Let's say you buy a stock for $50 and the price of the stock rises to $75. If you bought the stock in a cash account and paid for it in full, you'll earn a 50 percent return on your investment. But if you bought the stock on margin—paying $25 in cash and borrowing $25 from your broker—after paying back the broker, you'll earn a 100 percent return on the $25 you invested (minus any interest you owed the broker).

The downside to using margin is that if the stock price decreases, substantial losses can mount quickly. For example, let's say the stock you bought for $50 falls to $25. If you fully paid for the stock, you'll lose 50 percent of your money. But if you bought on margin, you'll lose 100 percent, and you still must come up with the interest you owe on the loan.

Investors who put up an initial margin payment for a stock may, from time to time, be required to provide the broker with additional cash or securities if the price of the stock falls. Some investors have been shocked to find out that the brokerage firm has the right to sell their securities that were bought on margin—without any notification and potentially at a substantial loss to the investor. If your broker sells your stock after the price has plummeted, then you've lost out on the chance to recoup your losses if the market bounces back.

Recognize the Risks

Margin accounts can be very risky and they are not appropriate for everyone. Before opening a margin account, you should fully understand that:

- You can lose more money than you have invested;
- You may have to deposit additional cash or securities in your account on short notice to cover market losses;
- You may be forced to sell some or all of your securities when falling stock prices reduce the value of your securities; and

- Your brokerage firm may sell some or all of your securities without consulting you to pay off the loan it made to you.

You can protect yourself by:

- Knowing how a margin account works and what happens if the price of the securities purchased on margin declines.
- Understanding that your broker charges you interest for borrowing money and how that will affect the total return on your investments.
- Being aware that not all securities can be purchased on margin.
- Asking your broker whether trading on margin is appropriate for you in light of your financial resources, investment objectives, and tolerance for risk.

Read Your Margin Agreement

To open a margin account, your broker is required to obtain your signature. The margin agreement may be part of your general brokerage account opening agreement or may be a separate agreement. The margin agreement states that you must abide by the margin requirements established by the Federal Reserve Board, FINRA, any applicable securities exchange, and the firm where you have set up your margin account. Be sure to carefully review the agreement *before* you sign it.

As with most loans, the margin agreement explains the terms and conditions of the margin account. For example, the agreement describes how the interest on the loan is calculated, how you are responsible for repaying the loan, and how the securities you purchase serve as collateral for the loan. Carefully review the agreement to determine what notice, if any, your firm must give you before either selling your securities to collect the money you have borrowed or making any changes to the terms and conditions under which interest is calculated. In general, a firm must provide a customer at least 30-days written notice of changes in the method of computing interest.

Know the Margin Rules

The Federal Reserve Board and self-regulatory organizations (SROs), such as FINRA and the securities exchanges, have rules that govern margin trading. Brokerage firms can establish their own "house" requirements that are more restrictive than those rules. Here are some of the key rules you should know:

Before You Trade

Minimum Margin. Before trading on margin, FINRA, for example, requires you to deposit with your brokerage firm a minimum of $2,000 or 100 percent of the purchase price of the securities, whichever is less. This is known as the "minimum margin." Some firms may require you to deposit more than $2,000.

Amount You Can Borrow

Initial Margin. According to Regulation T of the Federal Reserve Board, you may borrow up to 50 percent of the purchase price of equity securities that can be purchased on margin. This is known as the "initial margin." Some firms require you to deposit more than 50 percent of the purchase price.

Amount You Need After You Trade

Maintenance Margin. After you buy stock on margin, FINRA rules require your brokerage firm to impose a "maintenance requirement" on your margin account. This "maintenance requirement" specifies the minimum amount of equity you must maintain in your margin account at all times. The equity in your margin account is the value of your securities less how much you owe to your brokerage firm. FINRA rules require this "maintenance requirement" to be at least 25 percent of the total market

value of the securities purchased on margin. However, many brokerage firms have higher maintenance requirements, typically between 30 to 40 percent, and sometimes higher depending on the type of securities purchased.

Here's an example of how maintenance requirements work. Let's say you purchase $16,000 worth of securities by borrowing $8,000 from your firm and paying $8,000 in cash or securities. If the market value of the securities you purchased drops to $12,000, the equity in your account will fall to $4,000 ($12,000 - $8,000 = $4,000). If your firm has a 25 percent maintenance requirement, you must have $3,000 in equity in your account (25 percent of $12,000 = $3,000). In this case, you do have enough equity because the $4,000 in equity in your account is greater than the $3,000 maintenance requirement.

But if your firm has a maintenance requirement of 40 percent, you would not have enough equity. The firm would require you to have $4,800 in equity (40 percent of $12,000 = $4,800). Your $4,000 in equity is less than the firm's $4,800 maintenance requirement. As a result, the firm may issue you a "margin call" to deposit additional equity into your account since the equity in your account has fallen $800 below the firm's maintenance requirement.

Special Margin Requirements

Pattern Day Trader Margin Requirements. For a customer that is a "pattern day trader" FINRA requires that the broker impose special margin requirements on the customer's margin account. In general, these include an increased minimum equity requirement of $25,000 and a restriction that caps the purchasing power in the margin account at four times the maintenance margin excess as of the close of business of the previous day for equity securities. For additional information on these "pattern day trader" margin requirements please see the SEC's Investor Bulletin "Margin Rules for Day Trading" at http://www.sec.gov/investor/alerts/daytrading.pdf.

Understand Margin Calls

You Can Lose Your Money Fast and With No Notice. If your account falls below the firm's maintenance requirement, your firm generally will make a margin call to ask you to deposit more cash or securities into your account. If you are unable to meet the margin call, your firm will sell your securities to increase the equity in your account up to or above the firm's maintenance requirement.

However, your broker may not be *required* to make a margin call or otherwise tell you that your account has fallen below the firm's maintenance requirement. Your broker may be able to sell your securities at any time *without consulting you first*. Under most margin agreements, even if your firm offers to give you time to increase the equity in your account, it can sell your securities without waiting for you to meet the margin call.

Margin Loans

Carefully Consider the Risks of Using Margin Loans for Non-Securities Purposes. In addition to purchasing securities, some brokers may allow you to use margin loans for a variety of personal or business financial purposes, such as buying real estate, paying off personal credit, or providing capital. Using margin loans for non-securities purposes DOES NOT change the way these loans work. These loans are still secured by the securities in your margin account and thus subject to the same risks associated with purchasing securities on margin described above. The terms and conditions of these loans vary between brokers and are generally specified in the margin agreement. You should carefully consider the margin risks described above as well as any fees which may be associated with these loans before using them for any non-securities purpose.

Key Questions You Should Consider Before Buying Securities in a Margin Account

- ✓ Do you know that margin accounts involve a great deal more risk than cash accounts where you fully pay for the securities you purchase?
- ✓ Are you aware you may lose more than the amount of money you initially invested when buying on margin?
- ✓ Can you afford to lose more money than the amount you have invested?
- ✓ Did you take the time to read and understand the margin agreement?
- ✓ Did you ask your broker questions about how a margin account works and whether it's appropriate for you to trade on margin?
- ✓ Did your broker explain the terms and conditions of the margin agreement?
- ✓ Are you aware of the costs you will be charged on money you borrow from your firm and how these costs affect your overall return?
- ✓ Are you aware that your brokerage firm can sell your securities without notice to you when you don't have sufficient equity in your margin account?

Additional Information

For our Investor Bulletin detailing the margin rules for day trading, visit http://www.sec.gov/investor/alerts/daytrading.pdf.

For FINRA's resources related to margin accounts, visit http://www.finra.org/Investors/SmartInvesting/AdvancedInvesting/MarginInformation/, and for FINRA's investor bulletins on how to use margin accounts and the related risks, visit http://www.finra.org/Investors/SmartInvesting/AdvancedInvesting/MarginInformation/p005922 and http://www.finra.org/Investors/SmartInvesting/AdvancedInvesting/MarginInformation/p005927.

For additional investor education information, see the SEC's website for individual investors, www.investor.gov.

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